
ACCEC
American College of Coverage and Extracontractual Counsel
2017 ACCEC Law School Seminar
University of California, Hastings College of the Law
San Francisco, CA | February 10, 2017
Old Risks Meet the New Economy:
Insurance Issues for the 21st Century

AGENDA

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2017 Law School Symposium
UC Hastings College of the Law, San Francisco, CA

February 10, 2017
Old Risks Meet the New Economy: Insurance Issues for the 21st Century

8:30-9:00 am	**Registration and Coffee**
9:00-9:15 am	**Welcoming Remarks and Introductions** • Mary Craig Calkins, Kilpatrick Townsend & Stockton LLP; President, American College of Coverage and Extracontractual Counsel • Leo P. Martinez, Albert Abramson Professor of Law, University of California, Hastings College of the Law • David B. Goodwin, Covington & Burling & Andrew B. Downs, Bullivant Houser Bailey, Program Co-Chairs
Technology and Insurance	
9:15-10:00 am	**But What if We Flame Out? Trends in D&O Coverage of Particular Importance to Emerging Companies and their Insurers** • Mary Craig Calkins, Kilpatrick Townsend & Stockton LLP • Michael Manire, Manire & Galla LLP
10:00-10:45 am	**Oh No, You Don't: Navigating the Yates Memo Minefield** • Timothy Burns, Perkins Coie • Julia Molander, Cozen O'Connor
10:45-10:55 am	**Break**
10:55-11:35 am	**Covering the Soft Underbelly of American Business: Hot Topics in Coverage for Cyber Liabilities** • John Buchanan, III, Covington • Andrew B. Downs, Bullivant Houser Bailey • Jodi Short, Professor of Law, University of California, Hastings College of the Law

11:35 am- 12:05 pm	**The Insurance Consequences of the Sharing Economy** • Michael Barnes, Dentons • Mary McCutcheon, Farella Braun + Martel LLP
12:10-1:15 pm	**Lunch** • Tom Baker, William Maul Measey Professor of Law and Health Sciences, University of Pennsylvania Law School
1:15-1:30 pm	**Break**
Insurance and Ethics	
1:30-2:15 pm	**Ethics and Mediation: If The Law Says You Can't Disclose Anything, What Can You Disclose – And What If The Other Side Lies About It?** • David B. Goodwin, Covington & Burling • Joyce Wang, Carlson, Calladine & Peterson LLP
2:15-3:00 pm	**How Independent Am I?" Ethical Obligations of Independent Counsel** • Morris Ratner Little, Associate Professor and Associate Dean for Academic and Professional Success, University of California, Hastings College of the Law • Sara M. Thorpe, Nicolaides Fink Thorpe Michaelides Sullivan, LLP • Carl Metzger, Goodwin Procter LLP
3:00-3:15 pm	**Break**
3:15-4:00 pm	**Telling the Truth Without Inappropriate Revelations: What May and Must Defense Counsel Report Under the Policy and the Rules of Professional Conduct?** • Martin Checov, O'Melveny & Myers LLP • Meghan Magruder, King & Spalding • William Barker, Dentons
4:00-4:45 pm	**Don't Be Evil: What Google's Former Corporate Motto Means for Policyholders and Insurers** • Lorelie Masters, Perkins Coie • Leo P. Martinez, Albert Abramson Professor of Law, University of California, Hastings College of the Law • Tom Segalla, Golderg Segalla
4:45-6:00 pm	**Networking Reception**

PRESENTATIONS

But What If We Flame Out? Trends in D&O Coverage of Particular Importance to Emerging Companies and their Insurers

Mary Craig Calkins, Kilpatrick Townsend & Stockton LLP
Michael Manire, Manire & Galla LLP

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D&O Trends Affecting Emerging Companies

Competitive landscape for startups and emerging technology companies:

- Pressure to grow quickly
- Calls for rapid, stunning growth
- Competition for next "unicorn" – privately-held $1 Billion startup
- Investor expectations of exponential returns over lasting results
- Representations and filings regarding projected returns
- Trade secret protections
- Cybersecurity/Data security concerns
- Regulatory investigations
- Ransomware issues
- Etc.

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D&O Trends Affecting Emerging Companies

"Traditional" Claims facing startups:

- Securities Class Actions/Derivative Suits
  - Breach of Fiduciary Duty (care, loyalty, self-dealing)
  - Misrepresentation claims
  - Derivative Suits
- Section 220 Books & Records demands
- Appraisal actions
- Merger & Acquisition/Going Private issues
  - Inadequate compensation issues vs. adequate but objectionable
- Cyber-related suits and investigations
- Trade secret/Lanham Act claims
- Product disparagement/advertising
- EPL/FLSA claims

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D&O Trends Affecting Emerging Companies

Becoming "more traditional" and needing coverage (pending Administration changes, if any):

- Dodd Frank/Consumer Fraud Protection Bureau (CFPB)
  - Enforcement Actions
  - E.g., Dwolla 2016 Enforcement Action (misrepresenting data security practices and security of its online payment system despite no breach - $100,000)
- Telephone Consumer Protection Act (TCPA)
- Governmental investigations: accounting/representations/cyber breaches
- Qui Tam/Whistleblower actions
- False Claims Act actions
- Fiduciary Liability issues: Settlor Liability
- Crime issues:
  - Social engineering
  - Fraudulent impersonation
- Government funding issues (nonprofit/minority-owned businesses)

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Claim Trends Affecting Emerging Companies

- What brokers are seeing in the market:
  - SEC Investigations and Enforcement Coverage
    - Entity Coverage
  - Merger Objections
  - Focus on coverage for regulatory investigations
  - Derivative Investigation Costs
    - Sublimited coverages/drop down excess
  - Coverage for Section 220 Books & Records
    - Increased interest re exhaustion of inquiries before suit
  - Appraisal actions
  - Cyber activities

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Claim Trends Affecting Emerging Companies

- What we are seeing in the market:
  - Cyber/Bitcoin/FinTech/Insure Tech issues
  - Increased Defense costs
  - Plaintiffs' Attorneys' Fees
  - Late Notice/"Material Prejudice" inquiries
  - New definitions (Definition of "Claims," etc.)
  - Shaving of Limits issues
  - Multi-national claims
  - Enhanced Side A policies and increased limits
  - Evolution of new products (excess/drop down)
  - Coordination of Coverage/ "Relatedness" issues

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D&O Trends Affecting Emerging Companies

Recent Trends of Interest

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D&O Trends Affecting Emerging Companies

- Predictions: Shareholder class actions and other securities suits are alive and well in 2017, and are expected to increase in number.
- Surge of merger objection class actions, cyber security, follow-ons and international actions.
- Third party litigation spending hits all time high.
- 90%+ figure for M&As resulting in shareholder litigation per Cornerstone Research

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Filings on January 27, 2017 alone show continuing pace of new filings, with six reported federal court securities class action filings:

- Federal court merger objection class action lawsuit (D. Minn.) against Vascular Solutions and certain directors and officers;
- Traditional securities class action lawsuit (C.D. Cal.) against Gigamon and certain executives;
- Traditional securities class action lawsuit (E.D. Penn) against Egalet, Inc. and certain directors and officers;
- Federal court merger objection lawsuit (D. Colo.) against Stillwater Mining and certain directors and officers;
- Federal court merger objection lawsuit (D. Del.) against Universal American Corp. and certain executives; and
- Traditional securities class action lawsuit (N.D. Cal.) against State Street Corp. and certain directors and officers.

Kevin LeCroix, *D&O Diary* (Jan. __, 2017)

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April 2016, SEC announced a "Silicon Valley Initiative" that showed increased concerns at the regulatory level about private companies scoring tremendous valuations in private offerings.

- Focus on so-called "unicorns" (private companies with valuations greater than $1 billing.
- Comments by the SEC Chairman Mary Jo White highlight concerns at the Rock Center for Corporate Governance at Stanford.
- SEC emphasizing that although the SEC encourages capital formation for innovative Bay Area companies because they are so critical to our economy and markets, the SEC expects companies to embrace and demonstrate sound corporate governance and financial controls.

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SEC Chairman posed questions that directors, advisors and pre-IPO companies should be asking:

- Does board include outsiders with public company or large company experience?
- Does board members have regulatory and financial experience?
- Does board have sufficient industry expertise to analyze different viewpoints and spot critical issues?
- Is the company run and governed for the benefit of all of its investors?

- *E.g.*, Marrone Bio Innovations, Inc. (charges against the company and a former executive in February 2016 for inflating financial results in order to meet projections for first year as a public company, and insufficient internal controls allowing false documentation)

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D&O Trends Affecting Emerging Companies

Recent Cases of Interest

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Recent Cases of Interest

SEC and DOJ Investigations

- *Partner Investments, L.P., et al. v. Theranos, Inc., et al*., DE Ch. Ct CA 12816-VCL
- *Robert Colman, et al. v. Theranos, Inc. et al*., Case No. 5:16-cv-06822-NC, U.S. Dist. Ct, ND CA

Recent Cases of Interest

- *Theranos*

Biotech with "finger prick" blood-testing technology with start-up valued at $9 billion

- Class action alleges that core technology was faulty and that Theranos administered its blood tests using competitors' equipment
- Theranos CEO is banned from operating a laboratory
- Theranos' President and COO is leaving
- Congressional inquiry seeking explanation
- Theranos is facing class action lawsuit accusing it of consumer fraud
- Derivative suits?
- Investigations per public reports:
  - US Centers for Medicare and Medicaid Services
  - Department of Justice
  - Securities & Exchange Commission (accuracy of company's disclosures to investors)

Recent Cases of Interest

"While the rise and fall of Theranos has been dramatic, it is far from a rare case. In fact, it illustrates the perverse incentives faced by every startup in the Silicon Valley. As bad as these incentives are for investors, the might be even worse for consumers."

"But it takes time to build a sustainably profitable business, and Valley investors want rapid, stunning growth In the search for the next "unicorn" … investors prioritize exponential returns over lasting results."

J. Edelson & C. Dore, *Theranos Exposes the Perverse Incentives at Work in Silicon Valley* https://qz.om/673442/theranos etc. (visited 1/20/17) (authors are members of plaintiffs' bar)

Recent Cases of Interest

- *In re Dole Food Company Inc. Stockholder Litigation*, Civil Action No. 8703-VCL, Delaware Chancery Court
- *Arch Insurance Company, Liberty Mutual Insurance Company, Continental Casualty Insurance Company, Navigators Insurance Company, RSUI Indemnity Company and Berkley Insurance Co. v. David H. Murdock, C. Michael Carter, Dole Food Company, Inc. and DFC Holdings, LLC*, Case No. N16C-01-194 EMD CCLD (Del. Superior Court, Motion to Dismiss decided Dec. 21, 2016)

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Recent Cases of Interest

Arch v. Dole (coverage case)

- Insurers filed declaratory relief action against individual D&Os and Company, seeking declaration that insurers do not have to fund a settlement due to alleged fraud, or seeking to subrogate against insured per the exclusion.
- Shareholder action alleged that defendants engaged in lengthy process to manipulate stock price so that owner and CEO Murdock could acquire stock at lower price in going private transaction.
- After Vice Chancellor issued Memorandum Opinion with explicit findings, the defendants settled and sought reimbursement, focusing on final adjudication language of the dishonesty exclusion.
- The Court held:

  The Memorandum Opinion, outlining the Defendants' misconduct – was a step towards a final adjudication. That decision alone was not final and was not appealable.

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Recent Cases of Interest

"The language [of the exclusion] is not complicated. If a deliberate act of fraud by an insured is determined through a final and non-appealable adjudication, the Insurer will not be responsible for any claim made by that insured related to the adjudicated fraudulent act. [¶] The court does not find the language of the exclusions to be ambiguous. The Memorandum Opinion, without more (i.e., a Chancery Rule §4(b) entry of judgment or a Chancery Rule 58 order) was not a final and non-appealable adjudication adverse to such insured in the underlying action. The only final and non-appealable adjudication in the Chancery Court action was the Order and Final Judgment. Accordingly, Exclusion IV.A.6 does not apply to the facts of this case."

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Recent Cases of Interest

"While this Court does believe that Vice Chancellor Laster did make findings that some of the Defendants … committed fraudulent acts, the Memorandum Opinion was not a final and non-appealable adjudication. …."

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Recent Cases of Interest

- *Onyx Pharmaceuticals, Inc. v. Old Republic Insurance Co., RLI Insurance Co., Allied World Assurance Company (U.S.) Inc. and Berkley Insurance Co.*, San Mateo County Superior Court (CA), Case No. CIV 538248, filed April 18, 2016

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Recent Cases of Interest

Onyx Pharmaceuticals:

- Certain officers and directors of Onyx were sued in August 2013 in *In re Onyx Pharmaceuticals, Inc. Shareholder Litigation* (San Mateo County Superior Court)
  - Underlying claims against Board members alleged for breach of fiduciary duty in connection with the sale of Onyx to Amgen for a "premium price" of $125/share.
  - After two years of discovery, the Consolidated Amended Class Action Complaint asserted a single claim for the Breach of Fiduciary Duties of Loyalty and Good Faith against all defendants alleging failure to maximize value of Onyx stock, failure to protect shareholders against multiple conflicts of interest, agreeing to allegedly unreasonable preclusive deal protections, and failing to disclose material facts.
- Primary insurer National Union agreed to pay limits of $10M for defense costs and settlement;
- Excess follow-form insurers denied coverage, based on "Bump Up" exclusion;
- Gravamen of the case: Board did not achieve best price vs. inadequate price.

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Recent Cases of Interest

- *Yahoo! Inc. v. National Union Fire Insurance Co. of Pittsburgh, PA,* Case No. 5:17-cv-00447 (USDC, N.D. Cal., San Jose Div.), filed Jan. 27, 2016 (CGL Policy)


Shareholder Files Data Breach Securities Class Action Lawsuit Against Yahoo

YAHOO!

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Recent Cases of Interest

- **Second Coverage Lawsuit:** *Yahoo! Inc. v. National Union Fire Insurance Co. of Pittsburgh, PA,* (USDC, N.D. Cal., San Jose Div.), filed Jan. 31, 2016 (also CGL Policy)


THE D&O DIARY

Shareholder Files Data Breach Securities Class Action Lawsuit Against Yahoo

YAHOO!

RT ProExec

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Potentially Problematic Exclusions and Issues

- Potentially Problematic Exclusions and Issues:
  - So-Called Dishonesty Exclusions:
    - Deliberate criminal or deliberate fraudulent conduct
    - Personal profit/Financial advantage
    - Professional Errors/Omissions
      - But not failure to supervise those who perform or failed to perform professional services or Securities Claims
    - Final Adjudication standard
  - Inadequate Compensation (aka "Bump Up") Exclusions
  - "Loss" – Disgorgement and Restitution
  - Capacity arguments (".... acting in the capacity as such …")
  - Related Claims
  - BI/PD/Right of Privacy Exclusions ("bodily injury, violation of any right of privacy, mental anguish, … provided" exclusion not apply to Securities Claim)
  - Section 533 Intentional conduct arguments

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D&O Trends Affecting Emerging Companies

Additional Tips:

- Side A Purchases
- Pre-purchase audits to avoid language issues
- Protecting The Record/Protecting Coverage
    - Responses to Reservation of Rights Letters
    - Prompt notice/all stages
    - Addressing Allocation
    - Consent
        - Voluntary Payments
        - Selection of Counsel
        - Disparate Positions & Concerns
- Qualcomm Exhaustion/Fill issues (Side A)
- Privilege issues

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Oh No You Don't: Navigating the Yates Memo Minefield

Timothy W. Burns, Perkins Coie LLP
Julia Molander, Cozen & O'Connor PC

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Key Elements of the Yates Memo

- No cooperation credit unless full disclosure of all relevant facts about the individuals involved
- Both criminal and civil investigations should focus on individuals from the outset
- Civil and criminal gov't attorneys should be in routine communication
- Absent extraordinary circumstances, corporate settlements with government will not provide protection for individuals
- Corporate cases should not be resolved without a clear plan to resolve cases against individuals
- Civil attorneys should focus on individuals as well as the company and evaluate whether to bring suit based on considerations beyond the individual's ability to pay

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Yates Memo: Likely Impact

- A significant conflict between the corporation and individuals in most cases federal statutory cases
- Proliferation of defense counsel
- Expenditure of greater defense costs
- Increased prosecutions of individuals
- More civil cases brought against individuals
  - False Claims Act
  - Antitrust
  - Securities fraud
  - Tax
- More civil cases against individuals pursued to judgment
- More insurance litigation

- *Is a populist administration likely to change this focus in light of the 2010 election?*

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Yates Memo: Indemnification Concerns

- Unfettered right to separate counsel
  - Corporation's interests and individual's interests are likely to conflict
- More specificity around return of advancements in situations in which individuals are prohibited from seeking indemnification

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Yates Memo: Insurance Purchasing Concerns

- Higher limits
- Separate insurance for individuals
- Individuals
  - No recoupment
  - Narrower conduct exclusions that require final adjudication in the particular underlying claim
  - Greater certainty surrounding order of payments
  - Narrower Insured vs. Insured exclusion
  - Separate advice to the board
- Corporations
  - Is top-two imputation good enough when the top two are more likely to be targets?
  - Definition of Loss

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Yates Memo: Claim Concerns

- Impact of complaint being sealed
  - Claim
  - Notice
- Impact of admissions
- Prior acts exclusion
- Conduct exclusions
  - Willful violation of law
  - Co-conspirator or innocent insured
- Definition of loss
- Consent to settle
- Cooperation

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Covering the Soft Underbelly of American Business: Hot Topics In Coverage For Cyber Liabilities

John Buchanan, III, Covington

Andrew B. Downs, Bullivant Houser Bailey

Jodi Short, Professor of Law, University of California, Hastings College of the Law

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Why We're Here

- Cyber attacks are increasing in severity and intensity.
- They are difficult to underwrite.
- Coverage is too often provided in slices through a variety of different policies.
- Claims arise in unexpected places.
  - Internet of things.

October's cyberattack used the 'internet of things' to attack the internet itself. Here's why it could happen again.

What We Hope To Accomplish

- Selected highlights
- Knowing where to look and what to ask.
- Gratuitous punditry.

Insured Perspective: the "Hot Five" Cyber Gaps and Traps

- 5. Limits and sublimits
- 4. Retro dates and timing issues
- 3. The "*Cottage Health* traps": noncompliance exclusions, application conditions
- 2. "Social engineering" coverage
- 1. Cyber-physical loss—BI and PD exclusions

Limits and sublimits

- Lesson #1 from the claim trenches: Limits never high enough for an historic breach
  - Highest SIR you can afford
  - Highest limits you can afford
- Lesson #2: Watch out for exclusions disguised as severely sublimited coverage grants
  - E.g., "Bitcoin Ransom Endorsement" with $25k sublimit – on policy with $10m extortion coverage
- Lesson #3: Sublimits are tricky to administer after loss
  - Ask underwriters for sublimits at same level as aggregate policy limit

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Retro Dates and Timing Restrictions

- For example:

  This insurance applies to loss only if:

  * * * * *

  (2) The "network and information security wrongful act" was **committed on or after the Network and Information Security Retroactive Date** shown in the . . . Declarations and before the end of the policy period; and

  (3) A "claim" or "suit" that seeks "damages" because of the loss is first made or brought against any insured . . . during the policy period
- Lesson from the claim trenches: network intrusion = latent injury
  - Intrusion preceding retro date –> no coverage, though breach only first discovered during policy period
    - Forensic investigations and hind-sight
  - First cyber policy purchase: earliest Retro Date you can afford.

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The "*Cottage Health* Traps"

- *See Columbia Cas. v. Cottage Health* complaint, No. 2:16-cv-03759 (C.D. Cal., refiled 5/31/16)
- "Failure to Follow Minimum Required Practices" **exclusion**:
  - Insured fails "to continuously implement the procedures and risk controls identified in the Insured's application"—> NO COVERAGE
- Detailed technical **representations** in policy Application, combined with **"Application" policy condition**:
  - "memorializes [Insured's] acknowledgement that the representations made in the application were true, were the basis upon which the Columbia Policy was issued, were incorporated by reference within the Columbia Policy and were 'material to the acceptance of this risk or the hazard assumed by the Insurer under this Policy. This Policy is issued in reliance upon the truth of such representations'."
  - Erroneous statements in Application—> NO POLICY

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"Social Engineering" Coverage

- Cyber policies often exclude
- Do Crime policies cover?
  - **Funds Transfer Fraud** – common wording:
    - We will pay for loss of "funds" resulting directly from a "**fraudulent instruction**" directing a financial institution to transfer, pay or deliver "funds" from your "transfer account".
    - BUT "fraudulent instruction" must be "in fact fraudulently transmitted **by someone else** without your knowledge or consent"
  - **Computer Fraud** – common wording:
    - We will pay for loss of or damage to "money", "securities" and "other property" **resulting directly from the use of any computer to fraudulently cause a transfer** of that property from inside the "premises" or "banking premises":
    - a. To a person (other than a "messenger") outside those "premises"; or
    - b. To a place outside those "premises".
    - Arguably extends to employees duped by "fake president" emails – BUT insurers will dispute
- Lesson from the claim trenches: Request purpose-built coverage at the underwriting stage.

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Cyber Perils → Physical Losses: Who Covers?

Worldwide Threat Assessment of the US Intelligence Community

Senate Select Committee on Intelligence

James R. Clapper

Director of National Intelligence

- Devices designed and fielded with minimal security requirements and testing, and **an ever-increasing complexity of networks could lead to widespread vulnerabilities in civilian infrastructure** and U.S. Government systems.
- Broader adoption of IoT devices and AI—in settings such as public utilities and health care—will only exacerbate these potential effects.

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A Few Hackable Things . . .

- Toys
  - Hello Barbie (http://www.theguardian.com/technology/2015/nov/26/hackers-can-hijack-wi-fi-hello-barbie-to-spy-on-your-children)
  - Star Wars BB8 (https://www.pentestpartners.com/blog/star-wars-bb-8-iot-toy-awesome-fun-but-can-it-be-turned-to-the-dark-side-with-this-vulnerability/)
  - Toy drones (https://www.rt.com/news/hacker-drone-aircraft-parrot-704/)
- Commercial and military drones too (http://www.bbc.com/future/story/20140206-can-drones-be-hacked?ocid=ww.social.link.email)
- Home appliances, such as . . .
  - HVAC systems – e.g., Trane Thermostat (http://krebsonsecurity.com/2016/02/iot-reality-smart-devices-dumb-defaults/#more-33751)
  - Refrigerators (http://thehackernews.com/2014/01/100000-refrigerators-and-other-home.html)

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Hackable Things That Can Hurt . . .

- Automobiles
  - Jeep hack (http://www.wired.com/2015/07/hackers-remotely-kill-jeep-highway/)
  - Driverless cars (http://www.nationaldefensemagazine.org/archive/2015/May/Pages/ResearchersHackIntoDriverlessCarSystemTakeControlofVehicle.aspx)
- Medical devices
  - Insulin pumps (http://juntoblog.net/medical-device-hacks-when-cyber-risk-becomes-deadly/)
  - Pacemakers (http://www.forbes.com/sites/singularity/2012/12/06/yes-you-can-hack-a-pacemaker-and-other-medical-devices-too/#3a07041e13e0)
- Entire hospitals (https://securityevaluators.com/hospitalhack/securing_hospitals.pdf)

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BUT – Typical Cyber Policy Exclusion

2. Exclusions

This insurance does not apply to:

a. Bodily Injury

"Bodily injury".

* * * *

g. Property Damage

"Property damage".

- Just dove-tailing with coverage provided by Commercial General Liability (CGL) policies?
- Well . . . .

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2014 CGL Cyber Exclusions

- **Exclusion — Access or Disclosure of Confidential or Personal Information and Data-Related Liability — Limited Bodily Injury Exception Not Included**

  This insurance does not apply to:

  p. Access Or Disclosure Of Confidential Or Personal Information And Data-related Liability

  Damages **arising out of**:

  (1) Any **access to or disclosure of any person's** or organization's **confidential or personal information, including** patents, trade secrets, processing methods, customer lists, financial information, credit card information, **health information** or any other type of nonpublic information; or

  (2) The loss of, loss of use of, **damage to, corruption of,** inability to access, or inability to manipulate **electronic data**.

  This exclusion applies even if damages are claimed for notification costs, credit monitoring expenses, forensic expenses, public relations expenses or any other loss, cost or expense incurred by you or others arising out of that which is described in Paragraph (1) or (2) above.

- Lesson from the trenches: For cyber-physical risks, explore "difference in conditions" specialty coverage, protective vendor contract terms, all other risk management measures.

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Insurer Perspective

- Words matter
- Courts struggle with these issues just as much as policyholders and insurers do.
- There are significant gaps in coverage. Brokers and policyholders, just like underwriters, need to understand their risks in advance.

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Policy Language Examples

If during the **period of insurance**, and in the course of **your business** or **advertising** after the **retroactive date**, **you** discover or suspect a **breach** has occurred, **we** will pay all reasonable and necessary:

a. **breach forensic costs**;

b. outside legal fees **you** incur in managing **your** response to the **breach**;

c. costs **you** incur to notify each affected **data subject** of the **breach**;

d. costs **you** incur to notify any regulatory body, including the Information Commissioner's Office, of the **breach** where **you** are required by any law or regulation to do so;

e. costs **you** incur to use a third-party call centre to answer enquiries from affected **data subjects** following notification of the **breach** to such **data subjects**; and

f. **credit monitoring costs**;

incurred with **our** prior written agreement.

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More Examples

I. **INSURING CLAUSES**

A. **CYBER LIABILITY**

The Company shall pay **Loss** on behalf of an **Insured** on account of any **Claim** first made against such **Insured** during the **Policy Period** or, if exercised, during the Extended Reporting Period, for **Injury**.

B. **PRIVACY NOTIFICATION EXPENSES**

The Company shall pay **Privacy Notification Expenses** incurred by an **Insured** resulting from **Disclosure Injury** or **Reputational Injury**.

C. **CRISIS MANAGEMENT AND REWARD EXPENSES**

The Company shall pay **Crisis Management Expenses** and **Reward Expenses** incurred by an **Insured** and directly arising out of **Injury** covered under Insuring Clause A and/or **Expense** or **Loss** covered under Insuring Clauses D, E, F, G or H.

D. **E-BUSINESS INTERRUPTION AND EXTRA EXPENSES**

The Company shall pay:

1. The loss of **Business Income** an **Insured** incurs during the **Period of Recovery of Services** due to the actual impairment or denial of **Operations** resulting directly from **Fraudulent Access or Transmission**, and

2. **Extra Expenses** an **Insured** incurs during the **Period of Recovery of Services** due to the actual or potential impairment or denial of **Operations** resulting directly from **Fraudulent Access or Transmission**,

when the **Fraudulent Access or Transmission** causes an actual or potential impairment or denial of **Operations** during the **Policy Period**.

SPECIMEN

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Noteworthy Cases

- *Travelers Prop. Cas. Co. v. Federal Recovery Services*, 103 F.Supp.3d 1297 (D. Utah 2015).
  - Technology Errors and Omissions form does not cover policyholder's intentional refusal to return data to business associate.
- *P.F. Chang's China Bistro v. Federal Ins. Co.* 2016 WL 3055111 (D. Ariz. 2016).
  - Discussion of multiple issues following credit card data breach.
- *Camp's Grocery, Inc. v. State Farm Fire & Cas. Co.*, 2016 WL 6217161 (N.D. Ala. 2016).
  - Another credit card data breach. Apparently a commercial package policy without specialized cyber endorsements. Economic loss claims by card issuers are not within coverage for bodily injury, property damage, personal injury or advertising injury.

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Odd Stuff

- *Doctors Direct Ins., Inc. v. Bochenek*, 2015 Ill.App (1^{st}) 142929 (2015)
  - Medical professional liability policy with "cyber claims endorsement" extending coverage to privacy wrongful acts. Court concludes policy does not extend coverage to TCPA Claims.

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YAHOO!

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The Insurance Consequences of the Sharing Economy

Michael Barnes, Dentons US LLP
Mary McCutcheon, Farella Braun & Martel LLP

2017 Law School Seminar
U.C. Hastings College of the Law
February 10, 2017

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What Is the Sharing Economy?

- What is the App-Based Economy?
- Differences from traditional economies in ways that affect insurance
  - Blurring of lines
  - Constant innovation and change outpace products

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What Jobs/Exposures Are Affected?

- TNCs
- Ride-sharing
- Car-sharing
- Home-sharing
- Delivery services
- Freelancers
- Labor for Hire

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New Models Create New Liabilities

- Lines between employees and independent contractors are blurred.
- Lines between personal and business risks are blurred.
- Use of apps to share services creates products risks.
- Regulation of new platforms.

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Insurance Gaps

- Personal Lines
  - Space sharing
    - Homeowners liability is not designed for guests or renters.
    - Landlord/rental policy does not cover contents/valuables.
- Car sharing
  - Personal auto policies exclude vehicle rental for a fee.
- Ride sharing
  - Personal auto policies exclude auto used for "livery".
- Includes liabilities under Calif. Ins. Code Section 11580.1; *See Clarendon Nat'l Ins. Co. v. State Farm Mut. Auto Ins. Co.*, 359 Fed App. 734 (9th Cir. 2009).

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Insurance Gaps (continued)

- "Business Pursuits" exclusions in homeowners' liability coverage.
  - Full or part-time activity of any kind engaged in for economic gain including the use of any part of the premises for such purposes.
  - What is an "occasional" rental?
  - 1-2 "boarders"?
- Workers' Compensation
  - Uncertainty regarding status can lead to rating challenges.
- Business Liability
  - General Liability may exclude liability arising out of vehicles owned, operated by company or employee
  - Auto liability may exclude coverage for non-owned autos.
- Benefits
  - Coverage for mandated benefits for non-traditional workers.

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New Insurance Products

- Platforms may sell insurance.
  - Airbnb includes Host Protection Insurance
  - Liability insurance for hosts covering injuries to guests and property damage by guests.
  - Excludes intentional injuries, mold, bedbugs and asbestos
- HomeAway/VRBO-Sells vacation rental insurance to homeowners.

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New Insurance Products (cont'd.)

- TNC policies provide $1 million liability for rental period.
- Car-sharing companies provide liability, collision, comprehensive coverage.
  - Lesser coverage if driver "on app" but no pick-up.
  - Disputes as to whether "on app".
  - Passenger leaving a vehicle?
  - No requirements for medical payments, comprehensive, collision, UM/UIM.

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Will the industry keep pace with the technology?

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Ethics and Mediation: If The Law Says You Can't Disclose Anything, What Can You Disclose – And What If The Other Side Lies About It?

David B. Goodwin, Covington & Burling LLP
Joyce C. Wang, Carlson, Calladine & Peterson LLP

2017 Law School Seminar
U.C. Hastings College of the Law
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This presentation will cover:

- An attorney's duty of truthfulness vs. the role as zealous advocate
- What you can, can't and must disclose, particularly in negotiation and mediation
- California's mediation confidentiality statute and whether statements in mediation are discoverable or admissible
- The Guidelines for Professional Conduct

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ABA Rule 4.1 Truthfulness in Statements to Others

- In the course of representing a client, a lawyer shall not knowingly:
- (a) make a false statement of law or fact to a third person; or
- (b) fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6.

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ABA Preamble and ABA Rule 1.3 Diligence

- ABA Preamble, Section 2 states: As a representative of clients, a lawyer performs various functions….As an advocate, a lawyer zealously asserts the client's position under the rules of the adversary system.
- ABA Rule 1.3 Diligence
  - A lawyer shall act with reasonable diligence and promptness in representing a client.

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ABA Formal Opinion: Lawyer's Obligation of Truthfulness When Representing a Client in Negotiation: Application to Caucused Mediation

- How forthcoming an attorney needs to be in a caucused mediation setting
- When exaggeration or de-emphasis is acceptable
- What constitutes a statement of material fact
- How context matters

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The Basic Rule

Rule 4.1 only applies to statements of **material fact** that the lawyer **knows** to be false, and thus does not cover false statements that are made unknowingly, that concern immaterial matters, or that relate to neither fact nor law. Thus:

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ABA Formal Opinion

- A lawyer may never lie to the judge. In some circumstances, it might be appropriate to decline to answer an inquiry concerning the limits of the lawyer's settlement authority.
- Distinction between false statement of fact and "posturing":
  - Understating one's willingness to make concessions
  - Exaggerating one's strengths and minimizing weaknesses
  - Not disclosing the existence of a principal (except when nondisclosure would constitute fraud)
  - Nondisclosure by a lawyer of the existence of an insurance policy–unless disclosure is required by law

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Federal Settlement Confidentiality Rules

- Fed. R. Evid. 408
- Federal common law (applies in federal question cases)
- Note that parties frequently enter into confidentiality agreements at the start of a mediation (required by JAMS and other AD providers, for example)
  - A private confidentiality agreement would not bind non-parties, however

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The California Mediation Confidentiality Statute (California Evidence Code sections 1115-1128)

- Protects any communication or writing made <u>for the purpose of</u>, <u>in the course of</u>, or <u>pursuant to</u> a mediation or mediation consultation
- Nothing said, written, or admitted for the purpose of or in connection with a mediation is admissible, discoverable or can be compelled to be given
- Reference to mediation in subsequent trial is grounds for a new trial

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When Do The Statutes Apply?

- In a mediation (a process by which a neutral person facilitates communication between the disputants to assist them in reaching a mutually acceptable agreement, Cal. Evid. Code § 1115(a))
  - A mandatory settlement conference is *not* a mediation
  - Some local rules protect MSCs, though
- Includes all communications with a mediator for the purpose of initiating, considering, or reconvening a mediation or retaining the mediation (Cal. Evid. Code § 1115(c))
- And all communications for the purpose of, in the course of, or pursuant to a mediation (Cal. Evid. Code § 1119)
- It encompasses post-mediation communications until the earlier of (a) when the parties agree in writing that the mediation has ended, (b) the parties settle or (c) 10 ten days (Cal. Evid. Code § 1125)

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Statutes

- Evid. Code § 1119
  - "No evidence of anything said or any admission *made for the purpose of, in the course of, or pursuant to*, a mediation or a mediation consultation is admissible or subject to discovery, and disclosure of the evidence shall not be compelled, in any arbitration, administrative adjudication, civil action, or other noncriminal proceeding in which, pursuant to law, testimony can be compelled to be given."
  - "No writing … that is prepared for the purpose of, in the course of, or pursuant to, a mediation or a mediation consultation, is admissible or subject to discovery, and disclosure of the writing shall not be compelled in any arbitration, administrative adjudication, civil action, or other noncriminal proceeding in which, pursuant to law, testimony can be compelled to be given."
  - "All communications, negotiations, or settlement discussions by and between participants in the course of a mediation … shall remain confidential."

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Statutes

- Evid. Code § 1122
  - "A communication or a writing … that is made *for the purpose of, or in the course of, or pursuant to*, a mediation or a mediation consultation, is not made inadmissible, or protected from disclosure," if there is express written or oral waiver by all parties who are part of that communication
- Evid Code § 1128
  - "Any reference to a mediation during any subsequent trial is an irregularity in the proceedings of the trial for the purposes of Section 657 of the Code of Civil Procedure. Any reference to a mediation during any other subsequent noncriminal proceeding is grounds for vacating or modifying the decision in that proceeding, in whole or in part, and granting a new or further hearing on all or part of the issues, if the reference materially affected the substantial rights of the party requesting relief."

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Exceptions To Mediation Confidentiality

- Written settlement agreement if it waives the statutory protections or says it is binding
- Oral settlement put on the record in court
- The parties, mediator, and others attending the mediation all agree in writing to waive the mediation privilege
- Due Process requires disclosure
  - Only applied (thus far) in criminal cases
  - Mere loss of evidence is not enough
- California law does not recognize any other exceptions to mediation confidentiality
- California law does not permit courts to create non-constitutionally required exceptions to statute

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Mediation Confidentiality Is Interpreted Very Strictly

- California courts have applied the mediation confidentiality statutes to, e.g.,
  - Prevent a client from introducing evidence to support a legal malpractice claim
  - Prohibit a party from offering its own documents made in preparation for mediation
  - Prohibit evidence to support a motion for sanctions based on bad faith
- Courts do not allow parties to seek an inference from the assertion of mediation confidentiality

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California Mediation Confidentiality in Federal Court

- Does the California mediation confidentiality statute apply in federal court?
  - Fed. R. Evid. 501 looks to state law to govern privileges in diversity cases
  - Is the protection afforded in the California mediation confidentiality statute a privilege?
    - Is not located in the section of the Evidence Code addressing privileges (Cal. Evid. Code §§ 1000 et seq.)
    - Does not use the word "privilege" in the text
    - Not described as a "privilege" by the California Supreme Court (though often so-characterized by lower courts)
  - But federal cases treat statute as a privilege for purposes of Rule 501
    - Serves the function of a privilege
    - Would lead to anomalies if mediation communications were admissible in federal court but not in state court
- Does Evid. Code § 1128 apply to federal cases?

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Other Open Questions

- Can a party obtain discovery and offer evidence of events at a mediation if necessary to a defense to liability?
- Can a party offer evidence that a mediation took place in response to an argument that the party failed to undertake its contractual obligation to mediate before suing?
  - If a party asserts that "X" did not occur, but "X" in fact occurred at a mediation, can the opposing party offer evidence of "X"? What if "X" is a requirement to recover on a contract?
  - What do you do when attorneys for the other side say that something didn't happen, but it happened in mediation? (Should there be a crime-fraud exception?)
- Can a party offer evidence that a mediation took place, or is that off limits too?
- Is a reference to a mediation reversible error *per se?*

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Attorney Guidelines of Civility & Professionalism

- On the California State Bar website.
- Affirmatively adopted by numerous counties and state and federal courts.
- Aspirational guidelines for highest standards of civility in the profession – "best practices."
- Attorneys encouraged to pledge to abide by them, including informing clients of commitment to civility.

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The Guidelines address:

- Importance of dignity, decorum and courtesy to the fair and impartial administration of justice.
- Importance of improving justice to those who cannot afford legal representation
- Importance of treating clients with courtesy and respect.
- Abusive or unbecoming behavior is not acceptable.
- Communications about the legal system and profession should reflect profession integrity and respect.
- Attorneys should be punctual in appearances and advise clients that courtesy is expected in all meetings, hearings, etc.
- Service of process should not be done to disadvantage your opponent.

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Applying the Guidelines

- Written submissions should stick to the facts and issues.
- Attorneys should meet and confer and should not abuse the discovery process.
- Attorneys should explore settlement and AD early.
- Attorneys should disclose close personal relationships with a judge, arbitrator or mediator.
- Attorneys should respect privacy rights.
- Attorneys should negotiate agreements cooperatively.
- Additional guidelines for family and criminal law proceedings.

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How Independent Am I? Ethical Obligations of Independent Counsel

Carl Metzger, Goodwin Procter LLP
Sara M. Thorpe, Nicolaides Fink Thorpe Michaelides Sullivan LLP
Morris Ratner, Assoc. Prof., UC Hastings College of the Law - Moderator

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Introductions

- Morris Ratner, Assoc. Professor UC Hastings College of the Law – Moderator
- Carl Metzger, Goodwin Procter LLP
- Sara Thorpe, Nicolaides Fink Thorpe Michaelides Sullivan LLP

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Overview of Presentation

- Review basic principles
  - Insurer's duty to defend
  - Defense counsel's ethical obligations
  - Insured's right to "independent counsel"
- Examine issues that can arise for independent counsel
  - Requirement to, and limitations on, communicating with and reporting to insurer
  - Risks in disclosing information to insurer
  - Insurer billing guidelines
  - Third-party audit of counsel's bills

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Review of Basics: Insurer's Duty to Defend

- Primary insurance policy
  - Duty to defend as well as indemnify (i.e., pay covered claim)
    - "the Company shall have the right and duty to defend any suit against the insured seeking damages on account of bodily injury or property damage, even if any of the allegations of the suit are groundless, false or fraudulent . . ."
  - Duty to defend broader than duty to indemnify
- Insurer right to select counsel and control defense
  - Insurer use of "panel counsel"

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Review of Basics: "Tri-partite Relationship"

- When insurer defends insured, a "tripartite relationship" exists:
  - Where insurer retains counsel to defend its insured, tripartite relationship exists among (1) insurer, (2) insured, and (3) defense counsel
  - Premise is that both insured and insurer have *common interest* in defeating, minimizing, or resolving claim against insured
  - Defense counsel has two clients (insured and insurer)
  - Confidential communications between counsel and either/both insurer or insured are protected by attorney-client privilege and both insurer and insured hold the privilege
  - Attorney's work product is protected when transmitted to insurer
- However, some states do not recognize tri-partite relationship and hold insured is the only client (*see e.g.,* Ark., Conn., Mont., Mich.)

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Review: Counsel's Ethical Obligations

Confidentiality, communication, and competence

- <u>Confidentiality</u>
  - o ABA Model Rule of Prof. Conduct 1.6 (applies in 49 states, D.C., and U.S.V.I)
  - o California Business & Professions Code § 6068(e)(1); California Rule of Professional Responsibility 3-100
- <u>Communication</u>
  - o ABA 1.4
  - o Cal. Bus. & Prof. Code § 6068(m); Cal. 3-500
- <u>Competence</u>
  - o ABA 1.1
  - o Cal. 3-110

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Review: Counsel's Ethical Obligations

- Duty of Confidentiality – in general:
  - ABA Rule 1.6:
    - (a) lawyer shall not reveal information relating to representation unless client gives *informed consent*, disclosure is *impliedly authorized* to carry out representation, or disclosure is *permitted* by paragraph (b)
    - …(c) lawyer shall make reasonable efforts to prevent inadvertent or unauthorized disclosure of, or unauthorized access to, confidential information
  - Cal. Bus. & Prof. Code § 6068(e)(1); Cal. 3-100
    - Attorney's duty: "To maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client"
    - Rule 3-100: "A member shall not reveal information protected from disclosure by § 6068(e)(1)"

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Review: Counsel's Ethical Obligations

- Duty of Confidentiality – in general (cont'd):
  - Fosters "the trust that is the hallmark of the client-lawyer relationship"
    - ABA 1.6, Comment 2; Rule 3-100, Comment [1]
  - Includes matters communicated in confidence by client (i.e., protected by attorney client privilege and work product), and
  - Extends further to "information relating to the representation, *whatever its source*"
    - Rule 3-100, Comment [2]
  - Survives termination of attorney-client relationship
    - ABA 1.6, Comment 20

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Review: Counsel's Ethical Obligations

- Duty of Confidentiality – exceptions allowing disclosure:
  - Implied authorization includes reporting to insurers (*See* ABA comments)
  - Disclosure permissible, e.g.:
    - To the extent lawyer reasonably believes disclosure is *necessary* to prevent a criminal act the lawyer reasonably believes is *likely* to result in death or substantial bodily harm (3-100(B))
      - *Even then* must try to limit disclosure (3-100(D))
    - To prevent death or bodily injury (ABA 1.6 - not necessarily tied to crime)
    - To prevent crime/fraud (ABA 1.6)
    - To secure legal advice about lawyer's compliance with Rules (ABA 1.6)

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Review: Counsel's Ethical Obligations

- Duty of Communication:
  - ABA 1.4: A lawyer "shall":
    - keep client reasonably informed about status of the matter; and
    - explain matters to extent reasonably necessary to permit client to make informed decisions regarding the representation (ABA 1.4(a)(3); 1.4(b))
  - Cal. Bus. & Prof. Code § 6068(m); RPR 3-500: Lawyer "shall":
    - keep client reasonably informed about significant developments relating to the representation
      - *includes promptly complying with reasonable requests for information and significant documents when necessary to keep client informed*

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Review: Counsel's Ethical Obligations

- Duty of Competence:
  - ABA 1.1: "A lawyer shall provide competent representation …"
    - Competent representation requires "legal knowledge, skill, thoroughness and preparation reasonably necessary for representation"
  - Cal. 3-110: Lawyer "shall *not* intentionally, recklessly, or repeatedly":
    - "Fail to perform legal services with competence"
    - "Competence" means applying diligence, learning and skill, and "mental, emotional, and physical ability reasonably necessary" to serve
    - If insufficient learning /skill at outset, can become "competent" by associating with or consulting with competent lawyer or learning
    - Includes duty to supervise associates/staff

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Review: Right to Independent Counsel

- Many states have not addressed
- Some states hold counsel for insured should be "independent" but do not have a statute or clear case law of what that means
  - "Enhanced obligation" - Wash.: *Tank v. State Farm,* 105 Wash. 2d 381, 390 (1986)
- Some states have clear case law or statute
  - Ill.: *Maryland Cas. Co. v. Peppers*, 64 Ill. 2d 187, 195-6 (1976)
  - Calif.: Cal. Civ. Code § 2860; *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc., Inc.,* 162 Cal.App.3d 358 (1984)
  - Or. (in environmental context): ORS § 465.483

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Review: Right to Independent Counsel

- "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." Cal. Civ. Code § 2860
- Rationale: "[T]he insurer is paying the legal expenses."
  - *Fidelity Nat. Financial, Inc. v. National Union Fire Ins. Co.*, 2014 WL 1393743, at *6 (S.D. Cal. 2014)
- Effect: Informational, no attorney-client relationship between the insurer and independent counsel.
  - *San Gabriel Basin Water Quality Auth. v. Aerojet-General Corp.*, 105 F. Supp. 2d 1095, 1101 (C.D. Cal. 2000)

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Potential Issues for Independent Counsel

- What can independent counsel communicate?
  - Reporting obligation limited to *non-privileged* communications.
    - *First Pacific Networks, Inc. v. Atlantic Mut. Ins. Co*., 163 F.R.D. 574, 582 (N.D. Cal. 1995): "[T]he insured and its independent counsel retain fully the right to communicate between themselves in private — and to shield those communications from the carrier." *Id*. at 580
  - "[T]he duties specified in Civil Code section 2860 that *Cumis* counsel owes the insurer are limited to the duties to disclose, inform, consult and cooperate regarding nonprivileged information."
    - *Assurance Co. of Am. v. Haven*, 32 Cal. App. 4th 78, 90 (1995)

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Potential Issues for Independent Counsel

- What can independent counsel report?
  - Defense counsel has a duty to protect the attorney-client privilege
    - *See State Farm Fire & Cas. Co. v. Superior Court*, 216 Cal. App. 3d 1222, 1228 (1989) (noting it was independent counsel's "obligation to guard against improvident revelations to the insurance company")
  - At the same time, an insurer has right to reporting and may be able to assert a cause of action for negligent breach of statutory duty based on lack of reporting
    - *Assurance Co. of America v. Haven*, 32 Cal. App. 4th 78, 92 (1995)

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Issues for Independent Counsel

- Does attorney-client privilege extend to insurer communications?
  - Yes: "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 § 2860(d)
  - Rationale: Avoids chilling effect - the insured would be "faced with the 'decision' to either provide information to [its insurer] or face denial of defense and coverage for failure to cooperate
    - *Lectrolarm Custom Systems, Inc. v. Pelco Sales, Inc.*, 212 F.R.D. 567, 571 (E.D. Cal. 2002)
  - *However*, not necessarily the rule in other jurisdictions:
    - Interests between insurer and independent counsel *not* sufficiently aligned to protect information from disclosure
      - *Go Medical Indus. Pty., Ltd. v. C. R. Bard, Inc.*, 1998 WL 1632525, at *4 (D. Conn. 1998) (reversed in part on other grounds)
      - *In re Pfizer, Inc. Secs. Lit.*, 1993 WL 561125, at *8 (S.D.N.Y. 1993) (same)

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Potential Issues for Independent Counsel

- Insurer's billing guidelines
  - "A lawyer shall not permit a person who … pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services."
    - ABA 5.4(b)
  - A lawyer "shall not accept compensation [from another] for representing a client … unless: (1) there is no interference with the lawyer's independence of professional judgment …"
    - Cal. 3-310(F)(1)
  - Insurer-imposed restrictions on discovery or other litigation costs may well violate the insurer's duty to defend as well as the attorneys' ethical responsibilities to exercise their independent professional judgment in rendering legal services.
    - *Dynamic Concepts, Inc. v. Truck Ins. Exchg.*, 61 Cal.App.4th 999, 1009 (1998) (but no evidence that had happened)

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Potential Issues for Independent Counsel

- Insurer billing guidelines, cont'd
  - Prior approval regarding billing and practice rules violate defense counsel's duty to exercise independent judgment and his/her undivided loyalty to the insured
    - *in re Rules of Prof'l Conduct & Insurer Imposed Billing Rules & Procedures*, 299 Mont. 321 (2000)
  - Requiring advance consultation to perform certain tasks is appropriate so long as insured's confidential information that might be used to defeat coverage is not revealed.
    - Kent D. Syverud, *The Ethics of Insurer Litigation Management Guidelines and Legal Audits*, 21 INS. LITIG. REP. 180 (1999)

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Potential Issues for Independent Counsel

- Third-party audit of counsel's bills
  - Insurer's disclosure of privileged information, such as attorney invoices, to a third-party auditor *may* constitute a waiver of privilege, even where defense counsel's disclosure to insurer was protected
    - *In re Rules of Prof. Conduct & Insurer Imposed Billing Rules & Procedures*, 299 Mont. 321, 347 (2000) (privilege waived absent insured's timely informed consent)

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Telling the Truth Without Inappropriate Revelations What May and Must Defense Counsel Report Under the Policy and the Rules of Professional Conduct?

Martin Checov, O'Melveny & Myers LLP
Meghan Magruder, King & Spalding
William Barker, Dentons

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UC Hastings College of the Law
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Mark Twain
- ***Notebook***, 1894

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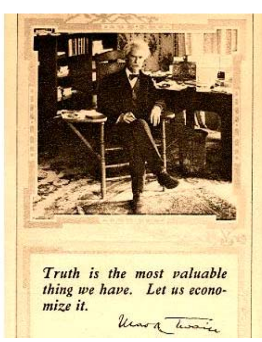

- *Following the Equator*, Pudd'nhead Wilson's New Calendar

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Duty of Confidentiality

- Model Rule 1.6(a):
  - "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 the disclosure is permitted by paragraph (b)."
- Cal. Bus. & Prof Code § 6068:
  - "It is the duty of an attorney …

    (e) (1) To maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client."
- Protection broader than privilege.

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Duty of Confidentiality

- Model Rule 1.8(b):
  - "A lawyer shall not use information relating to the representation of a client to the disadvantage of the client unless the client gives informed consent, [with exceptions not relevant here]."
- *Oasis West Realty v. Goldman*, 51 Cal. 4th 811 821 (2011):
  - Attorney may not, at any time, "'use against [a client or] former client knowledge or information acquired by virtue of the previous relationship.'"

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Third-Party Payor

- Model Rule 1.8(f)
  - A lawyer shall not accept compensation for representing a client from one other than the client unless:

    (1) the client gives informed consent;

    (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and

    (3) information relating to representation of a client is protected as required by Rule 1.6.

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Third-Party Payor

- Cal. RPC 3-310:
  - (F) A member shall not accept compensation for representing a client from one other than the client unless:
    (1) There is no interference with the member's independence of professional judgment or with the client-lawyer relationship; and
    (2) Information relating to representation of the client is protected as required by Business and Professions Code section 6068, subdivision (e); and
    (3) The member obtains the client's informed written consent, provided that no disclosure or consent is required if:
    (a) such nondisclosure is otherwise authorized by law; or
    (b) the member is rendering legal services on behalf of any public agency which provides legal services to other public agencies or the public.

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Implied Authority To Disclose

- When appropriate to representation.
- Requires
  - Utility to the representation
  - No apparent risk of harm to client
  - No client direction to keep secret

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Implied Authority When Insurer Has Duty To Defend

- Insurer right to manage
- Defense counsel should explain
- Insured acquiesces

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Joint Representation & Disclosure to Insurer

- In most jurisdictions, insurer with duty to defend is usually a co-client
- Ordinarily no secrets between clients
  - No privilege between clients in later dispute
  - But see ABA 08-450
- Insured must told of this at outset
- Shared info privileged against others

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Implied Authority When Insurer Has No Duty To Defend

- Information still necessary re funding of defense & settlement
- Duty to cooperate
- Defense counsel consults with insured

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Independent Counsel and Implied Authority To Disclose

- Counsel may not disclose information regarding issues where interests conflict
- Otherwise like insurer without duty to defend

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California & Cumis Counsel

- Cal. Civil 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 . . .

    (d) 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.

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Special Rules: Secrecy Requested or Both Defense & Coverage Affected

- Normal joint client rule: if insurer needs to know but disclosure impermissible, counsel must withdraw unless problem resolved
- Nondisclosure could have consequences, so counsel must consult insured about possible disclosure

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Special Rules: Secrecy Requested or Both Defense & Coverage Affected

- Joint client rule does not apply if insurer not client
- Normal joint client rule may be modified for insurance defense
  - Restatement LGL
  - Restatement of the Law of Liability Insurance
- Nevertheless, must avoid assisting fraud

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If Withdrawal Necessary, Can or Should It Be Noisy?

- Restatement LGL (noninsurance)
- Restatement LGL (insurance)
- Restatement of the Law of Liability Insurance
- ABA 08-450

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Application: Privileged and Sensitive Settlement Materials

- Examples:
  - Mediations materials
  - Settlement evaluations
  - Strategy memos
  - Legal and factual analysis
- Potential issues to consider
  - Waiver of applicable privilege?
  - Use of potentially harmful information in subsequent coverage action?

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Duty to Disclose Depends on Posture of Insurers

- Purpose of the cooperation clause
- An insured's obligations depend on whether:
  - Insurers agree to defend
  - Insurers refuse coverage
  - Insurers reserve rights
- If required to disclose information, how much?

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Will Disclosure Result in a Waiver of Applicable Privilege?

- General Rule
- Potential Protections
  - Common Interest Doctrine
  - Confidentiality Agreement
  - Mediation Privilege
- Potential Pitfalls

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Adverse Use of Settlement/Mediation Materials by Insurers

- Ethical duties regarding nondisclosure of confidential client information
- Applicable case law
- Practice pointers

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Don't Be Evil: What Google's Former Corporate Motto Means for Policyholders and Insurers

Lorelie Masters, Perkins Coie LLP
Leo P. Martinez, Albert Abramson Professor of Law, University of California, Hastings College of the Law
Tom Segalla, Goldberg Segalla LLP

2017 Law School Seminar
UC Hastings College of the Law
February 10, 2017

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Or, is bad faith evil?

POLICYHOLDER PERSPECTIVE – Lorelie Masters
INSURANCE COMPANY'S PERSPECTIVE – Tom Segalla
WHAT DOES THIS ALL MEAN? – Leo Martinez

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A Policyholder's Case for Bad Faith

Factors to Develop:

- Inconsistent communications.
- Contrary claim decisions.
- Claims handling manuals.
- Policy marketing materials.

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The State of Reverse Bad Faith

Totality of the Circumstances:

- The insurer as victim.
- Reverse bad faith – does it exist?
- Hadley v. Baxendale lives – does it apply both ways?

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What does this all mean?

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Old Risks Meet the New Economy:
Insurance Issues for the 21st Century

PAPERS

But What If We Flame Out?

Trends in D&O Coverage of Importance to Emerging Companies and Their Insurers

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Michael L. Manire
Manire & Galla LLP
New York, New York
MManire@maniregallalaw.com

Mary Craig Calkins
Kilpatrick Townsend & Stockton LLP
Beverly Hills, California
MCalkins@kilpatricktownsend.com

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In March of 2016, the Chairperson of the Securities and Exchange Commission Mary Jo White delivered a widely reported address in Silicon Valley highlighting the SEC's concerns about capital raising practices in start-up markets. Some of those concerns related to crowdfunding and the growth of secondary markets that allow for more active private trading of small company investments among sophisticated investors. The SEC has not traditionally been focused on that market, on the theory that sophisticated investors can take care of themselves. But Ms. White's comments emphasized the SEC's concerns about remarkably high valuations that can develop for some of these companies, especially those in the so-called "unicorn category."

> "So, if those participants choose — with eyes wide open — to invest in private companies at valuations that may be ethereal or overinflated, who loses when the truth behind inflated valuations is revealed? I think we all do," she said. "Not just the venture capital and private equity funds, but also smaller retail investors and the next Stanford student whose great idea needs funding, [because] investors are unwilling to take a bet on her because they were burned last time."

This paper presents examples of liability exposures faced by emerging companies at different stages of capital formation. It then discusses D&O insurance coverage issues raised by these examples and provides specific recent developments with respect to certain of those coverage issues.

I. __Liability Cases and Investigations__

Theranos, Inc.

Theranos, Inc. developed proprietary blood-testing technology that took it through three successful rounds of private capital raises. The last round valued the company at $9 billion. In October 2015, the Wall Street Journal reported major failures with its principal product. In April 2016, Theranos announced that the SEC and Department of Justice, among others, had commenced investigations of the company – an unusual action with respect to a private company. In October 2016, three investment partnerships that had privately invested over $90 million in Theranos sued the company and its two senior officers in Delaware Chancery Court for alleged fraud and various other common law and statutory violations. In November 2016, investors in funds that had purchased Theranos preferred stock filed a putative class action in the Northern District of California against the company and its two senior officers for alleged state law securities fraud violations.

- SEC and DOJ Investigations

- *Partner Investments, L.P., et al. v. Theranos, Inc., et al.*, DE Ch. Ct CA 12816-VCL
- *Robert Colman, et al. v. Theranos, Inc., et al.*, Case No. 5:16-cv-06822-NC, U.S. Dist. Ct., ND CA

Steifel Laboratories, Inc.

Steifel Laboratories, Inc. was a family-controlled private company that was the world's largest manufacturer of dermatology products until 2009, when it was acquired by SmithGlaxoKline. In 2011, the SEC sued Steifel and its former CEO and controlling shareholder for alleged violations of 10b5 in repurchasing employees' shares at artificially deflated prices in the period before the acquisition. A number of other private lawsuits were filed by individual stockholders of Steifel, including some former officers, who sold their shares back to the company before the 2011 acquisition. The private actions asserted a variety of claims, including securities fraud and ERISA violations.

- *SEC v. Steifel Laboratories and Charles Steifel*, Case No. 1:11-cv-24438-WJZ, U.S. Dist. Ct., SD FLA
- *100079 Canada, Inc. v. Steifel Laboratories, Inc.,* Case No. 11-223389-Civ-SCOLA, U.S. Dist. Ct., SD FLA
- *Timothy Finnerty v. Steifel Laboratories, Inc.,* Nos. 12-13947, 12-15060, 12-15642, U.S. Ct. App. 11th Cir.

GoPro, Inc.

GoPro, Inc. was founded in 2004, reportedly with a $236,000 investment by its founder. The company developed a line of wearable and mountable sport cameras or "capture devices." GoPro went public in June 2014, in an IPO that valued the company at $3 billion. The stock price quickly doubled. But by January 2016, GoPro's market capitalization had dropped by more than $7 billion from its historical high. Two securities class actions were filed against GoPro in January 2016, one asserting violations of the 1933 Act in the GoPro IPO, another asserting violations of §10b and the 1934 Act in the secondary market after the IPO.

- IPO Securities Class Action – *In Re GoPro, Inc. Shareholder Litigation*, Case No. CIV537077, CA Superior Ct, County of San Mateo
- Secondary Market Securities *Class* Action – *Joseph Bodri v. GoPro, Inc. et al.,* Case No. 3:16-cv-00232-JST U.S. Dist. Ct, ND CA

Dole Food Company, Inc.

Dole Food Company, Inc., after a six-year period of private ownership that began in 2003, raised roughly $400 million in an IPO in 2009. But in 2013, Dole's controlling stockholder, David Murdock, took the company private again in a cash merger. A group of Dole's selling stockholders filed an action against Mr. Murdock and others in Delaware Chancery Court, alleging breaches of fiduciary duty in connection with the acquisition. The case went to trial, and in August 2015, Vice Chancellor Laster found Murdock and others liable for breach of fiduciary duty. In a written decision, he stated that by driving the market price of Dole stock down before the acquisition, the defendants had "engaged in fraud" and "derived an improper personal benefit" from the transaction. The decision found the defendants liable for $148 million, roughly the difference in the amount paid to the stockholders in the merger and a "fairer price" as determined by the court. The defendants settled the case shortly after the trial by agreeing to pay the amount awarded by VC Laster.

Shortly after the Chancery Court trial decision, a 10b5 class action was filed against the same defendants in U.S. Dist. Court in Delaware on behalf of stockholders who sold their shares at artificially deflated values during the period when defendants driving down the market price before the 2013 acquisition. The 10b5 case recently settled for $74 million.

- *In re Dole Food Company Inc. Stockholder Litigation*, Civil Action No. 8703-VCL, Delaware Chancery Court
- *San Antonio Fire and Police Pension Fund, et al. v. Dole Food Company, Inc., et al*., Case 1:15-cv-01140-UNA, U.S. Dist. Ct., DE

II. Recent Coverage Cases

A. Coverage for Investigations – Alleged Wrongful Acts?

A frequently disputed issue under D&O policies over the last decade has been whether an insured's legal expenses in responding to a regulatory investigation are covered. Policy wording can vary significantly, but the basic issue is typically whether the investigation constitutes a "Claim" as defined in the policy. The market trend appears to be expansion of coverage for individuals who are targeted by investigations, sometimes as a "Pre-Claim Inquiry" or similar terms. A company's coverage for its own expenses still tends to be more limited.

Two recent decisions demonstrate that it is not just a policy's definition of "Claim" that determines coverage. Insuring agreements also typically require that the Claim to allege a "Wrongful Act" by an insured. In these two cases, courts found no coverage for investigations because no such allegations had been asserted by the investigation authority.

- **MusclePharm Corp. v. Liberty Insurance Underwriters, Inc., 2016 U.S. Dist. LEXIS 168698, 2016 WL 4179784 (D. Colo. Aug. 4, 2016)**

In this case, a Colorado District Court ruled that an SEC investigation of a company did not trigger coverage because there was no clear allegation of wrongdoing that would constitute a Wrongful Act under the a D&O policy's Insuring Agreement. Coverage did not apply until Wells Notices were issued for insured persons.

MusclePharm Corporation ("MusclePharm") was insured under a policy issued by Liberty Insurance Underwriters, Inc. ("Liberty"). On May 16, 2013, the SEC sent a letter (the "May letter") to MusclePharm advising that it was conducting an inquiry and requesting voluntary production of documents. On July 8, 2013, the SEC issued an Order Directing Private Investigation and Designating Officers to Take Testimony (the "Order"). The Order stated that the SEC had "information that tends to show … possible violations" of federal securities laws by MusclePharm and/or its directors and officers.

Under the policy's Insuring Agreement, Liberty was obligated to pay for loss resulting from a Claim for a Wrongful Act. Liberty denied coverage for the May letter and the Order because neither alleged a "Wrongful Act" within the meaning of the policy. The policy defines "Wrongful Act" as "any actual or alleged error, misstatement, misleading statement, act, omission, neglect, or breach of duty, actually or alleged committed or attempted[.]" Liberty eventually accepted coverage after two former MusclePharm officers were served Wells Notices on February 13, 2015.

MusclePharm filed suit against Liberty for breach of contract and bad faith for attorney fees and other costs incurred prior to the Wells Notices. The Court held that the Order did not constitute an allegation of a Wrongful Act within the meaning of the policy and that Liberty had no duty to indemnify MusclePharm for the attorneys' fees and other costs it incurred prior to issuance of the Wells Notices. The Court based its decision on the definition of "Wrongful Act," and particularly the word "alleged." The policy did not define "alleged," so the Court looked to the plain meaning as defined by Dictionary.com, Merriam-Webster and Black's, all of which define it as an "accusation" or "something asserted" but not yet proven. The Court ruled that for there to be an allegation, there must be a positive assertion that the implicated action is believed to have actually occurred, even if still subject to proof. The Court held that the Order, which states that the Commission has information "that if true tends to show" various "possible violations" of securities law "may have" occurred, did not rise to the level of an allegation.

- **<u>Employer's Fire Insurance Co. v. Promedica Health Systems</u>, 524 Fed. Appx. 241, 2013 U.S. App. LEXIS 8943, 2013 FED App. 0432N (6th Cir.), 2013-1 Trade Cas. (CCH) P78,360, 2013 WL 1798978 (6th Cir. Ohio 2013)**

Promedica was insured by a D&O policy issued by OneBeacon. Promedica sought to acquire a hospital in Toledo, Ohio and the FTC investigated the matter for possible violations of antitrust law. The coverage dispute turned on *when* a "Claim" arose. The policy defined "Claim" as:

(1) a written demand for monetary, non-monetary or injunctive relief (including any request to toll or waive any statute of limitations); or
(2) a civil, criminal, administrative, regulator or arbitration proceeding for monetary, non-monetary or injunctive relief commenced by:
  (a) the service of a complaint or similar pleading;
  …
  (c) the filing of a notice of charges, formal investigative order or similar document against an Insured for a Wrongful Act.

As explained by the Court, this definition of Claim had four elements:

(1) there must be a "written demand" or a "proceeding" "commenced by" a "complaint or similar pleading" or "the filing of a formal investigative order";

(2) the "demand" or "proceeding" must seek "monetary, non-monetary or injunctive relief";
(3) relief must be sought "against an Insured"; and
(4) relief must be "for a Wrongful Act," as defined by the policy.

The policy defined "Wrongful Act" to include an "Antitrust Violation," which is defined to include "any actual or alleged ... violation of … the Clayton Act of 1914 … [or] the Federal Trade Commission Act of 1914[.]"

The Court concluded that the FTC's letter marking the transition to a "full-phase" investigation of the insured's acquisition of a hospital did not constitute an allegation of a Wrongful Act within the meaning of the policy. The Court held that a "Claim" did not arise until months later, when the FTC initiated administrative and civil actions against the insured and made actual allegations of wrongdoing.

B. The Unanticipated Impact of Professional Services Exclusions

Private company D&O policy forms frequently include exclusions barring coverage for claims arising out the performance of "Professional Services." These exclusions can have unanticipated application, especially if the exclusion does not include appropriate exceptions, such as for "Securities Claims."

These two recent decisions demonstrate the difficulty of determining what kind of activities constitute the performance of Professional Services, and the importance of the coordination of an insureds D&O coverage and separate E&O or Professional Services coverages.

- **Beazley Insurance Company Inc. v. ACE American Insurance Company, et al., Case No. 15-cv-5119-JSR (N.Y.S.D. 2016)**

This is a dispute between three insurers of NASDAQ arising out of NASDAQ'S alleged mishandling of Facebook's $16 billion IPO in May 2012. NASDAQ had technical problems that caused delayed trading and shares in the company to slump. A series of lawsuits were filed against NASDAQ OMX Group, Inc. and NASDAQ Stock Market, LLC (collectively, "NASDAQ") and its directors and officers. A consolidated action (the "Facebook Class Action") was brought on behalf of a "Securities Class," alleging violations of Sections 10(b) and 20(a), and a "Negligence Class," alleging claims for common law negligence. Plaintiffs alleged that the breakdown in the trading platforms on the day of the IPO "caused Class Members substantial damages by, causing erroneous and failed trade executions, blinding Class Members as to their then-current positions in Facebook stock, preventing Class Members from executing orders at the National Best Bid/Offer prices, exposing Class Members to related failure of NASDAQ trading platform, and resulting in artificial downward pressure on the price of Facebook's stock.

NASDAQ maintained E&O and D&O insurance. The E&O policies provided coverage for "Damages resulting from any Claim … for any Wrongful Act … solely in rendering or failing to render Professional Services." Chartis Specialty Insurance Company ("Chartis"), NASDAQ's primary E&O insurer, reserved rights on coverage but agreed to advance defense costs.

NASDAQ's primary and first excess D&O insurers were ACE American Insurance Company ("ACE") and Illinois National Insurance Company ("Illinois National"). ACE denied coverage based on the "professional services" exclusion.

In April 2015, the parties agreed to settle the Facebook Class Action for $26.5M. Chartis had paid its $15M limits in defense costs. Beazley, the first excess E&O insurer, agreed to contribute its full $15M limit toward the settlement in exchange for NASDAQ assigning Beazley "any and all contractual rights or extra-contractual rights they have or that they may acquire … against ACE and/or Illinois National." In June 2015, Beazley initiated this action against ACE and Illinois National.

The critical issue was the applicability of the "professional services" exclusion found in the ACE D&O policy, which provides as follows:

> The Insurer shall not be liable for that portion of Loss on account of any Claim … by or on behalf of a customer or client of the Company *[i.e.*, NASDAQ], alleging, based upon, arising out of, or attributable to the rendering or failure to render professional services.

Beazley argued that the class of retail investors who brought and settled the Facebook Class Action were not "customers and clients" of NASDAQ, as required to trigger the exclusion. Beazley argued that NASDAQ's customers are its members – the market makers through which retail investors may buy and sell stock listed on the NASDAQ stock exchange – and the listing companies themselves (*e.g.*, Facebook). Beazley also argued that the settled claims in the Facebook Class Action were not "alleging, based upon, arising out of, or attributable to the rendering or failure to render professional services." Conversely, ACE argued that retail investors are "customers and clients" and that the settled claims arose out of "professional services" as matter of law.

In addressing whether retail investors in a company listed on a stock exchange are unambiguously "customers or clients," the Court recognized that a decision in *Lank v. New York Stock Exchange*, 548 F.2d 61 (2d Cir. 1977) held that "the primary purpose of the Exchange Act was to protect customers of the stock exchanges, that is, public investors." The Court also noted that district courts have repeatedly identified retail investors as "customers" of stock exchanges, clearly distinguishing between members of the exchange and customers of the exchange. The Court further noted that industry usage of the term "customer" included retail investors as evidenced by a statement from NASDAQ's Chief Information Officer Anna Ewing in a public investor conference call leading up to Facebook's IPO. In that call, she referenced "millions of customers" which the Court said could only be interpreted as meaning that investors, as well as the exchange's members, are customers.

Focusing on whether the claims in the Facebook Action were "alleging, based upon, arising out of, or attributable to the rending or failure to render professional services," the Court applied New York's "but-for" test. *See Scottsdale Indem. v. Beckerman*, 992 N.Y.S.2d 117, 121 (2d Dep't 2014) (holding that a "but-for" test applies to determine the applicability of an "arising out of" exclusion, such that if "none of the causes of action that [the underlying plaintiff] asserts could exist but for the existence of the excluded activity or state of affairs, the insurer is under no obligation to defend the action); *see also Mount Vernon Fire Ins. Co. v. Creative Housing Ltd*., 88 N.Y.2d 347, 350 (1996) ("If no cause of action would exist but for the [excluded conduct], the claim is based on [the excluded conduct] and the exclusion applies").

Beazley argued that had NASDAQ done everything it was required to do from a technical standpoint, a jury still would have imposed liability based on NASDAQ's alleged misrepresentations as to its abilities. The Court rejected this argument finding that the federal securities claims would have failed but for NASDAQ's allegedly botched rendering of professional services because without the failure to render professional services, there would have been no loss causation. "If NASDAQ's systems had functioned properly, the class would have had no damages and its claims would have failed." Accordingly, the Court ruled that the securities claims in the Facebook Class Action were "alleging, based upon, arising out of, or attributable to the rendering or failure to render professional services," and the exclusion applied.

- **FDIC v. Arrillaga-Torrens, 2016 U.S. Dist. LEXIS 115139 (D.P.R. Aug. 26, 2016)**

The FDIC, acting as receiver of a Puerto Rican bank, and pursuant to its authority under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), sued the bank's former directors to recover $55 million in losses it attributed to the directors' gross negligence in approving risking loans. As part of the same suit, the FDIC sued Liberty Mutual Insurance Company, ACE insurance Company, and XL Insurance Company (the "Insurers"), maintaining the Insurers' D&O polices issued to the bank covered the claims asserted against the directors. Among other things, the Insurers argued that the practice of "lending" is a professional service and the policy's professional services exclusion applied. The Court disagreed, but ultimately determined the professional services exclusion was ambiguous. The Insurers also argued that the insured vs. insured exclusion applied, which the Court also found to be ambiguous.

The policy's professional services exclusion bars coverage for Loss in connection with any Claim based upon, arising from, or in any way related to the rendering of or failure to render professional services of any kind or nature to or on behalf of any customer or client of the Insured Organization.

The Insurers argued that "lending" is a professional service requiring specialized skill, knowledge, experience or training, and that approving loans was the result of each director's "thorough, independent analysis, which required each directors' application of his or her professional underwriting skill and knowledge." The Insurers also argued that D&O policies, in general, are issued to cover supervisory and managerial decisions distinct from an insured's rendering of professional services, for which professional liability policies are issued, and to interpret otherwise would result in overlapping coverage contradicting well-established industry standards.

The policy did not define "professional services" and the professional services exclusion did not include "loan review and approval" as activities to be excluded from coverage. The Court held that it was not apparent that the directors were providing a service to a client or customer rather than to the bank itself in evaluating loan applications and approving loans. Furthermore, the Court was not convinced that coverage would contradict industry practice since the core purpose of D&O insurance is to protect corporate directors from claims made against them in their capacity as directors and officers and alleged breaches of their duties to corporations and shareholders. Accordingly, the Court concluded that the language of the professional services exclusion was ambiguous.

C. Insured v. Insured Exclusions

D&O policies typically bar coverage for Claims brought by the insured company against an individual insured, or by one individual insured against another. A private company might find that it has no coverage, for example, if it is sued by a former officer with respect to transactions in the company's securities between the company and that officer. Some of the private claims against Steifel Laboratories by employees who sold their stock back to the company before it was acquired might have triggered an insured v. insured exclusion. The first of three recent decisions applied the exclusion to bar coverage even when only one of two plaintiffs was an insured.

Much of the litigation on insured v. insured exclusions over the years has pertained to claims brought on an insured company's "behalf" by a regulator, receiver or bankruptcy trustee that has stepped into the company's shoes after insolvency or another crisis. The two other recent decisions below demonstrate that despite the evolution of policy forms intended to clarify this issue, results can differ.

- **The Marbella Condominium Association, et al. v. RSUI Indemnity Company, Case No. 16-cv-80987 (U.S. Dist. Ct., SD FLA 2017)**

A district court in Florida ruled that a condominium association's D&O insurance policy's insured vs. insured exclusion barred coverage for a claim because it was brought by two claimants, one of whom was a former officer of the association, and thus an insured.

The Marbella Condominium Association hired a contractor to install hurricane impact windows in the association's condominium building. The contractor installed windows that did not meet the requirements for hurricane impact windows. Two condominium owners, Jack Leone and Franklyn Field, sued the association, the contractor, and Norman Sloane, the association's president. Leone previously was the association's president. The association submitted the claim to its D&O insurer, RSUI, which denied coverage for the claim based on the policy's insured vs. insured exclusion. The association and Sloane ("Plaintiffs") filed a civil action alleging breach of contract and seeking declaration that coverage applied under the policy.

The policy's insured vs. insured exclusion provided that "[t]he Insurer shall not be liable to make any payment for Loss in connection with any Claim made against any Insured … brought by or on behalf of any Insured."

The policy defined "Insured Person" to mean "any past, present or future director, officer, trustee, Employee, or any committee member of a duly constituted committee of the Insured Organization."

RSUI argued that with the presence of an Insured (Leone) making a claim against another Insured (Marbella and Sloane), the insured vs. insured exclusion applies. Plaintiffs argued that the presence of a non-insured (Field) as a claimant prevents the insured vs. insured exclusion from applying. The Court rejected Plaintiffs' argument based on two cases: *PowerSports, Inc. v. Royal & Sunalliance Insurance Company,* 307 F. Supp. 2d 1355 (S.D. Fla. 2004) (holding where the underlying action involves claims by both insured and non-insured plaintiffs from its inception, the plain language of the insured v. insured provision bars coverage for the entire underlying action) and *Sphinx International, Inc. v. National Union,* 412 F.3d 1224 (11th Cir. 2005) (holding that where an insured plaintiff initiated the action and then recruited non-insured plaintiffs to join, the insured v. insured exclusion barred coverage).

Plaintiffs also argued that the exclusion did not apply based on the Seventh Circuit's 1999 decision in *Level 3 Communications, Inc. v. Federal Insurance Company*. In that case, plaintiffs who were not insured persons initially brought the underlying claim. An additional plaintiff who was an insured person under the policy at issue was later added as a claimant in the case. The Seventh Circuit held that the insured vs. insured exclusion did not preclude coverage because that "would produce the odd result that a claim fully covered when made could become fully uncovered when another plaintiff was permitted to join it."

Judge Bloom said that the circumstances in *Level 3* were not present, because the underlying action here involved claims by both an insured person (Leone) and an individual not insured under the Policy (Field) "from the inception."

The Court also rejected Plaintiffs argument that the claims of Leone and Field sought different damages. The Court held that while the measure of damages may be different by virtue of them owning different condominium units, the claims asserted were "brought on behalf of both together and stemmed from the same installation of non-compliant glass." As such, the allocation provision in the policy did not apply because the defense provisions were never triggered. "Allocation clauses only become relevant in the event that a loss involves both covered and uncovered claims. Whereas this action involves uncovered claims only, the allocation question is moot."

- **FDIC v. Arrillaga-Torrens, 2016 U.S. Dist. LEXIS 115139 (D.P.R. Aug. 26, 2016)**

In the same decision noted above that addressed a Professional Services exclusion, the court held that an insured vs. insured exclusion in the bank's D&O policy was also ambiguous as to whether it barred coverage for a claim by the FDIC against a failed institution's officers.

The insured vs. insured exclusion stated that the Insurer shall not be liable to make any payment for Loss in connection with any Claim "brought or maintained by or on behalf of the Insured Organization or any Insured Person, in any capacity."

Historically, the purpose of the insured vs. insured exclusion was to preclude coverage for collusive lawsuits between insureds. However, application of the exclusion to FIRREA cases are unique as the FDIC is a unique entity created and authorized by statute to act in multiple capacities as part of a complex regulatory scheme. As a receiver, the FDIC succeeds to all rights, titles, powers and privileges of the insured depository institution, and of any stockholder, member, accountholder depositor, officer, or directors of such institution with respect to the institution and the assets of the institution. As such, it may pursue, in its own right, claims against a failed bank's directors and officers for breach of their duties to the bank. After the FDIC becomes receiver, those claims belong to the FDIC, not to the failed bank or anybody else. This role distinguishes the FDIC from those actors the insured vs. insured exclusion was intended to prevent from bringing claims.

The Insurers seized on the "on behalf of" language and argued that the insured vs. insured exclusion is not limited to claims brought by the Insured Organization (the bank), or by Insured Persons (the directors and officers of the bank), but that it extends to entities asserting claims on behalf of an Insured. However, the Court held that just because the FDIC is suing to recover the losses the bank suffered does not mean it is suing on behalf of the bank. The money is recovered to pay off the receiver's administrative fees, then depositors, then general liabilities, and then shareholders. Also, no one reaps the benefits comparable to those enjoyed by collusive actors who seek to swindle insurance companies.

The Insurers, citing the U.S. Supreme Court case *O'Melveny & Myers v. FDIC*, 512 U.S. 79 (1994), argued that the FDIC was suing on behalf of the bank because O'Melveny states that the FDIC "steps into the shoes of [the bank]." The Court rejected this argument, stating that O'Melveny does not concern an insured vs. insured exclusion or insurance at all, and that "steps into the shoes of" does not equate to "on behalf of."

The Court also found no harm in the FDIC's refusal to identify in written discovery which supposedly non-Insured person or entities on whose benefit it brought the claim.

Regarding whether the Insurers should have incorporated a Regulatory Exclusion in the Policy to preclude coverage in this type of case, the Insurers cited cases where the Courts have applied the insured vs. insured exclusion to FDIC claims in absence of a Regulatory Exclusion. The FDIC and the Directors responded by citing cases where courts have reached the opposite conclusion.

The Court ultimately followed *St. Paul Mercury Insurance v. FDIC*, 774 F.3d 702, 711 (11th Cir. 2014), which summarized the arguments for and against exclusion, but opted not to resolve the disagreement between the parties. It stated that courts have addressed similarly worded insured v. insured exclusions, reaching different results, and that there are simply two schools of thought on how to interpret the exclusion.

The Court adopted the same view as the *St. Paul Mercury Insurance* court, that under these circumstances, the insured vs. insured exclusion is ambiguous.

- **FDIC v. BancInsure, Inc., 2017 U.S. App. LEXIS 452, 2017 WL 83489 (9th Cir. Jan. 10, 2017) (Cal.)**

In this case, the Ninth Circuit reached the opposite result as *FDIC v. Arrillaga-Torrens*, holding that an insured vs. insured exclusion was not ambiguous and operated to bar coverage for the FDIC's claims against a failed bank's former directors and officers.

The FDIC, acting as receiver of Security Pacific Bank ("Security Pacific"), brought a declaratory judgment action against Security Pacific's D&O insurer, BancInsure, seeking declaration as to whether the D&O policy covers losses arising from negligence, gross negligence and breaches of fiduciary duty of Security Pacific's former directors and officers. The policy's insured vs. insured exclusion bars coverage for legal actions brought "by, or on behalf of, or at the behest of" Security Pacific, a person insured under policy, or "any successor, trustee, assignee or receiver of Security Pacific."

The FDIC did not argue the insured vs. insured exclusion was ambiguous. Rather, it argued that other provisions in the policy were evidence of the intent to cover the FDIC's claims, or they at least create an ambiguity.

The policy includes an exception to the insured vs. insured exclusion for losses arising from "a shareholder's derivative action brought on behalf of Security Pacific by one or more shareholders who are not [insureds] and make a Claim without cooperation or solicitation of an insured. The FDIC argues the exception evidences an intent to cover its claims because (1) the claims are similar to those brought in shareholder derivative suits; (2) the FDIC succeeded to the interests of Security Pacific's shareholders, and (3) after it was appointed receiver, only the FDIC could bring an action against Security Pacific's former directors and officers.

The Court rejected this argument and pointed out that causes of action against a corporation's directors and officers for their malfeasance belong to the corporation—not to the shareholders—and a shareholder derivative suit is secondary means of enforcing a corporation's rights only when the board of directors fails or refuses to do so. The FDIC, as receiver, succeeded to the right of Security Pacific's board of directors to bring such a direct suit, but the insured vs. insured exclusion—the text of which expressly includes the terms "successor" and "receiver"—would continue to bar coverage of claims brought by the FDIC. The Court stated that "receiver" clearly and unambiguously includes the FDIC in its role as receiver of Security Pacific, and interpreting the shareholder-derivative-suit exception to provide coverage to the FDIC's claims would read the term "receiver" out of the insured vs. insured exclusion.

The standard form of the policy also had an exclusion for loss arising from "any action or proceeding brought by or on behalf of any federal or state regulatory or supervisory agency or deposit insurance organization (the "regulatory exclusion"). However, the D&O policy deleted the regulatory exclusion by endorsement and established a coverage sublimit for the formerly excluded claims. The FDIC argued that its claims would most naturally be excluded by the regulatory exclusion, and the deletion should be construed in favor of coverage. The Court disagreed and held that deleting the more specific regulatory exclusion does not necessarily alter the scope of the more general insured vs. insured exclusion. As a result, the FDIC's claims were barred by the insured vs. insured exclusion.

This is the same result as a Tenth Circuit decision in 2015, which involved a nearly identical BancInsure policy. In that case, the Court also found that the insured vs. insured exclusion unambiguously barred claims by the FDIC as receiver because the insured vs. insured exclusion expressly barred claims by a "receiver." *See BancInsure, Inc. v. FDIC*, 796 F.3d 1226, F.3d 1226 (10th Cir. 2015).

D. When is Loss Uninsurable as Disgorgement or Restitution?

Particularly since Judge Richard Posner's decision in *Level 3 Communications, Inc. v. Federal Insurance Co.*, 272 F. 3d 908 (7th Cir. 2001), courts have struggled with the issue of whether a judgment or settlement should be insured if it constitutes the return of "ill-gotten gain" by the insured. Decisions barring coverage have been based on both public policy and policy construction.

Summarized below is one pending coverage lawsuit based on a specific "bump-up" clause in a D&O policy, and two recent decisions finding that settlements of claims that arguably constituted disgorgement or restitution were nevertheless insurable.

- **Onyx Pharmaceuticals, Inc. v. Old Republic Insurance Co., et al., CIV538248, Superior Court of CA, San Mateo Co. (2016)**

This recently filed coverage case will be watched carefully, especially in light of the frequency of stockholder class actions challenging M&A transactions. The plaintiffs in the case ask a California court to construe a so-called "bump-up" clause that is now included in many D&O policies to bar coverage for certain M&A settlements.

Onyx Pharmaceuticals was acquired by Amgen Inc. in 2013 for $120 per share. Onyx stockholders sued certain of its officer and directors for breach of fiduciary duty for, among other things, failing to maximize the value of the plaintiffs' stock.

The stockholder suit settled for $30 million in June 2016.

Prior to the settlement, Onyx sued certain excess D&O insurers who had taken the position that any settlement of the stockholder action would be barred by the policy's "bump-up" clause, which read:

> In the event of a Claim alleging that the price or consideration paid or proposed to be paid for the acquisition or completion of the acquisition of all or substantially all the ownership interest in or assets of an entity is inadequate, Loss with respect to such Claim shall not include any amount of any judgment or settlement representing the amount by which such price or consideration is effectively increased.

Onyx argues in its complaint that the bump-up clause does not apply because rather than asserting that the price paid for Onyx stock was inadequate, the underlying stockholder action asserts that the stock was not sold for the "*best* or *maximum* price." Onyx also asserts that the clause applies only to matters in which the insured company is the acquiring company, rather than the acquired company, and that even if it does apply, it would not apply to the portion of the settlement that goes to pay plaintiffs' attorneys' fees and expenses.

Answers and counterclaims have been filed, and the action is pending before Judge Marie S. Weiner in San Mateo County.

- **TIAA-CREF Individual & Institutional Services, LLC, et al. v. Illinois National Insurance Co., C.A. No. N14C-05-178 JRJ CCLD, Superior Ct. of DE (Oct. 20, 2016)**

In this D&O policy decision, the insured financial institution sought coverage for settlements paid in lawsuits alleging that it had violated ERISA and various state laws by failing to pay certain account holders certain gains that had accrued on their accounts. TIAA-CREF's insurers argued that the settlements did not constitute insurable loss under the policies.

The Delaware court noted the absence of Delaware law barring coverage of disgorgement. The court also analyzed New York law and acknowledged that New York courts generally disfavor insurability of disgorgement. But the court distinguished the New York case law, noting that in this case the insured had settled while expressly denying liability, while the New York decisions barring coverage involved "conclusive links between the insured." The court granted summary judgment to the insured on the issue of coverage for the settlements.

- **United States Bank N.A. v. Indian Harbor Insurance Co., 68 F. Supp. 3d 1044 (D. Minn. 2014)**

This case involved professional liability insurance rather than D&O, but addressed the issue of whether a bank is covered for its settlement for claims brought by depositors seeking return of improper overdraft charges. The insurer argued that the settlement constituted restitution and was therefore uninsurable as a matter of Delaware law.

The court did not rule on whether restitution is uninsurable under Delaware law. Instead, the court found that the policy contained a specific exclusion addressing coverage for "ill-gotten gains," which barred coverage for restitution only if a final adjudication in the underlying action determined that the insured was not legally entitled to the money. The court found that the since there was no such adjudication, the settlement was insurable under this particular policy form.

E. When is Fraudulent Conduct Insurable?

D&O insurance uniquely raises the moral hazard issue of whether a person should be permitted to insure himself or herself against liability for intentional misconduct. The State of California bars insurance coverage for willful misconduct in California Insurance Code section 533, and fraudulent conduct is uninsurable as a matter of public policy in many states. But D&O insurance has been the battleground for the details surrounding this principle.

Over the years, fraud and personal profit exclusions in D&O policies have been modified to become more favorable to insureds. An exclusion 15 years ago might have applied to bar coverage of a settlement if the only allegation in the case was for fraud. Now, however, conduct exclusions are often written to apply only if the fraud or personal profit is established in a final nonappealable adjudication. The wording of different policies' exclusions still contain meaningful variations. It seems fair (to insurers) to ask, however, if these clauses have become too lenient.

A December 2016 decision on such an exclusion from the Delaware Superior Court is food for thought. It arises out of the *In re Dole Food Company Inc. Stockholder Litigation* described earlier in these materials.

- **Arch Insurance Company, et al. v. David H. Murdock, et al., 2016 Del. Super. LEXIS 645**

This December 21, 2016 decision arises out of an action filed by certain excess D&O insurers for the Dole Food Company, Inc., seeking a declaration that they have no obligation to reimburse David Murdock for the $148 million that he paid to settle a breach of fiduciary duty lawsuit after findings in a Memorandum Opinion that Murdock had engaged in fraudulent conduct. The underlying action arose out of a 2013 transaction in which Mr. Murdock acquired all of the outstanding stock of Dole and took it private.

The conduct exclusion in the governing policy barred coverage for:

> **Loss** on account of any **Claim** based upon, arising out of or attributable to:
>
> > a. any profit, remuneration or financial advantage to which the **Insured** was not legally entitled; or

> b. any willful violation of any statute or regulation or any deliberately criminal or fraudulent act, error or omission by the **Insured**;
>
> if established by a final and non-appealable adjudication adverse to such **Insured** in the underlying action.

In the underlying *In re Dole Food Company Inc. Stockholder Litigation,* the defendants went to trial on the allegations of breach of fiduciary duty. After trial, Vice Chancellor Laster issued a strongly worded decision finding Mr. Murdock and others liable for breach of fiduciary duty. More importantly, as Superior Court Judge Davis acknowledged in his December 21, 2016 decision in the coverage case, VC Laster's decision made "findings" that Mr. Murdock and two other defendants "committed fraudulent acts."

But before VC Laster's decision became an appealable judgment, Mr. Murdock agreed to settle the Stockholder Litigation by paying plaintiffs the full amount that Laster's decision awarded.

In the subsequent coverage case, Judge Davis asked the parties to brief the issue of whether the D&O policies' conduct exclusion barred coverage for Mr. Murdock's claim for coverage. The insurers argued that although the Chancery Court trial decision was not final and non-appealable as of the moment VC Laster issued it, it was an adjudication that the court's subsequent order approving Mr. Murdock's settlement rendered final and non-appealable pursuant to Delaware law. The court disagreed, stating "While this Court does believe that Vice Chancellor Laster did make findings that some of the Defendants … committed fraudulent acts, the Memorandum Opinion was not a final and non-appealable adjudication. …."

In his December 21, 2016 decision, Judge Davis reasoned that VC Laster's decision was not a final and non-appealable adjudication because there was no "docket entry showing the entry of an order in connection with that opinion." He acknowledged that the subsequent settlement and the ensuing Order and Final Judgment submitted by the parties and entered by the Chancery Court "are carefully crafted to mitigate the findings in" VC Laster's decision. But citing case law that a settlement does not constitute a final adjudication adverse to the defendant, he found that the conduct clause did not bar coverage:

> "The language [of the exclusion] is not complicated. If a deliberate act of fraud by an insured is determined through a final and non-appealable adjudication, the Insurer will not be responsible for any claim made by that insured related to the adjudicated fraudulent act. [¶] The court does not find the language of the exclusions to be ambiguous. The Memorandum Opinion, without more (i.e., a Chancery Rule §4(b) entry of judgment or a Chancery Rule 58 order) was not a final and non-appealable adjudication adverse to such insured in the underlying action. The only final and non-appealable adjudication in the Chancery Court action was the Order and Final Judgment. Accordingly, Exclusion IV.A.6 does not apply to the facts of this case."

The *Arch v. Murdock* coverage action remains pending in the Superior Court.

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Justice Department's Focus on Individual Responsibility Requires Broadening of Excess Side-A Difference-in-Conditions D&O Insurance Policies

By Tim Burns

The results of the recent national elections may change many things, but one thing the results are unlikely to change is the United State Department of Justice's focus on criminal and civil accountability for individuals involved in corporate wrongdoing. The current administration owes its electoral victory to a populist wave in rural America that was fueled in part by contentions that the previous administration did not sufficiently prosecute or punish perpetrators of the 2008 financial crisis. Given the need to retain its populist support, political survival likely will counsel the new administration to avoid being perceived as backing off of the Justice Department's push to hold individuals accountable. If the Justice Department's efforts continue, corporate executives would be well advised to have their corporations broaden directors' and officers' ("D&O") insurance protections to meet the challenges posed by the Justice Department's actions. The easiest way for most corporations to obtain the necessary protections is by seeking changes in the corporation's D&O insurance policies of last resort, the policies known in the industry as "Excess Side-A Difference-in-Conditions D&O Policies."

The Push for Individual Accountability

In September 2015, the Deputy Attorney General, Sally Yates, issued a memorandum ("the Yates Memo"), setting forth guidance on how the Justice Department would handle future corporate investigations and, to the extent practicable, pending ones. The memo listed six guideposts. First, the Justice Department made clear that, to be eligible for any cooperation credit in a criminal or civil matter, a corporation must provide the Justice Department all relevant facts concerning the individuals involved in or responsible for the corporate misconduct.

Corporations depend on cooperation credit to lessen the financial impact of any resolution with the government. Thus, conditioning any cooperation credit on full disclosures regarding individuals puts enormous pressure on corporations to make those disclosures. Second, the Justice Department specified that it would focus on individuals from the beginning of both criminal and civil corporate investigations. Third, the Justice Department stated that its criminal and civil attorneys would routinely communicate with each other to ensure that individuals are effectively pursued. Fourth, the Justice Department warned that, except in extraordinary circumstances, no corporate resolution would provide individuals with protection from criminal and civil liability like such settlements often had in the past. Fifth, the Justice Department directed that cases should not be resolved without a clear plan to resolve related cases against individuals. Finally, the Justice Department directed its civil attorneys to evaluate whether to bring suit against an individual based on considerations beyond the individual's ability to pay.

Since the publication of the Yates Memo, the Justice Department has strongly focused on individual accountability for corporate wrongdoing. For example, the Justice Department recently entered two settlements alleging corporate wrongdoing with each settlement requiring individuals to pay. In a False Claims Act case that the government brought against North American Health Care, Inc., the settlement required the corporation to pay $28.5 million, the chairman of the company's board to pay $1 million, and a senior vice president to pay $500,000. Similarly, the government recently entered a settlement with the former CEO of Tuomey Healthcare System for healthcare kickback violations. That settlement required the executive to pay $1 million and barred him from participating in federal health care programs for four years. The settlement also mandated the former CEO's assistance to the government in connection with the investigation of other entities and individuals.

Speaking on June 9 last year, the Acting Associate Attorney General, emphasized the importance of the Yates Memo and the Justice Department's intent to apply it across the board in its civil enforcement matters. According to the official, "[w]hether the conduct implicates the False Claims Act, or our tax, antitrust, environmental or other laws, we have made clear that it is department policy to pursue civilly those individuals who are responsible and hold them accountable, in addition to pursuing our civil case against the organization." Acting Associate Attorney General Bair pointed to four additional recent settlements involving individuals:

- A $4 million settlement with the estate of a former bank CEO that defrauded the Troubled Asset Relief Program;
- A $1.65 settlement with a home health agency owner;
- A $10.3 million settlement with a medical company and its owner for violating Medicare billing rules; and
- A $20 million settlement with a government contractor and its former president for misrepresenting its status as a woman-owned small business.

<u>Implications for Director and Officer Protection</u>

The government's focus on individual accountability has substantial implications for the defense of corporate wrongdoing investigations and lawsuits. It also has substantial implications for how and by whom the costs associated with the defense are paid.

First, the Justice Department's focus on individuals and the benefits offered to corporations for disclosure of information concerning individuals creates an increased potential for conflicts between the interests of the corporation and its executives in cases in which they are jointly investigated, prosecuted, or sued by the Justice Department. The increased risk of conflicts is bound to lead to a proliferation of lawyers in these cases and an increase in defense costs. Each defendant will want separate counsel, and it may be dangerous for the individuals not to insist on it.

In addition, if the Justice Department makes good on its commitment to pursue individuals, irrespective of their ability to pay a judgment or settlement, the resolution dynamics in these cases could change substantially. Corporate indemnification and D&O insurance has worked so well in the past because both are built for a world in which monetary settlements are the rule rather than the exception. If the government brings civil cases to trial for a finding of liability, that very finding could have enormous implications for indemnification and D&O insurance. Under many current arrangements, individuals could be forced to repay the corporation or the insurance company for defense costs previously advanced, and the corporation and the individual may not be able to count on any contribution from insurers for the resolution of the case or related cases.

The Justice Department's focus on individuals also is likely to lead to more insurance disputes involving corporate executives. D&O policies work best for individuals when the individuals are able to freely settle a government or private action without any finding of liability. That type of resolution usually does not trigger a well-negotiated D&O policy's fraud and illegal benefit exclusions and seldom allows the insurer to recoup defense costs that it already has paid for the executive's defense. To the extent the Justice Department now seeks to pursue civil cases based on factors other than obtaining a monetary resolution, the Justice Department is more likely to drive cases to a finding or an acknowledgement of the executive's wrongdoing. Either would make it much more likely for an insurer to dispute coverage for the individual and seek to recoup sums already paid.

Before the Justice Department's new policy, directors and officers had only moderate concerns about the payment for the defense of corporate wrongdoing cases. Generally, the corporation's counsel (even when the individual executives had separate counsel) took the lead in the cases and effected settlements with the government and private plaintiffs that seldom required any contributions from the directors and officers. The director's or officer's separate counsel was paid for by the insurance company or the corporation. Because the cases usually settled without a finding or admission of liability on the part of the directors and officers, there was no fear that they would have to repay any defense costs.

The Yates Memo has created a new world. The focus on individuals, the increased pressure on corporations to provide information about their officers and directors, the pursuit of individuals irrespective of payment ability, and the concomitant proliferation of lawyers and potential for insurance disputes put executives at a very real risk that they may have a less than ideal defense or that they may have to repay amounts insurers or the corporation paid for their defense. Individual directors and officers should insist that their corporation's D&O programs are changed in ways that ensure the directors or officers have separate independent counsel to defend them in federal statutory cases, that the fees of that counsel are paid in full (rather than the portion an insurance company tries to get away with paying), and that, if the director or officer settles or suffers an adverse judgment, they will not have to repay any defense costs that they received from their company or the insurer.

<u>A Very Short Primer on Indemnification and D&O Insurance</u>

Corporations generally protect directors and officers through indemnification agreements (or corporate bylaw indemnification provisions) and D&O insurance.

Corporate indemnification agreements require corporations not only to indemnify directors and officers for their legal expenses, settlements, and judgments, these agreements also require the corporation to pay the legal fees in advance to the directors and officers to ensure they are adequately protected. There are three major concerns about the efficacy of indemnification agreements at protecting directors and officers. First, if the corporation is insolvent, it likely will not be able to indemnify the directors and officers. Second, to indemnify a director or officer, a corporation must first determine whether the director or officer acted legally, not opposed to the interests of the corporation, and in good faith. If there is substantial evidence (or an admission or judgment) of illegal conduct or self-dealing, a corporation may not be able to indemnify. Third, if a director or officer is held not to be entitled to indemnification, then the director or officer must repay the defense fees that the corporation previously advanced.

Most corporations also purchase two types of D&O insurance to protect their directors and officers: traditional D&O insurance and Excess Side-A Difference-in-Conditions D&O insurance ("Side-A DIC"). Traditional D&O insurance protects directors and officers in some circumstances in which their corporation cannot indemnify them, and it also protects the corporation from its own liability for securities claims and its liability to indemnify its directors and officers. Traditional D&O insurance, like corporate indemnification, requires the insurer to advance defense fees but also allows the insurer to recoup those fees in certain instances in which it is later determined that the director or officer was not entitled to the fees.

Side-A DIC insurance is often thought to be the insurance of last resort for directors and officers because it only protects them (and thus cannot be used by the corporation) and it is intended to apply in instances in which traditional D&O insurance may not. For example, Side-A DIC insurance may protect the director and officer when the traditional D&O insurers are insolvent or when their policies are held to be property of the corporation's bankruptcy estate. Typically, like traditional D&O insurance, Side-A DIC insurance allows the insurer to recoup previously advanced defense costs if it is determined that certain exclusions (such as the fraud and illegal benefit exclusions) apply and the director and officer is held not to have been entitled to the insurance. Some Side-A DIC insurers, however, have started offering endorsements that remove their ability to recoup previously advanced defense costs. Notably, Side-A DIC insurers receive substantial premiums, but are thought to be well-insulated from having to pay on their D&O policies for most D&O claims. They usually pay only when other D&O insurers and the corporation do not. The amount of premium paid and the remoteness of potential responsibility for a loss often makes Side-A DIC insurers willing to offer very broad coverage.

<u>The Yates Memo and Broadening your Side-A DIC Insurance</u>

In light of the Yates Memo, corporations and their directors and officers would be well advised to discuss the following changes with their Side-A DIC insurers. The changes are intended to broaden coverage in a way that provides protections to directors and officers against the risks posed by the Justice Department's focus on individual liability.

<u>Recoupment</u>

Efforts to recoup previously advanced defense costs are likely to increase with the Justice Department's focus on individual accountability. Directors and officers should have their corporation seek endorsements from their Side-A DIC insurers that protect against the risk of the corporation or another insurer or the Side-A DIC insurer seeking to recoup previously advanced defense costs from a director or officer. Not only should Side-A DIC insurers foreswear their ability to seek recoupment, they should protect the director or officer if the corporation or another insurer seeks recoupment. In a post-Yates Memo world, this change approaches necessity. There is absolutely no public policy against an insurer paying without recourse the defense costs of a person later found to be guilty or liable.

Separate Counsel

The Justice Department's individual accountability efforts increase the likelihood that a director or officer involved in a government investigation or lawsuit should have his or her own separate counsel. Many traditional D&O insurers put hurdles in the way of an executive obtaining separate counsel. Accordingly, directors and officers should have their corporations seek amendments to their Side-A DIC insurance that offer protection against the risk of another insurer refusing to provide a director or officer separate counsel when a civil action has been filed against the director and officer and others or the director or officer is being investigated.

Reasonable Fees

The Justice Department's individual accountability efforts also are likely to increase the defense costs insurers will have to pay in connection with corporate wrongdoing matters. If past is prologue, insurers are likely to seek to reduce these defense costs by contending that they will not pay hourly rates for lawyers greater than the amount that insurers ordinarily pay in other lawsuits. The problem with this approach is that lawyers who defend against corporate wrongdoing investigations and cases have specialized expertise, are usually employed at large national law firms, and command rates that are a multiple of the rates that insurers pay for other types of cases.

Insurers often have little basis under their D&O insurance policies to insist on lower-rate lawyers, but insurers nevertheless do so. This creates a great risk for directors and officers. They can either accede to the insurer just paying a portion of the defense costs or engage in protracted litigation with the insurers to pay reasonable rates. Before the Yates Memo, directors and officers often would accede to the unreasonably low rates and their corporation would make up the difference so that the directors and officers could retain experienced counsel. In the post-Yates Memo world, that approach is more dangerous because a director or officer is more likely to have to return previously advanced defense costs to the corporation. Accordingly, directors and officers should insist on their corporations seeking changes in their Side-A DIC insurance that protects against traditional D&O insurers refusing to pay the standard rates of the specialized lawyers that directors and officers typically hire to defend them against major government investigations and litigation.

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Hack That Thing: Physical Harms from Cyber Perils — Are They Covered?
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When Things Get Hacked: Coverage for Cyber-Physical Risks

John Buchanan & Dustin Cho[1]

Hardly a day goes by lately without a headline about some new and previously unheard of cyber hack — involving not a conventional computer network, but rather some industrial machine or household appliance, or even a child's toy. These novel cybersecurity vulnerabilities arise courtesy of what the National Institute of Standards and Technology ("NIST") refers to as cyber-physical systems or "CPS": "co-engineered interacting networks of physical and computational components."[2] As NIST further explains:

> "Other phrases that you might hear when discussing these and related CPS technologies include:
> – Internet of Things (IoT)
> – Industrial Internet
> – Smart Cities
> – Smart Grid
> – 'Smart' Anything (e.g., Cars, Buildings, Homes, Manufacturing, Hospitals, Appliances)."[3]

The problem with many of these "smart" things is that — for a variety of reasons, many of them admirable — their protections against unauthorized electronic access are not so smart. Hence the steady stream of reports about novel cyber hacks involving networked things. For example:

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[1] John Buchanan is a partner and Dustin Cho is an associate in the Washington, D.C. office of Covington & Burling LLP. The authors represent policyholders exclusively in coverage litigation. The opinions stated in this paper are those of the authors and should not be attributed either to their law firm or to its clients.

[2] Nat'l Institute of Standards and Technology, Cyber-Physical Systems Homepage, http://www.nist.gov/cps/ (Feb. 18, 2016).

[3] *Id.*

- WiFi remote-controlled toy drones,[4] and more ominously, both commercial and military drones[5];
- "smart" household appliances, including "smart" toilets[6];
- electronically-controlled functions in a Jeep — including its transmission[7]; and
- medical devices, including insulin pumps and pacemakers.[8]

A recent report titled "Business Blackout," prepared by Lloyd's and the University of Cambridge, hypothesized a cyber-physical hack with far more devastating consequences: one that brings down an entire "smart" power grid.[9] In this imaginary (but far too plausible) "Business Blackout" scenario, a cyber attack on a utility's industrial control systems disables or destroys multiple power generators, resulting in cascading losses throughout the blacked-out power grid and beyond.[10] These losses include not only first-party physical property damage and time-element loss for utilities and the customers who depend on them, but also third-party property damage and bodily injuries arising from the grid shut-down, and even looting and other social unrest, with accompanying liabilities for many of the businesses concerned.[11]

Meanwhile, in recent years, the cyber insurance market has exploded, as insurers have developed competing products and increased their capacity to meet burgeoning demand from a variety of sectors for protection from risks relating to electronic data losses or security breaches. More than 30 carriers now offer at least one cyber insurance product.[12] These products generally provide liability coverage for privacy-breach claims; many offer other coverage options

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[4] *See* RT, "SkyJack: Hacker-Drone That Can Wirelessly Hijack & Control Other Drones," https://www.rt.com/news/hacker-drone-aircraft-parrot-704/ (Dec. 6, 2013).

[5] *See* K. Moskvitch, "Are Drones the Next Target for Hackers?," *BBC*, http://www.bbc.com/future/story/20140206-can-drones-be-hacked?ocid=ww.social.link.email (Feb. 6, 2014).

[6] *See* Kashmir Hill, "Here's What It Looks Like When a 'Smart Toilet' Gets Hacked," *Forbes*, http://www.forbes.com/sites/kashmirhill/2013/08/15/heres-what-it-looks-like-when-a-smart-toilet-gets-hacked-video/ (Aug. 15, 2013).

[7] *See* Andy Greenberg, "Hackers Remotely Kill a Jeep on the Highway — With Me in It," *Wired*, http://www.wired.com/2015/07/hackers-remotely-kill-jeep-highway/ (July 21, 2015).

[8] *See* Tarun Wadhwa, "Yes, You Can Hack a Pacemaker (and Other Medical Devices Too)," *Forbes*, http://www.forbes.com/sites/singularity/2012/12/06/yes-you-can-hack-a-pacemaker-and-other-medical-devices-too/ (Dec. 6, 2012).

[9] Lloyd's Emerging Risk Report, *Business Blackout: The Insurance Implications of a Cyber Attack on the US Power Grid* (May 2015), *available at* http://www.lloyds.com/~/media/files/news%20and%20insight/risk%20insight/2015/business%20blackout/business%20blackout20150708.pdf.

[10] *Id*. at 11-13.

[11] *Id*. at 16-19.

[12] *See* Richard S. Betterley, *The Betterley Report: Cyber/Privacy Insurance Market Survey 2015*, at 18–23 (June 2015).

including coverage for response costs in the event of a data breach, media liability, first-party property (destruction of data), first-party theft of data, and cyber extortion.

The problem with most of the currently available cyber insurance products is this: They expressly *exclude* physical bodily injury and property damage. These are no doubt intended as "dovetailing" exclusions: to prevent the cyber policies from duplicating the coverage traditionally afforded by general liability and first-party property policies. But do those more conventional policies cover bodily injury or property damage when it arises from a cyber-related peril? In this paper, we discuss the nature and scope of bodily injury and property damage risks stemming from data security failures, and analyze the coverage options available to protect against such risks.

I. Cyber Risks of Bodily Injury or Property Damage.

As Lucy Thomson explains in her analysis of *Cyber Physical Risks*,[13] in the past fifteen years, several cyber attacks have caused significant property damage or bodily injury — and it is only a matter of time before more such attacks occur. Hackers have remotely derailed trains, pumped raw sewage onto public and private property, modified HVAC systems in hospitals with vulnerable patients, and disabled oil pipeline leak-detection systems and nuclear power plant safety monitoring systems.[14] In 2014, the German government released a report that hackers manipulated the control systems at a German steel mill that prevented a blast furnace from shutting down properly, resulting in "massive" (but unspecified) damage.[15] And most recently, in December 2015, a hacker group caused a widespread power outage in Ukraine for several hours, potentially causing property damage and cutting off heat for tens of thousands of people.[16]

In addition to headline-grabbing attacks like these on critical infrastructure and industrial control systems, the burgeoning Internet of Things — networked consumer products and devices, from children's toys to kitchen appliances to medical devices, numbering over 50 billion objects by some estimates and growing daily — presents new potential risks for cyber attacks causing physical harm. These risks may be relevant to an ever broadening range of policyholders, including the growing ranks of companies that manufacture or use such products.

II. Liability Insurance Coverage for Bodily Injury or Property Damage Caused by Cyber Attacks.

Although cyber insurance is now widely available, nearly all of the widely available cyber insurance products currently exclude third-party liability coverage for bodily injury and property damage. A common explanation provided for this near-universal exclusion is that

[13] Lucy L. Thomson, *Cyber Physical Risks*, ABA Litigation Section Insurance Coverage Litigation Committee (2016).

[14] *See id.* at 7–9.

[15] *See id.* at 12.

[16] *See id.* at 9–10.

"such losses are covered under CGL . . . policies."[17] But in fact, many recent CGL policies now incorporate their own cyber-related exclusions — the scope of which is not always clear.

A. Commercial General Liability Policies

Over the past fifteen years, Coverage A (the bodily injury and property damage liability coverage part) of the standard CGL policy has been revised several times with respect to cyber-related risks. First, in 2001, the standard CGL policy was revised to state that damage to electronically stored data would not be considered damage to tangible property.[18] Next, in 2004, the standard CGL policy was revised to exclude "[d]amages arising out of the loss of, loss of use of, damage to, corruption of, inability to access, or inability to manipulate electronic data." Thus, damage to physical property caused by loss of electronic data was excluded by this "Exclusion P."[19] In 2013, the standard CGL policy added a sentence to Exclusion P that carved out from the exclusion any "liability for damages because of 'bodily injury.'"[20] That is to say, coverage was *preserved* for bodily injury arising out of the loss of electronic data.

In May 2014, the Insurance Services Office (ISO) published two versions of an endorsement that revises Exclusion P: one with a "limited bodily injury exception" and one without. (Excerpts from these endorsements are appended to this paper.[21]) The latter

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[17] Robert Bregman, "Cyber and Privacy Insurance Coverage," 37 IRMI, *The Risk Report*, no. 11, July 2015, at 1 ("The [cyber] policies exclude claims alleging bodily injury and property damage because such losses are covered under CGL/property insurance policies.").

[18] The 2001 Insurance Services Office CGL policy form added the following two sentences to the definition of "property damage":

> "For the purposes of this insurance, electronic data is not tangible property. As used in this definition, electronic data means information, facts or programs stored as or on, created or used on, or transmitted to or from computer software, including systems and applications software, hard or floppy disks, CD-ROMS, tapes, drives, cells, data processing devices or any other media which are used with electronically controlled equipment."

Note that property damage is defined as physical injury to tangible property (including resulting loss of use of that property) and loss of use of tangible property that is not physically injured. *See* ISO Properties, Inc., *Commercial General Liability Coverage Form, CG 00 01 10 01* § V.17, at 15 (2000).

[19] *See* ISO Properties, Inc., *Commercial General Liability Coverage Form, CG 00 01 12 04* § I.A.2.p, at 5 (2003). The definition of "electronic data" used in this exclusion was the same as the definition of "electronic data" that the 2001 standard CGL policy had introduced in its definition of "property damage."

[20] *See* Insurance Services Office, Inc., *Commercial General Liability Coverage Form, CG 00 01 04 13* § I.A.2.p, at 5 (2012).

[21] ISO also published a third version that applies only to Coverage B (and thus omitting the revisions to Exclusion P in Coverage A). *See* Insurance Services Office, Inc., *Exclusion —*

endorsement in part reverts to the 2004 variant of Exclusion P — simply excluding any damages arising out of the loss of electronic data, regardless of whether the damages are because of bodily injury or property damage.[22] The former endorsement in part adheres to the 2013 edition of Exclusion P, which carves out of that exclusion damages because of bodily injury.[23] What's new and identical in both endorsements is the addition of what is numbered Paragraph (1) of Exclusion P — an exclusion for all damages (whether because of bodily injury or not) arising out of "[a]ny access to or disclosure of any person's or organization's confidential or personal information, including patents, trade secrets, processing methods, customer lists, financial information, credit card information, health information or any other type of nonpublic information."[24]

1. Paragraph (1): "Access to . . . Nonpublic Information."

On its face, this new exclusion in Paragraph (1) of Exclusion P appears to be aimed solely at data breaches of private information, and would not go so far as to exclude traditional, physical bodily injury and property damage whenever the cause happens to involve an intruder accessing nonpublic data. But the terms "access to" and "nonpublic information" are undefined. In isolation, they are sufficiently unclear that an aggressive insurer might argue, for example,

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Access or Disclosure of Confidential or Personal Information (Coverage B Only), CG 21 08 05 14 (2013).

[22] The "limited bodily injury exception not included" endorsement states in relevant part:

> "This insurance does not apply to: . . . Damages arising out of: (1) Any access to or disclosure of any person's or organization's confidential or personal information, including patents, trade secrets, processing methods, customer lists, financial information, credit card information, health information or any other type of nonpublic information; or (2) The loss of, loss of use of, damage to, corruption of, inability to access, or inability to manipulate electronic data."

Insurance Services Office, Inc., *Exclusion — Access or Disclosure of Confidential or Personal Information and Data-Related Liability —Limited Bodily Injury Exception Not Included, CG 21 07 05 14* (2013).

[23] The "limited bodily injury exception" endorsement states in relevant part:

> "This insurance does not apply to: . . . Damages arising out of: (1) Any access to or disclosure of any person's or organization's confidential or personal information, including patents, trade secrets, processing methods, customer lists, financial information, credit card information, health information or any other type of nonpublic information; or (2) The loss of, loss of use of, damage to, corruption of, inability to access, or inability to manipulate electronic data. . . . However, unless paragraph (1) above applies, this exclusion does not apply to damages because of 'bodily injury'."

Insurance Services Office, Inc., *Exclusion — Access or Disclosure of Confidential or Personal Information and Data-Related Liability — With Limited Bodily Injury Exception, CG 21 06 05 14* (2013).

[24] *See* notes 22 and 23 above.

that a hospital's or a medical device manufacturer's liability for bodily injury caused by alteration of a patient's dialysis machine settings would constitute excluded damages because they arose out of "access to . . . any person's health information or any other type of nonpublic information."

In context, the better interpretation of this exclusion is that it does not stretch so far as to encompass all traditional bodily injury and physical damage caused by hacking of industrial control systems, malicious or negligent alteration of medical device settings, or other types of access to nonpublic electronic data that regulates networked "things." This is so for several reasons:

- *"Nonpublic Information." — First*, the settings and controls of devices and machinery, though not necessarily accessible to the "public," are not reasonably construed as the types of "nonpublic information" contemplated by the exclusion. The interpretive canon of *ejusdem generis*[25] instructs us that when a series of items in a list all share a certain core characteristic, a "catchall" term at the end of the list should not be read to extend unreasonably broadly beyond what the more specifically listed items have in common. In these endorsements, all of the listed types of "nonpublic information" are primary examples of traditionally confidential information whose confidentiality is recognized, and protected, by law.[26] Networked device settings and machine instructions do not generally enjoy either legal or popular recognition as inherently private information. Such data are qualitatively different from "trade secrets, processing methods, customer lists, financial information, credit card information, [and] health information." Accordingly, the catch-all term "and any other nonpublic information" in the exclusion endorsements should be read to capture other categories of information whose confidentiality is recognized under and protected by the law. It cannot reasonably be construed to sweep so far beyond the other listed terms as to encompass electronic control systems.

This reading is reinforced by the statement in both endorsements that lists examples of the damages to which the exclusion applies — all of which are damages associated specifically with data privacy breaches:

> "This exclusion applies even if damages are claimed for notification costs, credit monitoring expenses, forensic expenses, public relations expenses or any other loss, cost or expense incurred by you or others arising out of that which is described in Paragraph (1) or (2) above."

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25 "Under the principle of *ejusdem generis*, when a general term follows a specific one, the general term should be understood as a reference to subjects akin to the one with specific enumeration." *Norfolk & W. Ry. Co. v. Am. Train Dispatchers Ass'n*, 499 U.S. 117, 129 (1991).

26 The exclusion's list of various types of "confidential information" necessarily starts after the first term, "patents." The presence of this term in the exclusion can only be attributed to sloppy or uninformed drafting, because a defining characteristic of patents is that they are publicly disclosed.

All of these types of expense have become common responses to data breaches, and indeed it is difficult to conceive how the first two items in the list — notification costs and credit monitoring expenses — could arise in the event of traditional physical bodily injury or property damage. This passage's focus on privacy-breach damages reinforces the conclusion that the exclusion was intended only for privacy-related liabilities and does not extend to physical harm that happens to have resulted from a malfunctioning electronic device.

- *"Access To." — Second*, although manipulation of a machine or device's settings may involve "access to" those settings, the scenarios we are concerned with do not "aris[e] out of" the access to the data that comprises those settings (much less their "disclosure" to the public). Rather, they arise out of the overwriting or overriding of that data — whether intentionally (through hacking) or unintentionally (through user error or programming bug). In context, the exclusion for damages "arising out of . . . [a]ny access to or disclosure of . . . nonpublic information" means damages arising out of *obtaining* nonpublic information — the type of damages that typically arise from privacy breaches. When the hacking of industrial control systems or networked devices results in physical harm, by contrast, the originating cause is not the *obtaining* of nonpublic information, *i.e.*, the prior, correct settings for the machinery or devices in question; rather it is the introduction of new instructions that override the original settings. For example, a hacker could alter a dialysis machine's settings even if he could not read the "information" in those settings before he overwrote them. Likewise, a hacker could disrupt a digital signal that provides instructions to a networked device without necessarily receiving or decoding the original intended signal. The types of hacking that affect the operations of networked devices do not arise out of accessing any *data* relating to those devices, which is what the exclusion requires. It is immaterial that the physical harms in these scenarios arise out of someone's access to the *system or location* where the "nonpublic information" is stored. What causes the harm is the new, erroneous digital settings or instructions that replace the original settings or instructions. Whether or not those original, correct settings are considered "nonpublic information," the intruder's access to the substantive content of that original information is essentially beside the point: the harm arises from the newly introduced malicious information. Therefore, the physical harms do not arise from access to the "nonpublic information" itself, and the exclusion does not apply.

- *Extrinsic Evidence. — Third*, reading this exclusion broadly to remove from coverage all sorts of traditional bodily injury and property damage merely because an early link in the causal chain of events involved "access to . . . nonpublic information" would be inconsistent with insurers' contemporaneous explanations of this endorsement. The memorandum that ISO submitted to regulators explaining its adoption of these endorsements states that "damages related to data breaches, and certain data-related liability, are not intended to be covered under the abovementioned coverage part. These types of damages may be more appropriately covered under certain stand-alone policies including, for instance, an information security protection policy or a cyber liability policy."[27] Although the memorandum also notes that the endorsement

[27] Insurance Services Offices, Inc., *Access or Disclosures of Confidential or Personal Information Exclusions Introduced*, Commercial Lines Forms Filing CL-2013-ODBFR, at 7, 8 (2013), *available at* http://www.serff.com/index_sfa.htm.

without the "limited bodily injury exception" would "result in a reduction of coverage," the memorandum is clear that this statement applies only to the extent that that endorsement reverts from the 2013 amendment of Exclusion P with respect to the loss of electronic data.[28] ISO's express intent not to reduce coverage, and to limit the new exclusion to the types of risks that are covered by common cyber liability policies, is consistent with an ISO executive's explanation at the time the endorsements were introduced, suggesting that the new exclusions were intended to dovetail with coverage available under freestanding cyber policies.[29] Neither the freestanding ISO cyber policies he referenced nor any other commonly available cyber policy form provides coverage for traditional physical bodily injury and property damage caused by rogue electronic devices.

2. Paragraph (2): "Loss of . . . Electronic Data."

The exclusion numbered Paragraph (2) of Exclusion P uses the same language used in CGL policies since 2004 to exclude damages arising out of "[t]he loss of, loss of use of, damage to, corruption of, inability to access, or inability to manipulate electronic data." As noted above, since 2014 this exclusion comes in two different versions. The "limited bodily injury exception" formulation, like the 2013 standard CGL policy, expressly does not apply to damages because of bodily injury. The other version, like the 2004 standard CGL policy, contains no such express carve-out for bodily injury. In both formulations, as with Paragraph (1), the language of this Paragraph (2) exclusion is unclear with respect to coverage for physical harms arising from hackers overwriting or overriding the controls of electronic devices.

Setting aside the lack of an express bodily-injury carve-out in one of the forms (which clearly preserves coverage for bodily injury despite Paragraph (2)), the plain language of the exclusion focuses on the *loss* of data, which does not necessarily occur in a cyber attack — and even where it does occur, any physical harms that are caused by the hacker altering the behavior of a machine or device do not result from lost data, but rather from the hacker's introduction of *new* instructions. However, an aggressive insurer might argue that a hacker overwriting the instructions for a device constitutes "damage to" or "corruption of" data; or that a distributed

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[28] *See id.* at 8 ("However, when this endorsement is attached, it will result in a reduction of coverage *due to the deletion of an exception* with respect to damages because of bodily injury arising out of loss of, loss of use of, damage to, corruption of, inability to access, or inability to manipulate data.").

[29] *See* "ISO Comments on CGL Endorsements for Data Breach Liability Exclusions," *Insurance Journal*, July 18, 2014, *available at* http://www.insurancejournal.com/news/east/2014/07/18/332655.htm (quoting Ron Biederman, assistant vice president, Commercial Casualty at ISO as explaining that the endorsements arose because: "As the exposures to data breaches increased over time, standalone policies started to become available in the marketplace to provide certain coverage with respect to data breach and access to or disclosure of confidential or personal information. For instance, ISO Information Security Protection Policy EC 00 10 contains both first and third party coverage through eight separate insuring agreements which address data breach and other cyber-related exposures.").

denial of service attack or other disruption of the transmission of instructions to a device constitutes “inability to access” or “inability to manipulate” data.

Again, like Paragraph (1), Paragraph (2) should be read in context, so that this exclusion does not swallow up coverage for all traditional bodily injury and property damage, merely because a cyber attack is a direct or indirect cause of that injury or damage.

Some cyber attacks that cause physical harm arise out of the hacker’s introduction of new data, such as a new script to control the device. Although such an attack may incidentally involve the overwriting of data, the physical harm does not “arise out of” the loss of the original data. Nor can such harm be considered to be caused by “damage to” or “corruption of” data. Following the principle of *noscitur a sociis*,[30] those terms should be interpreted in light of the other terms in the list: “loss of,” “loss of use of,” “inability to access,” and “inability to manipulate.” All of these terms focus on the presence or absence of the original data, not on the harmful effects from the introduction of new, malicious data. Accordingly, harm arising out of such new data does not arise out of “damage to” or “corruption of” the old data within the meaning of this exclusion.

Other cyber attacks, however, may not depend upon the introduction of new data, but rather may involve destruction or disruption of network transmissions or device instructions. Paragraph (2) is ambiguous as to whether physical harms resulting from these types of attacks are excluded from coverage. Ultimately, the question of coverage for such attacks may be fact-intensive and depend upon a careful analysis of how the harm arose: *i.e.*, whether or not the significant cause was the “loss of” data or an “inability” to access or manipulate data.

B. Other Coverage Solutions

Given the foregoing ambiguities with respect to CGL coverage and the growing potential for exposure, many policyholders may want to purchase clearer coverage for risks of physical harm from cyber attacks. One option is a difference-in-conditions cyber insurance policy that drops down and pays losses caused by a security failure that are not covered by an underlying policy due to a cyber exclusion. AIG’s CyberEdge PC is one of the few products of which we are aware that currently offers such coverage. However, other coverage options may soon be available in the rapidly evolving insurance market for cyber-related risks.

III. First-Party Property

With respect to first-party property policies, common exclusions may create significant gaps in coverage for certain physical harms resulting from cyber attacks. In particular, the Lloyd’s Underwriters Non-Marine Association (NMA) forms NMA 2914 and 2915 exclude from coverage “loss, damage, destruction, distortion, erasure, corruption or alteration of ELECTRONIC DATA from any cause whatsoever (including but not limited to COMPUTER

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[30] “[W]e rely on the principle of *noscitur a sociis* — a word is known by the company it keeps — to ‘avoid ascribing to one word a meaning so broad that it is inconsistent with its accompanying words . . . .’” *Yates v. United States*, 135 S. Ct. 1074, 1085 (2015) (quoting *Gustafson v. Alloyd Co.*, 513 U.S. 561, 575 (1995)).

VIRUS) or loss of use, reduction in functionality, cost, expense of whatsoever nature resulting therefrom." They define the term "COMPUTER VIRUS" as "a set of corrupting, harmful or otherwise unauthorised instructions or code including a set of maliciously introduced unauthorised instructions or code, programmatic or otherwise, that propagate themselves through a computer system or network of whatsoever nature." (The NMA forms except damage directly caused by fire or explosion from these electronic data exclusions.)

Another London Market form, LMA 3030, excludes from property terrorism insurance "[l]oss or damage by electronic means including but not limited to computer hacking or the introduction of any form of computer virus or corrupting or unauthorised instructions or code or the use of any electromagnetic weapon."[31] The ambiguity of the phrase "by electronic means" is only heightened by the form's "carve-out" for losses "arising from the use of any computer, computer system or computer software programme or any other electronic system in the launch and/or guidance system and/or firing mechanism of any weapon or missile." (Arguably, that carve-out might suggest that even damage from a car bomb would be excluded from coverage if the car had electric steering — clearly an unreasonable interpretation.)

Although such standard-form exclusions may create coverage gaps for physical harms from hacked systems, they may not appear in the manuscripted policies or insurer proprietary forms typically sold to large corporate policyholders — or they may be negotiable. The emerging risk of physical property damage arising from hacking of networked devices discussed in this paper is yet another reason why insurance buyers — and their brokers — need to scrutinize property policy forms thoughtfully.

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In sum, both insurers and insureds are confronting a relatively novel set of risks: old-fashioned physical harms arising from newfangled cyber perils. Insureds confronted with these cyber-physical losses will undoubtedly argue that they should be covered under their conventional all-risk general liability and first-party property policies. Puzzled insurer-side claims handlers may well look for reasons why these novel risks — which their actuaries may never have priced into policy premiums — should fall outside the scope of conventional policy terms.

To address these new issues, insureds would be well advised to take the following steps:

- *Understand the cyber-physical risks involved*: This means surveying the industrial control systems and other networked "smart" devices that the insured either manufactures or uses in its own operations; hardening the cybersecurity of those systems and devices; and thinking through the potential consequences if those cybersecurity measures fail, affording a hacker unauthorized access.

[31] Lloyd's Market Association, *Terrorism Insurance Physical Loss or Physical Damage Wording*, LMA 3030 (Sept. 1, 2006), *available at* http://www.lmalloyds.com/LMA/Wordings/lma3030.aspx.

- *Understand how all policy language will respond to those risks*: This means at a minimum closely reading the policy terms under cyber, general liability, property and any other potentially applicable lines of coverage, such as E&O and D&O. Do the "dovetailing" exclusions actually dovetail? Or do they leave gaps — whether because they contemplate protection from another line of coverage that in fact has a reciprocal exclusion, or merely because the terms of the coverage grant in one line do not align intelligently with the exclusion in another?

- *If possible, plug the gaps and clarify the coverage grants*: Some buyers of insurance may be able to negotiate changes in their existing lines of coverage that clarify coverage specifically for cyber-physical risks. Others may need to explore the purchase of new specialty coverage solutions, such as difference-in-conditions excess coverage.

- *Expect disputes*: They are virtually inevitable at the claims stage with any previously unrecognized or underestimated risk. But attention to both the big picture and the nitty-gritty details at the underwriting stage may reduce the chances that cyber-physical losses will result in the next wave of coverage litigation.

APPENDIX:
EXCERPTS FROM ISO DATA-RELATED LIABILITY ENDORSEMENTS

Exclusion — Access or Disclosure of Confidential or Personal Information and Data-Related Liability — With Limited Bodily Injury Exception

Commercial General Liability CG 21 06 05 14

A. Exclusion **2.p.** of **Section I — Coverage A — Bodily Injury And Property Damage Liability** is replaced by the following:

2. Exclusions

This insurance does not apply to:

p. Access Or Disclosure Of Confidential Or Personal Information And Data-related Liability

Damages arising out of:

(1) Any access to or disclosure of any person's or organization's confidential or personal information, including patents, trade secrets, processing methods, customer lists, financial information, credit card information, health information or any other type of nonpublic information; or

(2) The loss of, loss of use of, damage to, corruption of, inability to access, or inability to manipulate electronic data.

This exclusion applies even if damages are claimed for notification costs, credit monitoring expenses, forensic expenses, public relations expenses or any other loss, cost or expense incurred by you or others arising out of that which is described in Paragraph **(1)** or **(2)** above.

However, unless Paragraph **(1)** above applies, this exclusion does not apply to damages because of "bodily injury".

As used in this exclusion, electronic data means information, facts or programs stored as or on, created or used on, or transmitted to or from computer software, including systems and applications software, hard or floppy disks, CD-ROMs, tapes, drives, cells, data processing devices or any other media which are used with electronically controlled equipment.

Exclusion — Access or Disclosure of Confidential or Personal Information and Data-Related Liability — Limited Bodily Injury Exception Not Included

Commercial General Liability CG 21 07 05 14

A. Exclusion **2.p.** of **Section I — Coverage A — Bodily Injury And Property Damage Liability** is replaced by the following:

2. Exclusions

This insurance does not apply to:

p. Access Or Disclosure Of Confidential Or Personal Information And Data-related Liability

Damages arising out of:

(1) Any access to or disclosure of any person's or organization's confidential or personal information, including patents, trade secrets, processing methods, customer lists, financial information, credit card information, health information or any other type of nonpublic information; or

(2) The loss of, loss of use of, damage to, corruption of, inability to access, or inability to manipulate electronic data.

This exclusion applies even if damages are claimed for notification costs, credit monitoring expenses, forensic expenses, public relations expenses or any other loss, cost or expense incurred by you or others arising out of that which is described in Paragraph **(1)** or **(2)** above.

As used in this exclusion, electronic data means information, facts or programs stored as or on, created or used on, or transmitted to or from computer software, including systems and applications software, hard or floppy disks, CD-ROMs, tapes, drives, cells, data processing devices or any other media which are used with electronically controlled equipment.

The Insurance Consequences of the Sharing Economy

Michael Barnes, Dentons US LLP

Mary McCutcheon, Farella Braun & Martel LLP

I. Insuring One's Risk As A Host Renter

As Bay Area residents prepared for thousands of football fans and media to descend on their region for last year's Super Bowl, one began to hear the sorts of rumblings that typically precede big events. Traffic will be terrible. Parking will be worse. Good luck getting a table at a restaurant. Oh, and good luck finding a place a sleep if you're from out of town.

Former Mayor Willie Brown had advice for the naysayers: rent your house! "Everyone is going to make a killing, including the private citizens who are smart enough to [rent] their homes."

The Super Bowl may not be the sharing economy windfall that Willie promised. But that doesn't mean host rental companies haven't made their mark in the Bay Area. From folks renting out in-law units as a way to keep pace with skyrocketing cost of living, to wealthy residents who spend months in Europe or Vail, short term rentals have become a way of life in most destination cities, including San Francisco.

While the broader policy discussion of the pros and cons of short term rentals often focuses on the impact this new market has on neighbors and communities, the focus for hosts and potential hosts is much more immediate: What risks do I run by having strangers pay to stay in my home, and do I have insurance for them?

Closing the insurance gap

Most typical homeowners and renters insurance policies exclude coverage for commercial use. As a result, a host's personal insurance probably won't pay for property damaged by a renter (i.e. first party coverage), or for damages suffered by a renter or third party allegedly caused by the host while hosting (i.e. third party coverage).

It has long been part of the host rental firms' business model to provide some measure of first party property protection. One company, with its "host guarantee" providing up to $1,000,000 to replace damaged property, has succeeded in assuaging many hosts' concerns that guests will destroy their homes.

Until recently, however, some may not be available if guests were injured on the property. If a guest damaged a host's expensive treadmill, the host might be able to get it replaced by the company. But if the guest fell off the treadmill and broke a leg, the host was out of luck.

In 2014, one company introduced a host protection insurance program, providing $1,000,000 of liability coverage for hosts, which has been updated and refined since then. The insurance now is typically primary, and is written on general commercial liability forms.

Making sure there is protection

Even if the host rental company provides insurance, hosts should make sure they have their own insurance coverage. The most important first step is to ensure that they don't void their existing insurance by hosting without telling their insurer. The should check their policies and accurately answer questions on their insurance application. In some cases, a failure to disclose the rental operation could result in a loss of all coverage, even for damage or liability that has nothing to do with hosting. The next step is to see if the insurance actually covers risks associated with hosting. If it doesn't (and it probably won't), the host should consider purchasing a new policy or a rider to the existing policy that does so. They always are safer having their own insurance, rather than depending solely on a policy from the hosting company. Finally, hosts should consider obtaining umbrella coverage that will respond to host-related risks. One million dollars sounds like a lot of coverage, but those limits can exhaust quickly if a young and healthy guest with a lifetime of future earnings ahead of her gets injured in the home.

One of the benefits of the rapid spread of the sharing economy is that insurers are responding to the new needs of the market. The old guard as well as some new players are rushing to provide insurance products targeted to the short term rental market. Most hosts, particularly those that own their homes, would be well advised to take advantage.

II. Transportation Network Companies

Although there are no specific regulatory requirements for home-sharing, and while pizza delivery guys have been an institution for decades, the same is not true for "ride-sharing" companies, which provide prearranged transportation services for compensation using an online-enabled application or platform to connect drivers using their personal vehicles with passengers. The space in which these companies operate has very heavily-regulated insurance requirements.

In California, the Public Utilities Commission created an entire separate classification for these companies: Transportation Network Companies ("TNCs"), found at www.cpuc.ca.gov/PUC/Enforcement/TNC/. The California Department of Insurance, in turn, has established a Three-Period Insurance Requirement for Auto Sharing:

1. Period 1 – App is open; driver waiting for a match. The TNC must carry minimum:
    - $50,000 for death or personal injury per person
    - $100,000 for death or property damage per incident
    - $30,000 property damage coverage

2. Period 2 – Match accepted, but passenger not yet picked up. TNC must carry minimum $1 million in coverage. Either the driver or the TNC can provide this insurance.

3. Period 3 – Passenger in vehicle and until passenger exits vehicle. In addition to the insurance specified in Period 2 above, $1 million in uninsured motorist coverage required.

Most of the debate in this regulatory framework revolves around "Period 1." The inclusion of "Period 1" insurance requirements, albeit with lower required limits, represents a compromise between regulators and TNC companies. The TNC companies contend that, during Period 1, no ride has been initiated, so arguably the risk should be borne entirely by the driver's personal insurance. But regulators contend a driver who is driving around waiting for a possible ride may be on the road, in high density areas, far more than the average driver. Thus, from a regulatory perspective, the driver may present a different class of risk and isn't in the same category as "ordinary" drivers.

There is also a nationwide debate concerning whether such drivers are employees (a debate which could easily apply to many sharing economy companies, not limited just to TNCs). From an insurance perspective, workers' compensation insurers need certainty. They agree to insure a company's entire workforce. If it turns out the company had more employees than the insurer thought when it issued the policy, then the insurer can usually do a premium audit to charge for that. But the right to conduct a premium audit expires after a period of time. If a court determines now that individuals classified as independent contractors four years ago were in fact employees, the workers' compensation carrier will be put in the position of having to pay compensation claims brought by employees for whom it was never able to collect premium.

There are also public safety and consumer protection concerns surrounding sharing economy companies. Both insurance regulators and consumer advocacy groups want to make sure that those who earn a living through the sharing economy understand the various potential insurance protections they are giving up: workers' compensation insurance, employer-provided health insurance, etc. In the case of TNC drivers and users, many do not understand how the available insurance products work and how they overlay with the driver's personal insurance. United Policyholders has conducted educational seminars for TNC drivers on this topic.

III. Policy Provisions And Case Authorities

While there is relatively little case law addressing sharing economy losses, existing case law is sufficient to raise concerns for both the policyholders and the insurers.

Ride Sharing Services

In the ride sharing area, there has long been a recognized exclusion for the use of vehicles as livery or commercial cargo purposes.

A typical auto exclusion provides there is no coverage for "bodily injury or property damage arising out of the ownership, maintenance or use of a vehicle while used to carry persons or property for a charge or while available for hire by the public." In *Farmers Ins. Exch. v. Knopp*, 50 Cal. App. 4th 1415 (1996), the insured was driving a car owned by his employer, a charter service that carried customers for hire. Customers would call the company, request transportation, and a driver and car would be dispatched to pick up the customer and transport him or her to a destination. After the passenger was dropped off, the driver would either proceed to another fare or return to the office at the direction of his dispatcher. When the accident occurred, the insured had dropped off a fare and was returning to the office, as he had been instructed to do. The court found that, although the insured had no passenger at the time of the accident, he was still involved in the *process* of carrying a person for a charge.

The *Knopp* court reasoned that there are three phases to the process of carrying a person for a charge: (1) the request for service and dispatching of the vehicle to pick up the customer; (2) the physical transportation of the customer as directed; and (3) the return of the transporting vehicle to its place of business or further dispatching to another site to pick up a new passenger. The *Knopp* court found those steps were intertwined, hence the automobile was being "used" to carry persons or property during all three steps. As a result, the "public livery" exclusion applied on those facts, even though the vehicle had no passengers.

Other cases have reached divergent results, depending on the specific facts of the claim. *Compare Allstate Ins. Co. v. The Normandie Club*, 221 Cal. App. 2d 103 (1963) (applying public livery exclusion where accident occurred while insured was transporting a small clientele of persons for a fee) *with Truck Ins. Exch. v. Torres*, 193 Cal. App. 2d 483 (1961) (exclusion held inapplicable where insured was driving tractor-trailer rig to his grandmother's house for a couple of days after delivering a load).

One open question is the extent to which such exclusions are enforceable. Some cases have construed subsection 11580.1(c) to set forth an exclusive list of exclusions allowed in automobile liability policies issued in California. *See*, *e.g., Hertz Corp. v. Home Ins. Co.*, 14 Cal. App. 4th 1071, 1078 (1993) ("[We] have examined the provisions of section 11580.1 and found nothing which would permit an insurer under a primary automobile insurance policy to exclude accidents caused by an intoxicated driver.") The "public livery" exclusion is not listed as a specific approved exclusion. In *Clarendon Nat. Ins. Co. v. State Farm Mut. Auto Ins. Co.*, 359 Fed. Appx. 734 (9th Cir. 2009), the court acknowledged that the "public livery" exclusion was not among the exclusions permitted by section 11580.1(c), but concluded that subsection 11580.1(b)(3) authorized the incorporation of other exclusions so long as the policy provides an "explicit description" of "the purposes for which coverage . . . is specifically excluded." The *Clarendon* court thus found the "public livery" exclusion met the requirements of section 11580.1(b)(3) and, as such, was enforceable.

For most drivers, the most important stage will be when their app is on but they have not accepted a ride, sometimes called the "standby period." In those cases, they might be in the *process* of driving for a fee and excluded from personal coverage under *Knopp*, yet not fully engaged so as to receive the full protection of the TNC's coverage. That said, most of the major auto insurers are now offering a supplemental "standby period" coverage for an additional premium that will fill this gap.

TNCs may seek to access their general liability, as opposed to auto liability, policies, for serious claims. The question of whether the auto liability exclusion in a GL policy applies to their liability may depend on the nature of the relationship between the driver and the TNC. If the driver is an employee, most auto liability exclusions will apply. If the driver is an independent contractor, however, the exclusion may not apply if it is limited to liability arising out of the use of a vehicle owned, operated, etc. by the insured TNC or its "employee". *See American States Inc. Co. v. Progressive Cas. Ins. Co*., 180 Cal. App. 4th 18, 28 (2009); *Cincinnati Ins. Co. v. Blue Cab Co., Inc*., 2015 U.S. Dist. LEXIS 40895 at *13-14 (N.D. Ill. 2015).

Home Rentals

As with the use of autos for a business or quasi-business (that is, income) purpose, standard personal lines policies for general liability risks (homeowners, renters, or condominium policies) may be ill-suited for the novel risks of the new economy.

Virtually all homeowners policies exclude "business" activities, typically defined as "any activity engaged in for economic gain including the use of any part of any premises for such purposes." Many policies specifically define "business" to include "any property rented or held for rental by an insured person." Patently, the rental of one's home for supplemental income would be "business" under this definition. And while some think that buying a personal umbrella policy will fill this gap, it will not: personal umbrella policies provide *personal* liability insurance, and exclude "business" activities just like primary policies do.

That said, policies typically contain two exceptions for the rental of the insured's residence when: (1) rented "occasionally" for residential purposes, or (2) a portion is rented to not more than two roomers or boarders. The disputes will be over the applicability of those two exceptions.

While all these cases will be decided on their specific facts, a couple of federal cases are instructive. In *Allstate Ins. Co. v. Sylvester*, No. 07-00360, 2008 WL 2164657 (D. Haw. May 21, 2008), the insureds owned and rented beach-front suites in Hawaii to tourists. The insureds purchased the rental property to be their residence in February 1990 and began renting it out six or seven years later. The insureds moved out of the property in April 2006, but stayed there on long weekends if there was a vacant room.

The insureds advertised the property on multiple websites, made approximately $125,000 in rental revenue in 2006, and rented the suites at approximately 806 times during a one-year policy period. The suites were rented every night in 2006 with an occupancy rate of 60%. In October 2006, an injured renter sued the limited liability company the insureds had created for the rental of the property.

The *Sylvester* court concluded that the property's "rental frequency was not 'occasional'" and the insureds were not the primary residents of the property at the time of the injury. *See also Raner v. Security Mut. Ins. Co*., No. 601409, 2011 WL 903192 (N.Y. Sup. Feb. 14, 2011) ("[T]he term 'premises occasionally rented . . .' is not ambiguous, and its plain and ordinary meaning refers to episodic, non-systematic rentals. . . . Dolan could not reasonably expect that her Cabana, which she had been renting every summer for over 20 years . . . was an occasional rental covered by the Policy."). Rather, the insureds in *Sylvester* "lived elsewhere, attempted to rent out suites on a full-time basis, and only stayed in a room on the insured property when it was unoccupied for a long weekend." Based on the definition of "occasional" as "[o]ccurring from time to time,"[n]ot habitual, infrequent," "irregular, "[n]ow and then; from time to time; sometimes," and the nature and frequency of the rentals for a ten year period, the rentals were not occasional. *See also Hess v. Liberty Mut. Ins. Co*., 458 So. 2d 71, 72 (Fla. App. 3 Dist. 1984) (though term "occasionally rented" was not defined in policy, it was not ambiguous and referred to "rentals occurring now and then").

In contrast is *Travelers Home & Marine Ins. Co. v. Liston*, No. 10-931, 2011 WL 4859191 (W.D. Penn. Oct. 13, 2011). In *Liston*, the insured purchased a property with the intent to renovate, "flip," and reside in it, but began renting the property in October 2008 to reduce its financial burden. According to the insured, he only rented the property on the weekends as a short-term rental, and he and his girlfriend would stay at the property during the week. When the property was not being rented, the insured and his girlfriend stayed at the rental property the majority of time, including nights, and somewhere in between 50% or less or 99% of the time. The insured marketed the rental property on multiple websites and renovated and separately rented a barn on the property. The court concluded that Travelers failed to show the insured's rental of his property was not occasional for four reasons: (1) the insured had the intent to return to the property after each rental; (2) the rentals did not "constitute a majority of the time," even when measured against a one-year policy period; (3) the rentals were short-term; and (4) the insured did not clearly rent out the property for business purposes but to reduce the home's financial burden on him. Apparently conceding the weakness of the last factor, however, the court reasoned that "no one factor is dispositive, and in this case the majority of factors weigh in favor of a finding that Liston's rental was 'occasional.'"

As with TNCs, the insurance industry is responding to these new needs, and some companies (such as Underwriters at Lloyd's) are offering insurance specifically designed for short-term rental operations. Because such insurance is considered commercial coverage, it does not exclude "business" activities as a homeowners policy does. Persons who regularly rent their homes are thus encouraged to make sure they have proper coverage. Although it is possible that their regular homeowners insurer might cover a short-term rental claim, those who plan to do without insurance designed for the risk will have to ask themselves Clint Eastwood's famous question from *Dirty Harry*: "Do I feel lucky?"

Rights of Insurers and Duties of Independent Counsel

By William T. Barker
Dentons U.S., L.L.P.
233 South Wacker Drive, Suite 7800
Chicago IL 60611
312-876-8140
Fax 312-876-7934
william.barker @dentons.com

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William T. Barker is a partner in the Chicago office of Dentons U.S. LLP, with a nationwide practice representing insurers in complex litigation, including matters relating to coverage, claims handling, sales practices, risk classification and selection, agent relationships, and regulatory matters. He sometimes serves as an expert witness on matters of insurance, professional responsibility and standard of care He is a co-author (with Ronald D. Kent) of INSURANCE BAD FAITH LITIGATION, SECOND EDITION and (with Charles Silver) of PROFESSIONAL RESPONSIBILITIES OF INSURANCE DEFENSE COUNSEL. He has been described as the leading lawyer-commentator on the connections between procedure and insurance. See Charles Silver & Kent Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 DUKE L.J. 255, 257 n.4 (1995).

Mr. Barker is a member of the American Law Institute and an Adviser to its project on the Restatement of the Law of Liability Insurance. He is a Special Advisor to the ABA Standing Committee on Ethics & Professional Responsibility. He is a past Director of the Association of Professional Responsibility Lawyers. He is Co-Chair of the Subcommittee on Ethics of the ABA Section of the Litigation Insurance Coverage Litigation Committee and a Vice Chair of the ABA Tort Trial & Insurance Practice Section ("TIPS") Committee on Insurance Coverage Litigation. He is TIPS Liason to the ABA Standing Committee on Lawyers' Professional Liability, a past Chair of the TIPS General Committee Board, the TIPS Ethics & Professionalism Committee, the TIPS Appellate Advocacy Committee, and the TIPS Robert B. McKay Law Professor Committee.

Chapter 14 Rights and Obligations When Policyholder Has Independent Counsel

SYNOPSIS

*** * * ***

§ 14.03 What Rights Do Insurers Have When Dealing with Independent Counsel?

[1] Insurers Are Entitled to Advance Consultation About Defense Expenditures and Activities

Once counsel has been selected, "[t]he *Cumis* rule requires complete independence of counsel."[1] (The *Cumis* rule is discussed in §§ 6.03 & 6.05, above.) "Cumis counsel represents solely the insured."[2] Counsel may select defense strategies disadvantageous to the carrier.[3] The insurance contract does not govern the relationship between the insurer and defense counsel. But counsel (especially counsel representing and answerable solely to the policyholder) could injure the policyholder's coverage by failing to act in accordance with the policyholder's duties under the policy (*e.g.*, by failing to communicate information the insurer is entitled to receive). At least as long as consulting with the insurer does not entail any substantial risk of harm to the policyholder, counsel's duties to the policyholder require counsel to engage in such consultation (if requested by the insurer) to avoid any risk of injuring the policyholder's coverage interests.

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CA—
State Farm Fire & Cas. Co. v. Superior Ct., 216 Cal. App. 3d 1222, 1226 (1989).

See also Mosier v. Southern Cal. Physicians Ins. Exchange, 63 Cal. App. 4th 1022, 1042 (1998).

2

US/CA—
Emp'rs Ins. Co. of Wausau v. Albert D. Seeno Constr. Co., 692 F. Supp. 1150, 1157 (N.D. Cal. 1988);

CA—
63 Cal. App. 4th at 1042; Assurance Co. of America v. Haven, 32 Cal. App. 4th 78, 87 (1995).

3

NY—
Nelson Elec. Contr. Corp. v. Transcontinental Ins. Co., 231 A.D.2d 207 (1997) (subcontractor policyholder did not breach duty of cooperation by having independent counsel forego claim against general contractor which would have reduced carrier's net liability, but required subcontractor to provide uninsured indemnity to general contractor, on the basis that the best defense strategy was to present a common defense against the injured workers).

Moreover, disclosure to the insurer of information relating to the representation is impliedly authorized to the extent necessary to avoid the risk of breaching the insurance policy, as long as disclosure does not endanger any policyholder interests and as long as the policyholder has not directed that such information be kept confidential. (See §§ 10.02 above, 14.04[3] below.)

Again, California Civil Code § 2860 codifies some of these obligations and imposes them directly on defense counsel:

> (d) 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 … .

In *Hartford Casualty Insurance Co. v. J.R. Marketing, L.L.C.*,[41] a concurring opinion noted that that existence of a conflict on some issues

> does not mean the insurer and insured are entirely at odds. Their interests remain aligned as to third party claims unaffected by the coverage dispute. And even as to the claims implicating that dispute, "[b]oth the insured and the insurer, of course, share a common interest in defeating the claims." The conflict exists only to the extent that "if liability is found, their interests diverge in establishing the basis for that liability."[1]

The independent counsel scheme created by § 2860,

> like its counterparts in other jurisdictions, contemplates that "an insurer can reasonably insist that independent counsel fully inform it of factual and legal developments related to the defense, consult with it on defense strategy and tactics, and consult with it before incurring major expenses in the course of the defense." Indeed, "[t]he insurer's advice, insight, or suggestions may prove valuable to the insured."[2]

These duties to disclose relevant information and to consult with the insurer seem especially well founded in the insurance contract. While a conflict of interest denies the insurer the right to direct counsel,[4] to receive information prejudicial to the policyholder on the subject of

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CA—

Hartford Cas. Ins. Co. v. J.R. Marketing, L.L.C., 61 Cal. 4th 988 (2015).

[1] 61 Cal. 4th at 1012 (Liu, J., concurring)

[2] 61 Cal. 4th at 1012 (Liu, J., concurring), *quoting* (Richmond, *Independent Counsel in Insurance,* 48 San Diego L.Rev. 857, 890 (2011) (footnotes. Omitted by Justice Liu.).

[4] *See*:

US/RI—

Hartford Cas. Ins. Co. v. A & M Assocs., Ltd., 200 F. Supp. 2d 84, 90 (D.R.I. 2002) (explaining that the insurer cannot control the litigation);

the conflict, and to impede actions beneficial to the policyholder on that issue, it does not eliminate the insurer's interest in the defense. The insurer still desires the most effective and efficient defense, as the insurer is still obliged to pay defense costs and may be required to pay any judgment or settlement. The policyholder is still bound by the contractual duty of cooperation except insofar as that duty is excused by the conflict. Moreover, the insurer retains the right to settle at its own expense and the right to deny payment of any settlement not approved by it. Exercise of these rights requires full and timely information, so the insurer can consider settlement opportunities and actions that may be necessary to fulfill any duty to the policyholder to accept reasonable settlement demands.

Moreover, the insurer should at least be entitled to make suggestions on defense options and decisions and to have the information necessary to do so. While the policyholder and defense counsel are not bound by any such suggestions, they cannot be harmed and may be helped by receiving them. As Dean Syverud observed with respect to common defense counsel guidelines, "[t]he advance consultation by defense counsel contemplated in the Guidelines is as minimal a form of cooperation as one can imagine."[5] "As long as the consultations do not reveal confidential information held by the insured that might be used to defeat coverage, allowing the insurer to consult on the defense cannot harm the insured."[6]

Consultation is valuable, in and of itself, in achieving an economical defense. Lawyers make money by delivering services. Their incentive is, therefore, to maximize service levels, which is antithetical to minimizing costs. "Even a lawyer who aims to provide only worthwhile defense efforts can subconsciously resolve doubts in favor of doing more, and so earning more."[7]

Consultation, even without an approval requirement, tends to restrain inefficient efforts:

> The lawyer's evaluation is sharpened by responding to the adjuster's comments and questions. Consultation also allows the claims staff to consider with counsel whether the effort proposed could safely be postponed, particularly when there is still a possibility of settlement.[8]

In short, consultation is valuable to the insurer and cannot be prejudicial to the policyholder (as long as any confidential information bearing on coverage is withheld from the insurer, as all agree it must be). Moreover, "[t]o the extent that such consultation avoids unnecessary discovery or motion practice, it also benefits the judicial system."[9]

WI—
Jacob v. W. Bend Mut. Ins. Co., 203 Wis. 2d 524, 536 (Ct. App. 1996) (explaining that unless the insurer is willing to accept coverage, it has no authority to affect independent counsel's defense of the insured).

[5] Kent D. Syverud, *The Ethics of Insurer Litigation Management Guidelines and Legal Audits*, 21 No. 7 INS. LITIG. REP. 180, 188 (1999).

[6] Douglas R. Richmond, *Independent Counsel in Insurance*, 48 SAN DIEGO L. REV. 857, 890–91 (2011).

[7] Opinion of Geoffrey C. Hazard, Jr., 15, *In re* Ugrin, Alexander, Zadick & Higgins, P.C., 299 Mont. 321 (2000) ("Hazard Op.").

[8] Hazard Op. 15; see Hazard Op. at 15–17 (expanding on the point)

[9] Hazard Op. at 4.

The Restatement of the Law of Liability Insurance provide such a right to consultation by stating that, when the insured has an independent defense, "[t]he insurer has the right to associate in the defense of the legal action,"[10] just as an excess insurer or other nondefending insurer would have.[11]

Even in a case which most severely restricted the insurer's use of prior approval requirements, it was conceded that requirements of advance consultation are permissible. At oral argument, Justice Gray had the following exchange with one of Petitioners' counsel, Robert James:

> *Mr. James:* Rule 1.8 is fairly straight forward. A lawyer shall not accept compensation for representing a client from one other than the client unless there is no interference with the lawyers independence of professional judgment. Rule 5.4 is very similar. It essentially says the same thing. A lawyer shall not permit a person who recommends, employs or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment. When the billing rules say that we need pre-approval to hire experts to conduct research to file a motion, to file pleadings, to engage in trial preparation or to decide how to staff a case we simply can't agree to do so. Why? Our position is that the plain and ordinary meaning of these ethical rules prohibit us from allowing an insurance company from directing and regulating our judgment to do so. It's just that simple.
>
> *Justice Gray:* Counsel, if the billing rules said "consult" instead of "approve," would they still violate the rules?
>
> *Mr. James:* No, I think that we consult with the insurance company all the time with insurance adjusters and tell them here's what we think should be done so I think that one of the things that the insurance companies can expect defense counsel to do is to consult with them and find out what our thinking is, why we are thinking [that] and in many cases an adjuster may say let me question you about that. Maybe this isn't a good thing at this particular time and maybe you will agree or maybe you will disagree.[12]

Advance consultation on substantial expenses may also lead the insurer to settle to avoid that cost or to withdraw its reservation of rights to regain control of the defense. Either of these results would be beneficial to the policyholder.

Were the insurer unaware that independent counsel was representing only the insured, the provision of legal advice to the insurer could result in creation of an attorney-client relationship

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[10] RESTATEMENT OF THE LAW OF LIABILITY INSURANCE § 17(4) (Tent. Dr. No. 1 April 11, 2016).

[11] *See* RESTATEMENT § 23(1)(b) (right to associate includes "[a]reasonable opportunity to be consulted regarding major decisions in the defense of the action that is consistent with the insurer's level of engagement with the defense of the action").

[12] Transcribed from tape of argument.

not intended by the lawyer[13] (and creating the very conflicts that the counsel's independence was intended to avoid). But that could occur only if the insurer had a reasonable belief that the lawyer was acting on its behalf, and the process by which independent counsel was retained ordinarily should negate any such expectation.[14] Any communication or consultation between independent counsel and the insurer is purely informational.[15] If there is any doubt about the lawyer's relationship with the insurer, the lawyer should clarify that the insurer is not a client. And, in some jurisdictions, the fact that the lawyer is independent counsel will automatically preclude existence of any attorney-client relationship with the insurer, without regard to the insurer's belief.[16]

[2] Insurers Are Entitled To Challenge Defense Expenditures and Activities That They Regard as Inappropriate and To Withhold Payment for Costs and Services They Have Not Approved

Even where there is a conflict of interest, an insurance policy is not a blank check, requiring payment by the insurer for whatever work defense counsel chooses to do. An insurer is entitled not to pay for services that are overpriced or inappropriate to the case.[17] The provider of

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[13] RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 14 (2000).

[14] *See*

CA—
Mosier v. S. Cal. Physicians Ins. Exch., 63 Cal. App. 4th 1022, 1043 (1998) (quoting First Pac. Networks, Inc. v. Atl. Mut. Ins. Co., 163 F.R.D. 574, 579 (N.D. Cal. 1995)).

[15]

CA—
63 Cal. App. 4th at 1043 (quoting First Pac. Networks, Inc. v. Atl. Mut. Ins. Co., 163 F.R.D. 574, 579 (N.D. Cal. 1995)).

See

US/WA—
Bell Lavalin, Inc. v. Simcoe & Erie Gen. Ins. Co., 61 F.3d 742, 748 (9th Cir. 1995) (status reports and confidential information about defense provided by independent counsel do not create any duty of loyalty to insurer).

[16]

OH—
Swiss Reinsurance Am. Corp. v. Roetzel & Andress, 163 Ohio App. 3d 336, at 1525 (2005) (concluding that conflict of interest precluded existence of attorney-client relationship between insurer and lawyer that it hired to defend insured).

[17] *See, e.g.,*

CA—
Center Found. v. Chicago Ins. Co., 227 Cal. App. 3d 547 (1991) (challenge to fees of Cumis counsel upheld in case where conflict of interest divests insurer of right to control defense); *see also* Caiafa Prof'l Law Corp. v. State Farm Fire & Cas. Co., 15 Cal. App. 4th 800 (1993) (same).

services is not the sole judge of their necessity.[18] Insurers must also be able to review all legal bills, including those submitted by independent counsel, to protect against fraud. For example, they must be able to determine that all services billed were actually performed, that lawyers are not turning expense items into profit centers by tacking surcharges onto them, etc.

So, sooner or later, a representative of the insurer must decide whether particular services are appropriate and should be paid for. A preapproval requirement simply requires that question to be addressed before the services are rendered instead of afterwards.

In other words, the insurer is entitled to challenge defense activities and expenditures it regards as excessive or inappropriate, and do so before they are executed, to the point of warning that it will not voluntarily pay for them. Accordingly, even where the policyholder is represented by independent counsel, insurers are still "entitled to apply billing Guidelines for purposes of obtaining the most effective, professional and efficient defense possible for their insureds."[19] But, while an insurer is entitled to some time to review and evaluate independent counsel bills that it is asked to pay, unreasonable delay in doing so can constitute a breach of the duty to defend.[19.1]

Of course, the insurer's refusal to pay does not end the matter. The policyholder can direct counsel to execute the disputed recommendations for expenses or activities, and counsel will be obliged to do so. Either before or after that is done, the policyholder or counsel can seek to collect from the insurer for those expenses or services. If a court or arbitrator finds the expenses or services appropriate, the insurer will have to pay.[20] Otherwise, the policyholder will have to pay, unless the inappropriateness of the expenses or services prevents counsel from collecting from anyone.

In short, neither party may sit as judge in its own case. If disputes cannot be compromised, they must be submitted to an outside adjudicator. Both sides must take account of

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18

CA—
Sarchett v. Blue Shield, 43 Cal. 3d 1, 8–10 (1987) (medical insurance, requiring payment for all "necessary" services; collecting cases from other jurisdictions).

19 Kent D. Syverud, *The Ethics of Insurer Litigation Management Guidelines and Legal Audits*, 21 No. 7 INS. LITIG. REP. 180, 187 (1999); *accord* Opinion of Geoffrey C. Hazard, Jr., 3–4, *In re* Ugrin, Alexander, Zadick & Higgins, P.C., 299 Mont. 321 (2000);

CA—
Pepsi-Cola Metro. Bottling Co. v. Ins Co. of N. Am., 2010 U.S. Dist. LEXIS 144401, at *32-34 (C.D. Cal. Dec. 28, 2010) (reduction of payments in accordance with billing guidelines was a premissible method of disputing reasonableness of fees).

19.1 **CA—**2010 U.S. Dist. LEXIS 144401, at *21–22.

20

CA—
A California statute provides for mandatory arbitration of fee disputes with independent counsel. CAL. CIV. CODE § 2860(c). If the policyholder contends that the insurer has breached the policy or acted in bad faith by prolonged delay in responding to the tender of defense, that dispute should be resolved by the court before compelling arbitration of the dispute about the amount of the fees. Janopaul Block Cos. v. Super. Ct., 200 Cal. App. 4th 1239, 1249–51 (2011).

the likely rulings of such an adjudicator on the facts presented, and disputes are unlikely to be pressed unless the parties have very different predictions about such a ruling.

Outright refusal to pay has significant risks for the insurer. If held to be incorrect, it may be deemed a breach of the duty to defend, freeing the policyholder from policy restrictions on refusal to settle and, in some jurisdictions, even subjecting the insurer to an estoppel to assert coverage defenses.[21] However, a California court has treated payment of independent counsel fees as a form of first-party benefit, meaning that an insurer is not subject to any extracontractual liability for withholding payment of amounts subject to a bona fide dispute.[22] To avoid these risks, an insurer may wish to advance the disputed funds, while reserving the right to seek to recoup them.[23] But the ability to recoup may be problematic where the policyholder is impecunious, and counsel may have defenses to recoupment not available to the policyholder. If recoupment is to be sought, the insurer should either (1) obtain an agreement that the advances will be returned if the insurer prevails in later litigation or (2) seek prompt adjudication of the propriety of the expenses or services in question. Failure to do one or the other may prevent recoupment even if the expenses or services might be found beyond the insurer's obligations to pay.

The Restatement of the Law of Liability Insurance provides that:

> In the event of a dispute during the course of the defense about the reasonableness of fees, either party should have the option of paying counsel under protest the difference between what the parties contend to be a reasonable fee, and counsel should have the option of receiving under protest what it regards as only a partial payment, and thereby defer the resolution of the reasonableness of the fees until after the duty to defend has ended and any coverage defenses have been adjudicated or settled, so as not to invade the attorney-client privilege or work-product immunity. [24]

Nothing in this alternate procedure regarding payment is inconsistent with a right to advance review of proposed defensive actions and to give notice if the insurer intends to dispute fees incurred to take what it regards as unnecessary or inefficient defensive actions.

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[21] *See* 3 Jeffrey E. Thomas & Francis J. Mootz, III, NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION §§ 16.03[3][g][iii], 17.02, 20.04[2][b].

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CA—
Behnke v. State Farm Gen. Ins. Co., 196 Cal. App. 4th 1443, 1470 (2011).

[23]

CA—
Buss v. Super. Ct., 16 Cal. 4th 35, 52 (1997).

See also William T. Barker & Ronald D. Kent, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION, § 2.11.

[24] RESTATEMENT OF THE LAW OF LIABILITY INSURANCE § 17, cmt. *b* (Tent. Dr. No. 1 April 11, 2016).

Apart from the possibility of freeing the policyholder to settle, an unreasonable refusal to pay could be the basis of a bad faith claim, as defense costs are a form of first-party benefit.[25]

[3] The Montana Supreme Court's Rejection of Prior Approval Requirements Is Unlikely to Be Applied in an Independent Counsel Context

The Montana Supreme Court has held that any requirement of prior approval impermissibly interferes with a lawyer's obligation to exercise independent judgment on behalf of the policyholder.[26] The decision was rendered with respect to ordinary defense counsel, and the concern that motivated it does not justify an extension of the holding to representations in which independent counsel represent policyholders. This is so because independent counsel recommend options to policyholders and follow policyholders' instructions. They do not follow insurers' instructions and, therefore, are not subject to insurers' prior approval. They may learn that an insurer will not willingly pay for a defense-related service they believe should be employed, but they are nonetheless entirely free to recommend the service to the policyholder, to perform it at the policyholder's request, to bill for it, and to help the policyholder sue for reimbursement. Independent counsel thus stands in the same position as any other lawyer whose client has arguable contractual rights against another party which the latter disputes.

The propriety of this conclusion is reinforced by the similarity of the procedure to that approved by the ABA Standing Committee on Ethics for cases in which counsel is not independent.[27] Its Opinion 01-421 assumes that the insurer has directed the lawyer to proceed in a particular way, rather than merely declining to pay for services the lawyer has recommended. Because actual direction of the lawyer creates no insurmountable problem, a mere threat to

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[25] *E.g.*:

US/CA—
Tibbs v. Great Am. Ins. Co., 755 F.2d 1370 (9th Cir. 1985);

CA—
Continental Casualty Co. v. Royal Ins. Co., 219 Cal. App. 3d 111 (1990);

ND—
Smith v. Am. Family Mut. Ins. Co., 294 N.W.2d 751 (N.D. 1980).

See also William T. Barker & Ronald D. Kent, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION, § 3.08[3].

[26]

MT—
In re Ugrin, Alexander, Zadick & Higgins, P.C., 299 Mont. 321 (2000).

See also discussion in § 14.03[1], above.

[27] The procedures approved in ABA Opinion 01-421 for handling particular conflicts in insurance defense representations appear to have been first recommended in Ellen S. Pryor & Charles Silver, *Defense Lawyers' Professional Responsibilities: Part I-Excess Exposure Cases*, 78 TEX. L. REV. 599, 644 (2000). But those procedures are logically implied by the conflicts rules applicable to all representations involving duties to multiple persons.

withhold payment can hardly do so.

Much of the ABA Opinion addresses what the policyholder must be told about a representation in which the insurer expects to exercise a power to direct counsel. No such requirements apply to an independent counsel representation, so they need not be discussed here.

If counsel believes that some insurer decision poses a substantial risk to the policyholder, counsel should point that out to the insurer and request reconsideration. If the insurer will not reconsider, then counsel must inform the policyholder, fully describe the risks and benefits, and inquire whether the policyholder will consent to having counsel proceed on the basis the insurer requests. The Tennessee Bar describes such a consultation as follows:

> Counsel should describe the decision and its risks and benefits from the standpoint of the insured. Of course, these will include whatever risks to the insured that counsel believes might result from the compliance. But objection to the insurer's directive would also have risks and therefore, where appropriate, counsel should point out that the insurer might take the position that any unjustified refusal to permit counsel to follow its direction would breach the insurance contract. If the insurer were correct in so contending[,] an objection would endanger the insured's coverage. On the other hand, if the insured permits counsel to follow the insurer's directive, the insured could also reserve the right to hold the insurer responsible for any resulting damage to the insured. (The insurer would be liable if the directive were found to breach its duties under the insurance policy.) The insured should be advised of the utility of obtaining independent counsel, at the insured's own expense, in considering whether to acquiesce in the insurer's directive (perhaps under protest). If the insured acquiesces, after being properly advised, counsel may comply with the insurer's directive.[28]

If the policyholder gives informed consent (perhaps coupled with a declaration of intent to hold the insurer responsible for any resulting injury), then counsel may comply with the insurer's direction. If the policyholder refuses to consent, then counsel cannot proceed in the way the insurer requests. If the insurer will not rescind the disputed decision, counsel must then withdraw. (A request to withdraw will necessarily involve the court, which may resolve any dispute between insurer and policyholder.)

In an independent counsel situation, there will be no possible need for withdrawal and no need to get the insurer's consent for proposed activities or expenses. The lawyer and the policyholder need only discuss whether to assume the risk of nonpayment and the burden of litigating for payment. If the policyholder is willing to advance the necessary funds or if the lawyer is willing to extend credit (possibly on a nonrecourse basis), they may proceed and pursue

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TN—
TENN. BD. OF PROF'L RESP., Formal Ethics Op. 2000-F-145, at 3.

the insurer later. In the meantime, the insurer remains obligated to continue funding agreed expenses and activities.

While the Montana Supreme Court presumably would reject the ABA analysis, its opinion is both distinguishable when the problem is presented in an independent counsel context and should be rejected by other courts even where it is not distinguishable. (See § 11.04, above.)

[4] An Insurer Is Entitled to Pay No More Than Market Rates for the Type and Quality of Service Reasonably Necessary to the Defense of the Case

In a few states, statutes regulate the fees that insurers must pay independent counsel. Thus, in California,

> [t]he 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 … .[29]

Absent such a statute, lawyers are still limited to charging fees permissible under the applicable Rules of Professional Conduct. Most such rules are based on ABA Model Rule 1.5:

> (a) A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses. The factors to be considered in determining the reasonableness of a fee include the following:

(1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;

(2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer;

(3) the fee customarily charged in the locality for similar legal services;

(4) the amount involved and the results obtained;

(5) the time limitations imposed by the client or by the circumstances;

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CA—
CAL. CIV. CODE § 2860(c).

See also

AK—
ALASKA STAT. § 21.96.100(d) (similar provision).

(6) the nature and length of the professional relationship with the client;

(7) the experience, reputation, and ability of the lawyer or lawyers performing the services; and

(8) whether the fee is fixed or contingent.[30]

In addition to the limits imposed by the Rules of Professional Conduct, the insurer has a right to have the insured make the selection in accordance with the contractual duty of good faith and fair dealing. As explained in *Center Foundation v. Chicago Insurance Co.*:[31]

> the duty of good faith imposed upon an insured includes the obligation to act reasonably in selecting as independent counsel an attorney qualified to present a meaningful defense and willing to engage in ethical billing practices at a standard stricter than that of the marketplace. Conduct arguably acceptable in the ordinary attorney-client relationship where the latter pays the former from his own pocket is not necessarily appropriate in the tripartite context created when independent counsel undertakes to represent the insured at the expense of the insurer.

Insurers are likely to argue that a reasonable fee for defense services is established by the rates charged by lawyers from whom the insurers regularly purchase similar services. In their view, the cost of defending the insured ought not to be increased by the fortuitous existence of circumstances entitling the insured to independent counsel.

But lawyers not regularly retained by the insurer obliged to pay for independent counsel may resist accepting payment at the rates that the insurer normally pays for similar services. Insurers are able to provide their regular counsel with a volume of work warranting a significant discount in the rates charged for that work. Independent counsel do not receive a similar volume of work. If they have adequate business at rates not affected by such a discount, they have no incentive to accept the discounted rates charged by firms the insurer regularly retains.

If the insurer were obliged to pay no more than its customary discounted rates, a policyholder seeking independent counsel might find it necessary to supplement the insurer's payments to obtain comparable counsel or accept the services of less able (and therefore less expensive) counsel than would normally be retained for the particular case. Accordingly, policyholders would argue that the insurer's customary discounted rates are not adequate or reasonable for independent counsel.

One argument sometimes made in support of limiting the insurer's obligation to payment of its customary rates is that providing a defense by independent counsel is a form of substitute performance where a conflict of interest has rendered the performance contemplated by the contract partially impracticable.[32] One commentator summarizes this argument as follows:

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[30] MODEL RULES OF PROF'L COND., Rule 1.5(a) (2011).

[31] Center Foundation v. Chicago Insurance Co., 278 Cal. Rptr. 13, 21 (Cal. Ct. App. 1991).

[32] *See* RESTATEMENT (SECOND) OF CONTRACTS § 270 (1981).

> because the conflict does not excuse the insurer's duty to defend, the doctrine of substitute performance should be understood to effectuate the terms of the contract, i.e., the insurance policy, without conferring an advantage on either party. "Substitute performance" should therefore be a minimal variation from the performance originally contemplated. This approach is said to track courts' general recognition that a party injured by a contract breach should receive the benefit of its bargain but never a windfall.
>
> Continuing, substitute performance advocates theorize that courts that allow an insured to select defense counsel and control the defense because of a conflict of interest rendering the insurer's duty to defend impractical are supplying a substitute for the carrier's performance so as to preserve the carrier's remaining contractual obligations. As a substitute for the carrier's duty to defend, it follows that the alternative performance must conform to the original. The insured's defense should not be funded at a level substantially lower than the defense the carrier otherwise would have provided so that the insured receives the benefit of its bargain, but nor should the insured's defense costs substantially exceed those which the carrier would have paid were it in control lest the insured be unjustly enriched. Therefore, the carrier cannot be obligated to pay independent counsel hourly rates greater than those it would pay panel counsel.[33]

This argument has a number of flaws. Most fundamentally, the doctrine of impracticability applies to excuse performance only where "a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made."[34] Nonoccurrence of a conflict of interest can hardly have been a basic assumption by the insurer: existence of conflicts in a significant number of cases and the need to provide a defense despite them is well known to insurers. Moreover, increased expense in performance generally is not considered to render performance even partially impracticable.[35] An insurer drafts the policy, and it could contractually specify limits on

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[33] Douglas R. Richmond, *A Professional Responsibility Perspective on Independent Counsel in Insurance,* 33 No. 1 INSURANCE LITIGATION REPORTER 5, 9 (2011).
[34] RESTATEMENT (SECOND) OF CONTRACTS § 261.
[35] Allan Farnsworth, CONTRACTS § 9.6, at 646 (3d ed. 1999).

See, e.g.:

US—
Carabetta Enters., Inc. v. United States, 482 F.3d 1360, 1366 (Fed. Cir. 2007) (finding that increased cost of performance did not make government agency's performance impracticable);

DC—
East Capitol View Cmty. Dev. Corp. v. Denean, 941 A.2d 1036 (D.C. 2008) (noting the rule).

the rates payable to independent counsel. If the insurer has failed to include such language, it can hardly claim surprise when it is called upon to pay more than its customary rates to retain independent counsel appropriate to the case. And the insurer is still protected by the limitation of the fees payable to a reasonable amount.[36]

Putting the matter succinctly, "while the substitute performance approach is superficially appealing, it quickly unravels when closely scrutinized."[37]

The policy promises the policyholder an adequate and appropriate defense to any suit seeking any relief that, if established, would be covered.[38] This is promised at no cost to the policyholder. To fulfill this promise, the insurer must be obliged to pay independent counsel fees equal to "the prevailing market rates in the relevant community" for the type and quality of services reasonably necessary for the defense of the particular lawsuit.[39] The market rate will

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But see

CA—
Habitat Trust for Wildlife, Inc. v. City of Rancho Cucamonga, 175 Cal. App. 4th 1306, 1341 (2009) (excessive and unreasonable expense may render performance impracticable).

[36] *See*

IL—
Mobil Oil Corp. v. Md. Cas. Co., 288 Ill. App. 3d 743, 759 (1997) (approving rate of $150/hour for independent counsel, even though insurer only paid its own, very experienced attorneys $94/hour).

[37] Douglas R. Richmond, *A Professional Responsibility Perspective on Independent Counsel in Insurance*, 33 No. 1 INS. LITIG. REP. 5, 10 (2011).

[38] 3 Jeffrey E. Thomas & Francis J. Mootz, III, NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 17.01; William T. Barker & Ronald D. Kent, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION, § 3.02[1]–[4].

[39]

US—
Blum v. Stenson, 465 U.S. 886, 900 (1984) (statutory fees under 42 U.S.C. § 1988).

See

NJ—
Aquino v. State Farm Ins. Co., 349 N.J. Super. 402, 415–16 (App. Div. 2002) (trial court must determine reasonable hourly rate and consider necessity of the work done);

NY—
Prashker v.U.S. Guar. Co., 1 N.Y.2d 584, 593 (1956) (independent counsel entitled to a reasonable fee).

See also RESTATEMENT OF THE LAW OF LIABILITY INSURANCE § 17, cmt. *b* (Tent. Dr. No. 1 April 11, 2016) ("The reasonableness of defense fees in relation to the complexity of the claim and the risks at stake is a fact question. What the insurer usually pays lawyers to defend similar claims is relevant but not dispositive. Law firms regularly retained by an insurer commonly accept reduced rates in return for a good supply of business. A lawyer providing an independent defense should not be required to accept the rates paid to the typically reflect the factors enumerated in Model Rule 1.5.

The market rate may or may not be the customary rate charged by the lawyer(s) the insured has chosen to retain, depending on whether it is appropriate to the case:

> not all cases are alike. The “novelty and difficulty” of a matter may be either factual or legal. A catastrophic injury, wrongful death, or professional liability case, for instance, is much different from a slip-and-fall or automobile case involving minor injuries. Insurers obligated to engage independent counsel chosen by an insured must acknowledge that the defense of difficult matters generally requires experienced and skilled lawyers and that such lawyers can command greater rates than lawyers who handle relatively minor or simple cases. Fortunately for all concerned, liability insurers, as professional litigants, understand this quite well. Most insurers factor the nature of a case into their defense assignments and they typically have strata of law firms on their panels. Thus, and by way of example, although Firms A and B on an insurer’s panel may receive simple cases to defend at very low hourly rates, Firms C and D are assigned complex matters or large losses, and are compensated at higher hourly rates.[40]

If a policyholder chooses to use more capable attorneys than the case requires, the policyholder may have to pay the extra cost beyond what would be required for less capable, but adequate attorneys. And disputes regarding the required level of capability (and the corresponding reasonable rate) may need to be adjudicated. Pending adjudication, insurer, policyholder, and lawyers need to have some agreement on payment of fees as the litigation proceeds.

[5] An Insurer’s Cost-Minimization Rights May Be Affected if It Breaches the Duty To Defend

[a] *Hartford Casualty Insurance Co. v. J.R. Marketing, L.L.C.*

[i] The Court of Appeal Decision

In *Hartford Casualty Insurance Co. v. J.R. Marketing, L.L.C.*,[41] a California court held

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insurer’s regular defense lawyers, unless the lawyer so regularly accepts other business at those rates that they represent the reasonable value of his or her services. On the other hand, the lawyer’s regular rates or amount of time spend on a matter may be excessive in relation to the complexity of the claim or the amount at stake in the matter.”).

[40] Douglas R. Richmond, *Independent Counsel in Insurance*, 48 SAN DIEGO L. REV. 857, 885 (2011) (footnotes omitted).

[41]

CA—
Hartford Cas. Ins. Co. v. J.R. Marketing, L.L.C., 216 Cal. App. 4th 1444 (2013), *rev'd in part*, 61 Cal. 4th 988 (2015).

that an insurer that had breached the duty to defend and had been required to pay its insured's independent counsel could not seek to recover from defense counsel the amount by which those fees were allegedly excessive. The California Supreme Court granted review and reversed,[41.1] depriving the court of appeal opinion of precedential weight. The description of that opinion is retained to identify and illuminate issues not addressed by the supreme court and as background for the supreme court's decision.

Hartford issued policies to J.R. Marketing, L.L.C. and Noble Locks Enterprises, Inc. Certain suits were tendered to Hartford for defense. Hartford initially refused a defense, but (after the policyholders filed suit) ultimately provided a defense under reservation; it refused to provide independent counsel. The trial court held that Hartford was obliged to provide independent counsel. It ordered Hartford to pay bills within 30 days of receipt, subject to a right to seek recovery of allegedly excessive or unnecessary amounts after resolution of the underlying action. However, it also held that, because of its prior breaches of the duty to defend, Hartford could not invoke the limits on hourly rates imposed by § 2860 of the California Civil Code.[42] Squire Sanders was retained as independent counsel.

After the underlying matter was resolved, the policyholders submitted legal bills totalling over $15 million, which Hartford paid and then filed a new action seeking recovery of allegedly excessive charges and charges for allegedly unnecessary services. Squire Sanders demurred to the complaint, challenging Hartford's claimed right to recover allegedly unjust enrichment resulting from payment of the disputed charges, and the superior court sustained the demurrer. (It denied demurrers filed by the policyholders.)[43] The court of appeal affirmed.

Reiterating conclusions it had reached in a prior, unpublished decision, it first stated that the billing rate limitations and arbitration right provided by § 2860

> come with an important caveat. " '[T]o take advantage of the provisions of [section] 2860, an insurer must meet its duty to defend and accept tender of the insured's defense, subject to a reservation of rights.' " When, to the contrary, the insurer fails to meet its duty to defend and accept tender, the insurer forfeits the protections of section 2860, including its statutory limitations on independent counsel's fee rates and resolution of fee disputes. More generally, "[w]hen an insurer wrongfully refuses to defend, the insured is relieved of his or her obligation to allow the insurer to manage the litigation and may proceed in whatever manner is deemed appropriate."[44]

[41.1] **CA—**Hartford Cas. Ins. Co. v. J.R. Marketing, L.L.C., 61 Cal. 4th 988 (2015).

[42] **CA—** 216 Cal. App. 4th at 1448–51.

[43] **CA—** 216 Cal. App. 4th at 1452.

[44] **CA—**

Because Hartford had refused the tender of defense, the court held that it was not entitled to the protections of § 2860.[45]

The court also recognized that Hartford had a right, after the underlying case was concluded to seek reimbursement of any defense expenditures solely allocable to noncovered claims.[46] However, that right is based on the law of unjust enrichment—a right that runs only against a party who has been unjustly enriched. In the court's view, the right to independent counsel

> "envisions an attorney pursuing an insured's defense independently of the insurer rather than intertwined with it." Thus, under this scheme, where, as here, the insurer breaches its duty to defend the insured, the insurer loses all right to control the defense, including, necessarily, the right to control financial decisions such as the rate paid to independent counsel or the cost-effectiveness of any particular defense tactic or approach. Retroactively imposing the insurer's choice of fee arrangement for the defense of the insured by means of a post-resolution quasi-contractual suit for reimbursement against the insured's separate counsel, such as Hartford seeks to pursue here against Squire, runs counter to these *Cumis*-scheme principles … .[47]

In addition to undercutting the policyholder's right to control the defense, allowing an independent suit against defense counsel would expand the insurer's dispute resolution rights as a result of its breach of its duty to defend. Had the breach not rendered § 2860 inapplicable, the insurer would be limited to proceeding in arbitration, and ought not to obtain the right to litigate as one fruit of its breach.[48] Moreover, Squire Sanders had not conferred a benefit primarily on Hartford, but rather on its (insured) clients. If they agreed to the payment of excessive or noncovered amounts, it is to them (rather than the law firm) that Hartford should look for reimbursement.[49]

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216 Cal. App. 4th at 1454–55 (citations omitted).
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CA—
216 Cal. App. 4th at 1455.
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CA—
216 Cal. App. 4th at 1455, *following* Buss v. Superior Court, 16 Cal. 4th 35, 50 (1997).
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CA—
216 Cal. App. 4th at 1457–58 (citations and foonote omitted).
[48]On this point, the opinion is a little schizophrenic: it had just correctly held the right to arbitrate to be a benefit to the carrier, which benefit was forfeited by breach of the duty to defend. Now it treats the right to litigate as a benefit which ought not to be acquired by breaching the duty to defend. More realistically, litigation is the inferior option remaining if the right to arbitrate has been lost.
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[ii] The Supreme Court Decision

The California Supreme Court narrowly defined the issue it had agreed to review:

> from whom may a CGL insurer seek reimbursement when (1) the insurer initially refused to defend its insured against a third party lawsuit; (2) compelled by a court order, the insurer subsequently provided independent counsel under a reservation of rights—so-called *Cumis* counsel—to defend its insured in the third party suit; (3) the court order required the insurer to pay all "reasonable and necessary defense costs," but expressly preserved the insurer's right to later challenge and recover payments for "unreasonable and unnecessary" charges by counsel; and (4) the insurer now alleges that independent counsel "padded" their bills by charging fees that were, in part, excessive, unreasonable, and unnecessary?[49.1]

CA—
216 Cal. App. 4th at 1458–60.

[49.1] **CA—**61 Cal. 4th at 992 (citations omitted). The court identified three questions that it did not decide:

> the trial court's 2006 enforcement order, requiring Hartford to promptly pay *Cumis* counsel's bills, specified that Hartford "is … not permitted to take advantage of Section 2860." Nevertheless, the order stated that counsel's bills "still must be necessary and reasonable" and that, "[t]o the extent Hartford seeks to challenge fees and costs as unreasonable or unnecessary, *it may do so* by way of reimbursement after resolution of the [Marin County action]." (Italics added.) In light of the 2006 enforcement order's express provision authorizing Hartford to seek reimbursement for excessive fees, we need not and do not decide here whether, absent such an order, an insurer that breaches its defense obligations has *any* right to recover excessive fees it paid *Cumis* counsel.
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> Next, section 2860 specifies that disputes concerning the fees charged by *Cumis* counsel are to be resolved by final and binding arbitration. In contrast, the 2006 enforcement order provided that any dispute over allegedly excessive fees would be addressed in a court action. Because the 2006 enforcement order is final and not subject to our review, and because Squire Sanders has raised no issue about the effect of section 2860's arbitration provision on the current litigation, we do not decide whether, in general, a dispute over allegedly excessive fees is more appropriately decided through a court action or an arbitration.
>
> Finally, because the 2006 enforcement order expressly stated that resolution of any fee dispute would take place *after* the underlying litigation concluded, we do not decide *when* such fee disputes generally ought to be decided relative to the underlying

It summarized its conclusion as follows:

> We conclude that under the circumstances of this case, the insurer may seek reimbursement directly from *Cumis* counsel. If *Cumis* counsel, operating under a court order that expressly provided that the insurer would be able to recover payments of excessive fees, sought and received from the insurer payment for time and costs that were fraudulent, or were otherwise manifestly and objectively useless and wasteful when incurred, *Cumis* counsel have been unjustly enriched at the insurer's expense. *Cumis* counsel provide no convincing reason why they should be absolutely immune from liability for enriching themselves in this fashion. Alternatively, *Cumis* counsel fail to persuade that any financial responsibility for their excessive billing should fall first on their own clients—insureds who paid to receive a defense of potentially covered claims, not to face additional rounds of litigation and possible monetary exposure for the acts of their lawyers.[49.2]

The court reasoned that if

> Squire Sanders's bills were objectively unreasonable and unnecessary to the insured's defense in the underlying litigation and that they were not incurred for the benefit of the insured, principles of restitution and unjust enrichment dictate that Squire Sanders should be directly responsible for reimbursing Hartford for counsel's excessive legal bills.[49.3]

Squire Sanders argued that it was only an incidental beneficiary of Hartford's performance of a preexisting contractual obligation. But Hartford did not simply perform its contractual obligation. That obligation was limited both by the 2006 enforcement order and by the rules of professional conduct to payment of reasonable costs. Nor did Hartford voluntarily pay the amounts billed, but did so under compulsion of court order. These facts negated any claim that any benefit to Squire Sanders was incidental.[49.4]

Squire Sanders also urged that allowing a claim for restitution against defense counsel would frustrate public policy by unduly interfering with the insured's attorney-client privilege and its absolute right to direct independent counsel's defense. The court again disagreed: "Although *Cumis* counsel must indeed retain the necessary independence to make reasonable choices when representing their clients, such independence is not inconsistent with an obligation of counsel to justify their fees."[49.5] Moreover, the governing statute specifically requires *Cumis*

> litigation. [61 Cal. 4th at 997 n.7]

[49.2] **CA—**61 Cal. 4th at 992–93.
[49.3] **CA—**61 Cal. 4th at 999.
[49.4] **CA—**61 Cal. 4th at 1000–01.
[49.5] **CA—**61 Cal. 4th at 1002.

counsel to justify their fees, albeit in arbitration, rather than litigation.[49.6] Squire Sanders argued that the arbitration process was "more collaborative," but the court noted there is an inherent degree of tension in any dispute resolution process and concluded that it "fail[ed] to see how the degree of tension in the relationship between Hartford and the insureds in this case—even if purportedly higher than in cases where section 2860 is triggered—meaningfully heightens any threat to *Cumis* counsel's independence."[49.7]

Squire Sanders also contended that section 2860 arbitration was less disruptive

> because it provides for contemporaneous resolution of fee disputes as they arise during the course of the underlying lawsuit against the insureds. Squire Sanders asserts that contemporaneous proceedings intrude less on counsel's independence than after-the-fact litigation, because a contemporaneous proceeding provides "real-time guidance to counsel about which activities [they] may undertake," without raising the concern that counsel will "hav[e] the rug pulled out from under [them] years after the fact by the insurer."[49.8]

The court found this point "speculative at best."[49.9] The statute does not dictate timing, and defense counsel might prefer to delay addressing billing issues, "insofar as this would allow counsel to devote their full attention to the insureds' defense while the third party suit is in progress, rather than becoming embroiled in side arguments with the insurer over fees."[49.10] But there was no need to resolve timing issues, because those were dictated here by the enforcement order, drafted by Squire Sanders and upheld on a prior appeal.[49.11]

Squire Sanders argued that the insured had exclusive authority to monitor and control counsel's expenditures and that it should bear the responsibility for any failure to do so, subject to a right of indemnity from counsel, The court rejected this argument because it

> all but ignores the realities of cases like the one before us. Squire Sanders acknowledges that the insureds in this case were not sophisticated, frequent litigators accustomed to monitoring their counsel's day-to-day litigation decisions. Having contracted with Hartford, and having paid premiums, to be spared the fees and expenses of their defense, there is no indication that the insureds had reasonable cause to expect that they would nonetheless face exposure if Squire Sanders submitted unreasonable and excessive bills to Hartford. Nor is there any indication the insureds expected that they would have to mount and finance a separate litigation against their own counsel in order to have any hope of recovering the funds they were ordered to pay to the

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[49.6] **CA—**61 Cal. 4th at 1002–03.
[49.7] **CA—**61 Cal. 4th at 1004.
[49.8] **CA—**61 Cal. 4th at 1004.
[49.9] **CA—**61 Cal. 4th at 1004.
[49.10] **CA—**61 Cal. 4th at 1004.
[49.11] **CA—**61 Cal. 4th at 1004.

> insurer as a result of counsel's unreasonable billing. Such a circuitous, complex, and expensive procedure serves neither fairness nor any other policy interest. We see no persuasive ground to hold that any direct liability to Hartford for bill padding by Squire Sanders must fall solely on the insureds.[49.12]

Squire Sanders also expressed the fear that if its client refused to waive attorney-client privilege, it might be unable to defend against Hartford's claim for fees. But there was no concrete indication that this would be necessary and, in any event,

> an objective assessment of the litigation as a whole to determine whether counsel's bills appear fundamentally reasonable is unlikely to involve an examination of individual attorney-client communications or the minute details of every litigation decision. If privileged information on these subjects is included in counsel's billing records, it can be redacted for purposes of assessing whether counsel's bills are reasonable. Trial courts are accustomed to dealing with claims of attorney-client privilege in a manner that balances the competing interests of the parties, and can thus presumably address any privilege issues that arise on a case-by-case basis.[49.13]

Justice Liu, in a concurring opinion, pointed out that there remained a significant issue as to the division of any liability to Hartford between Squire Sanders and J.R. Marketing. While the court assumed (in accordance with Hartford's allegations) that any unreasonable fees or unnecessary services conferred no benefit on J.R. Marketing, Squire Sanders was free to contest this assumption on remand. To the extent that any such fees or services were incurred for the benefit of J.R. Marketing,

> such fees necessarily fall outside the scope of today's holding. For that holding is premised on the dual assumptions "that Squire Sanders's bills *were* objectively unreasonable and unnecessary to the insured's defense in the underlying litigation *and* that they were not incurred for the benefit of the insured." On remand, it will be Hartford's burden to show not only that the fees it seeks to recover from Squire Sanders were not "*objectively reasonable at the time they were incurred*, under the circumstances then known to counsel" but also that the fees were not incurred for J.R. Marketing's benefit. If Squire Sanders's fees were unreasonable but incurred primarily for J.R. Marketing's benefit, Hartford's reimbursement action should lie against J.R. Marketing, not Squire Sanders.[49.14]

[iii] Analysis

Looking at the case solely in terms of the issue defined by the supreme court, the decision

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[49.12] **CA—**61 Cal. 4th at 1005.

[49.13] **CA—**61 Cal. 4th at 1005–06 (citations omitted).

[49.14] **CA—**61 Cal. 4th at 1010 (concurring op.).

seems correct. If the fees were really so unreasonable that charging them would have been a violation of the California Rules of Professional Conduct, then Squire Sanders was unjustly enriched to the extent that the fees exceeded the largest permissible charge. That would be equally true if the charges were "fraudulent" or the bills "padded" with clearly unnecessary work.

But an insurer's right to pay only reasonable charges is not merely a right not to pay amounts that counsel could not lawfully charge. It is a right to pay no more than the market rate for services reasonably necessary to the proper defense of the case. (See § 14.03[4], above.)

Insofar as the fees at stake were potentially lawful charges for services requested by or beneficial to J.R. Marketing, the court of appeal's result seems largely correct, though some of the court's reasoning is questionable. The policyholders presumably agreed to pay the rates charged by the law firm. By doing so, they incurred a valid debt to the law firm when it rendered service to them, even if adequate service could have been obtained from a less expensive firm, unless the rates were so exorbitant that it was unethical to charge them. Thus, at least with respect to the rates charged, the law firm was not unjustly enriched by Hartford's payment.

The Restatement (Third) of Restitution and Unjust Enrichment provides that "[e]ven if the claimant has conferred a benefit that results in the unjust enrichment of the recipient when viewed in isolation, the recipient may defend by showing that some or all of the benefit conferred did not unjustly enrich the recipient when the challenged transaction is viewed in the context of the parties' further obligations to each other."[50] An illustration of that rule is that

> A owes B $ 5,000. Intending to pay C, another creditor, A sends $ 5,000 to B who accepts the payment despite notice of A's mistake. (B's notice of A's mistake means that B is not entitled to defend as a bona fide payee by the rule of § 67.) A has a prima facie claim to restitution of the mistaken payment (§ 6), but B is not unjustly enriched by A's unintended payment of a valid debt. B is not liable to A in restitution.[51]

While the payment to the law firm in this case was compelled (by the order to pay), the law firm was still not, as to the rates charged, unjustly enriched. Even as to possibly unnecessary work, if the policyholders approved it, it also might have created a valid debt of the policyholder, precluding unjust enrichment of the law firm. While a more refined analysis would have been desirable, the result seems at least approximately correct.

Insofar as the court of appeal's reasoning suggests that the policyholders had unfettered freedom to approve law firm rates or the cost-effectiveness of particular work, that is inconsistent with the policyholders' own duty of good faith, as discussed in § 14.03[4] above. The duty of good faith is not dependent on the other party's performance of its own contractual obligations.[52] Even if the carrier has breached the duty to defend, the policyholder is obliged to reasonably

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[50] RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 62 (2011).

[51] RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 62, Illus. 2.

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CA—
Gruenberg v. Aetna Ins. Co, 9 Cal. 3d 566, 578 (1973).

manage defense costs. The policyholder alone is liable for any excessive amounts it agreed to pay and it would be unjustly enriched if the carrier instead had been required to pay such amounts without reimbursement.

[b] *National Union Fire Insurance Co. v. Seagate Technology, Inc.*

National Union Fire Insurance Co. v. Seagate Technology, Inc.[53] was a high stakes dispute over application of the principle that an insurer that wrongfully denies coverage cannot rely on the limitation of independent counsel rates provided by Section 2860 of the California Civil Code. Seagate was sued in 2000 by Convolve, Inc. and the Massachusetts Institute of Technology for patent infringement. National Union and certain of its affiliates (collectively, AIG) insured Seagate. AIG initially refused the tender of defense, but began paying for independent counsel (at § 2860 rates) in 2003. In 2004, AIG sought a declaration that it had no duty to defend. In 2007, the district court ruled that a duty to defend had arisen on November 1, 2001, but terminated on July 18, 2007. Seagate appealed, but AIG withdrew the defense. In 2012, the Ninth Circuit held that the duty to defend had not terminated. As a result, the question arose whether AIG was required to pay the full rates charged by Seagate's counsel after it withdrew the defense, or only § 2860 rates. This was said to be a $20 million question.[54]

As the court saw it, everything turned on whether, after the ruling that the duty to defend had terminated, AIG had "wrongfully" withdrawn its defense.[55] The court relied on general principles regarding the finality of judgments:

> In the ordinary case, the duty to defend terminates upon a judicial determination that the insured does not have a potentially-covered claim. The decision granting summary judgment became such a judicial determination when judgment was entered under Rule 54(b). The entry of judgment created a final order with res judicata effect. It is a "basic proposition that all orders and judgments of courts must be complied with promptly. If a [defendant] believes that order is incorrect the remedy is to appeal, but, absent a stay, he must comply promptly with the order pending appeal."[56]

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US/CA—
Nat'l Union Fire Ins. Co. v. Seagate Tech., Inc., 2013 U.S. Dist. LEXIS 10502 (N.D. Cal. Jan. 25, 2013).

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2013 U.S. Dist. LEXIS 10502, at *2–4; Nat'l Union Fire Ins. Co. v. Seagate Tech., Inc., 2013 U.S. Dist. LEXIS 89242, at *3–5. Some of the issues in the case turned on the distinctions among the companies, but those can be disregarded for purposes of the point discussed here.

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US/CA—
2013 U.S. Dist. LEXIS 10502, at *13–14.

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US/CA—

Seagate had appealed but had not sought a stay. "As a result, NIU was entitled to the benefit of the (erroneous) ruling that there was no longer a duty to defend."[57] The court also found persuasive an unpublished Fourth Circuit opinion concluding that withdrawal of a defense in a similar situation was not unjustified under North Carolina law:

> "it would tip the balance too far in favor of the insured to hold that an insurer must wait for all appeals of a declaratory judgment (relieving it of a duty to defend) to be exhausted before removing its defense of the insured. The fact that the insurer provided a defense for the insured until the time the insurer received a declaratory judgment Order demonstrates to this Court that the insurer adhered to the spirit of the public policy requiring defense of insured persons."[58]

Following reversal, AIG's contractual responsibilities were "reinstated retroactively."[59] In the court's view, "During the pendency of the appeals, Seagate should have been aware that it was retaining expensive counsel at a risk to itself. If Seagate had wanted to change this calculus, it should have made a motion for stay pending appeal."[60]

Putting aside the issue of what effect should be given to the judgment, prior to its reversal, there is some equitable appeal to Seagate's position on the particular facts in that case. Had AIG continued to fund the defense, California law would have permitted it to reserve the right to recover amounts expended on a defense it was not obligated to provide.[61] Seagate was the rare insured who could be relied upon to reimburse a multimillion defense bill, should it be found that no defense was due. In that situation, the issue was only who should have to advance costs during the pendency of the appeal. But one cannot base a rule of law on the exceptional ability of one

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57 2013 U.S. Dist. LEXIS 10502, at *5 (citations omitted).

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58 2013 U.S. Dist. LEXIS 10502, at *5–6.

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59 2013 U.S. Dist. LEXIS 10502, at *7, *quoting* Auto-Owners Insurance Co. v. Potter, 242 F. App'x 94, 101 (4th Cir. 2007),

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60 2013 U.S. Dist. LEXIS 10502, at *7.

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61 2013 U.S. Dist. LEXIS 10502, at *14.

US/CA—

Buss v. Super. Ct., 16 Cal. 4th 35, 46–53 (1997).

insured to provide reimbursement for benefits not due.

This decision will surely be appealed, unless the parties settle. How it will fare on appeal is hard to predict.

§ 14.04 Ethical Obligations of Independent Counsel

[1] Overview

There is a vast amount of literature on the ethical obligations and problems of lawyers defending policyholders on behalf of insurers. There is a smaller, but still substantial amount of literature dealing with whether and when a policyholder is entitled to independent counsel. There is very little published writing addressing the ethical obligations and problems of lawyers serving as independent counsel for policyholders.[1] Of course, those duties include all of the usual duties of a lawyer retained by the policyholder to defend a suit. But independent counsel do have their own special ethical issues, which deserve our attention. Some of these issues, notably regarding fees and consultation with the insurer are addressed in § 14.03 above, with particular attention to the interaction of the lawyer's duties and the insurance law duties of the policyholder. Insurance law has a primary role in those issues, with lawyer duties a secondary consideration. This section addresses issues where lawyer duties come to the fore and insurance law plays a secondary role.

[2] Obtaining Informed Consent to the Representation

A key feature of independent counsel is that the lawyer is paid by the insurer, even though the policyholder is the lawyer's sole client. Such third-party payment implicates Model Rule 1.8(f):

> A lawyer shall not accept compensation for representing a client from one other than the client unless:
>
> (1) the client gives informed consent;
>
> (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and
>
> (3) information relating to representation of a client is protected as required by Rule 1.6.[2]

Looking first to the requirement of "informed consent," the Model Rules define that as "the 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."[3] (See also § 9.03, above.) It is not necessary to

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[1] The only substantial treatments known to us are James M. Fischer, *The Professional Obligations of* Cumis *Counsel Retained for the Policyholder but not Subject to Insurer Control*, 43 TORT TRIAL & INS. PRAC. L.J. 173 (2008), and Douglas R. Richmond, *A Professional Responsibility Perspective on Independent Counsel in Insurance*, 33 No. 1 INS. LITIG. REP. 5 (2011). Our own thinking on these issues has benefited from those articles.

[2] MODEL RULES OF PROF'L COND. Rule 1.8(f) (2011). *See also* Rule 5.4(c) ("A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services.").

[3] Model Rule 1.0(e).

"inform a client … of facts or implications already known to the client … ; nevertheless, a lawyer who does not personally inform the client … assumes the risk that the client … is inadequately informed and the consent is invalid."

Thus, while the process by which independent counsel was provided and selected will often have informed the policyholder about some aspects of independent counsel's representation, it is wise for independent counsel to discuss the terms of that representation and some of the problems it can present at the outset and to have that consent and the underlying advice confirmed in writing. Of particular importance are any facts which might raise questions as to counsel's independence of the insurer, such as representations of the insurer or its affiliates in other matters. (See § 6.05[15] above.) Such facts might cause the policyholder to look elsewhere for counsel, if the policyholder makes the selection, or to object to the insurer's selection, if the insurer makes the selection.

The policyholder should understand any significant limitations on the scope of the representation and some important aspects of the way in which the representation will be conducted. The policyholder should be informed of the extent to which the insurer will be consulted in defense planning and the general nature of the problems that can arise if the insurer disagrees with the defensive activities proposed by counsel. (See § 14.03[1]–[2] above.) This information could affect the ways in which the policyholder chooses to be involved in defense planning, even where no dispute has yet arisen. The policyholder should be informed of the arrangements with the insurer regarding payment of fees or the need to negotiate such arrangements, and of any possibility that the policyholder might have to pay or advance some portion of the fees. (See § 14.03[2]&[4] above.) The policyholder should be informed of the extent to which confidential information will be shared with or withheld from the insurer and of the problems that can arise from such sharing or withholding. (See §§ 14.03[1] above and 14.04[3] below.)

In an independent counsel situation, the insurer will have no right to control the defense, so counsel's independence of judgment would seem assured. But the fee arrangement (or any collateral relationship with the insurer) may provide incentives that could affect counsel's judgment. If so, these must be explained.

[3] Handling Confidential Information and Cooperation with Insurer

[a] Providing and Withholding Information

As in all representations, information relating to the representation must be kept confidential, as provided in Model Rule 1.6.[4] However, disclosure of such information may be impliedly authorized if useful to the representation, not injurious to the interests of the policyholder, and not forbidden by the policyholder. (See § 10.01, above (discussing confidentiality in representations by assigned counsel).)

Disclosure is useful to the representation if necessary to comply with the policyholder's duty of cooperation, thereby preserving the policyholder's coverage. (See § 14.03[1] above.) Even if disclosure may not be necessary to comply with the policyholder's duty of cooperation, it may be useful if it avoids a risk that the duty might be breached. Disclosure may also be useful if it will help persuade the insurer to take or authorize some action favored by the policyholder

[4] MODEL RULES OF PROF'L COND. Rule 1.6 (ABA 2011).

(such as settling the case).

Disclosure would be injurious to the policyholder's interests if it would assist the insurer in disputing coverage, so coverage sensitive information must be kept from the insurer unless the policyholder gives informed consent to disclosure.[5] (If defense counsel is not a coverage lawyer, it may be necessary to obtain coverage advice to determine what information is or is not coverage sensitive.) Disclosure may also be injurious to other interests of the policyholder, such as interests in reputation. And, of course, the policyholder may forbid disclosure of certain information even if not otherwise injurious to the policyholder.

If information to be withheld is not coverage sensitive, withholding it might breach the policyholder's duty of cooperation. The policyholder should be advised of this risk. If defense counsel is not able to evaluate that risk, the policyholder should be warned of it and advised to consult other counsel if evaluation is desired. (See § 9.02[5] & [7], above.)

[b] Avoiding Waiver and the Common Interest Rule

But counsel must also beware of the risk of waiving privilege for information communicated to the carrier. Voluntary disclosure of privileged information to a nonprivileged person can waive the privilege.[6] Because the carrier shares common interests with the policyholder in defeating or minimizing the claim, it might be thought that information could be shared without risk of waiver under a common interest arrangement.[7] But the exception to the waiver rule permitting sharing of information among persons of common interest has an additional requirement that is often overlooked: each party to the common-interest arrangement must be represented by a lawyer.

The rejected Federal Rule of Evidence 503 on attorney-client privilege formulated the common-interest rule as one permitting sharing between lawyers: the privilege extends to communications "by [the client] or his lawyer *to a lawyer representing another* in a matter of common interest."[8] While that rule never took effect, federal courts often look to it as a succinct statement of the common law that Rule 501 of the Federal Rules of Evidence makes authoritative in cases where federal law provides the rules of decision.[9] The Third Circuit has explained the basis and evolution of the rule:

> Recognizing that it is often preferable for co-defendants

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Illinois law is exceptional on this issue, taking the view that the insurer and policyholder are persons of common interest on all aspects of a defense representation, even where there is a coverage dispute and the policyholder is represented by independent counsel. Waste Management, Inc. v. International Surplus Lines Ins. Co., 144 Ill. 2d 178, 194 (1991). Where this rule applies, the policyholder must be warned. As a practical matter, this results in an exception to what would otherwise be the applicable attorney-client privilege. Independent counsel subject to this rule should still not make disclosures of material damaging to the policyholder's interests without a court order to do so.

6 RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 79 (2000).

7 RESTATEMENT § 76.

8 Rule 503(b)(3), reprinted in 3 Joseph M. Mclaughlin, WEINSTEIN'S FEDERAL EVIDENCE, SECOND EDITION § 503 (emphasis added).

9 3 Joseph M. McLaughlin, WEINSTEIN'S FEDERAL EVIDENCE, SECOND EDITION § 501.02[1][c].

> represented by different attorneys in criminal proceedings to coordinate their defense, courts developed the joint-defense privilege. In its original form, it allowed the attorneys of criminal co-defendants to share confidential information about defense strategies without waiving the privilege as against third parties. Moreover, one co-defendant could not waive the privilege that attached to the shared information without the consent of all others. Later, courts replaced the joint-defense privilege, which only applied to criminal co-defendants, with a broader one that protects all communications shared within a proper "community of interest," whether the context be criminal or civil. Thus, the community-of-interest privilege allows attorneys representing different clients with similar legal interests to share information without having to disclose it to others. It applies in civil and criminal litigation, and even in purely transactional contexts.[10]

But, as implied by the statement in Rejected Rule 503, one noteworthy feature of the resulting rule is that "to be eligible for continued protection, the communication must be shared with the attorney of the member of the community of interest."[11] The Restatement's formulation of the common-interest rule also imposes this requirement: "If two or more clients with a common interest in a litigated or nonlitigated matter *are represented by separate lawyers* and they agree to exchange information concerning the matter, a communication of any such client that otherwise qualifies as privileged … that relates to the matter is privileged as against third persons."[12] As a result, "[a] person who is not represented by a lawyer and who is not himself or herself a lawyer cannot participate in a common-interest arrangement."[13]

In 2012, the Texas Supreme Court applied the requirement that each party have counsel to deny privilege in a case where counsel for a workers compensation carrier had shared reports to the carrier with the employer, who was interested because payments under the policy were subject to a deductible of $1 million per claim.[14] Under Texas law, the carrier alone was liable, and the employer was not a party to the proceeding.[15] There is no insurer-insured privilege,

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Teleglobe Communs. Corp. v. BCE, Inc. (In re Teleglobe Communs. Corp.), 493 F.3d 345, 36364 (3rd Cir. 2007).

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US—

493 F.3d at 364.

12 RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 79 (2000) (emphasis added).

13 RESTATEMENT § 79, cmt. *d.*

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TX—

In re XL Specialty Ins. Co., 373 S.W.3d 46 (Tex. 2012).

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TX—

though communications between the two relating to liability insurance claims may sometimes be covered by the attorney-client privilege.[16] Because the employer was not represented by counsel regarding the matter, the communications could not be protected from waiver by the common-interest exception (which the Texas court dubbed the “allied litigant doctrine).”[17] Nor was the employer a joint client.[18] Accordingly, disclosure to the employer had waived the privilege, making the disclosed communications available to the employee in a bad faith action against the carrier.

It would seem that the communications might still have been protected by the work product immunity. (See § 10.07[5], above.) But no argument based on that doctrine was made in the case. Unless that protection were available and adequate to prevent adverse effect on the policyholder, the resulting risk to privilege would have meant that independent counsel’s duty of confidentiality would preclude sharing of privileged information unless the carrier were represented by counsel, through whom the information was shared.

The Restatement of the Law of Liability Insurance provides that, even in an independent counsel situation, “[t]he insured’s provision of information to the liability insurer does not waive confidentiality of the information with respect to third parties.”[19] It reasons that:

> The grounds for protecting confidentiality in the independent counsel context are identical to those in ordinary-duty-to-defend context. The conflict of interest that lies behind the independent counsel requirement does not eliminate the common interest of insurer and insured in defeating the third-party claim; it does not change the factthat the insurer serves as the insured's agent for purposes of settling; and it does not eliminate the need forthe insurer and insured to share confidential information in a manner that is protected from third parties.[20]

Notwithstanding the Restatement, the implication of the foregoing is that a carrier that wishes to receive privileged information from independent counsel may itself need to have counsel regarding the matter and conduct any sharing through counsel, lest a court take the view that sharing without such counsel waives the privilege.

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373 S.W.3d 46, 53–54.
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TX—
373 S.W.3d 46, 53–54.
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TX—
373 S.W.3d 46, 54.
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373 S.W.3d 46, 54–55.
19 RESTATEMENT OF THE LAW OF LIABILITY INSURANCE § 17(5) (Tent. Dr. No. 1 April 11, 2016).
20 RESTATEMENT § 17, cmt. *d* (citation omitted).

[c] Courts Ought Not To Confuse the Common Interest Rule with the Joint Client Rule

In *Maplewood Partners, L.P. v. Indian Harbor Insurance Co.*[21] the court treated a nondefending insurer as a co-client of the policyholder's defense counsel, thereby granting the insurer access to the policyholder's privileged and work product materials from the underlying litigation for use in the coverage litigation. The error of constructing an attorney-client relationship for that purpose is discussed in § 4.04[6], above. This section will contrast the court's handling of the waiver issue under the joint client rule with the treatment that should have been accorded under the common interest rule.

This was a coverage suit, in which Maplewood and related entities and individuals contended that Indian Harbor had paid less than was due for defense and indemnification of underlying suits. There were three of these, the "RRGC action," the "Slashy matter," and the "Green claim." Indian Harbor sought discovery of materials the Maplewood parties claimed were privileged. Indian Harbor argued that it had been a joint client, so that no privilege or immunity barred its access to the documents.[22] The court essentially agreed.[23]

The policy was a financial services liability policy, which did not impose a duty to defend, but did require the insurer to pay for defense expenses (along with damages, judgments, settlements, etc.) in excess of the $250,000 retention. Defense expenses could not be incurred without Indian Harbor's consent, and the policyholders agreed " 'to provide the Insurer with all information, assistance, and cooperation that the Insurer may reasonably request.' "[24]

Retention of defense counsel is not described, but it appears that they (two separate firms) were retained by the policyholders, as would be the norm under a duty to reimburse policy (in contrast to a duty to defend policy). In the RRGC action, defendants acted as a joint defense group. Defense counsel Miller communicated regularly with Indian Harbor, through the insurer's [monitoring] counsel. Miller provided assessments of liability, litigation updates, and settlement estimates, all pursuant to and consistent with the Policy's cooperation clause. Miller also prepared a litigation budget and a "Pre-trial Report" for Defendant, who paid for the preparation of the

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US/FL—
Maplewood Partners, L.P. v. Indian Harbor Ins. Co., 295 F.R.D. 550 (S.D. Fla. 2013).

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US/FL—
295 F.R.D. at 556–57.

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US/FL—
295 F.R.D. at 603–04. The opinion extensively analyzed confidentiality issues, and that discussion is addressed in § 14.04[3], below. The discussion here focuses solely on whether there was joint representation.

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US/FL—
295 F.R.D. at 557–58.

Report, which included an assessment of the financial and legal risks of the litigation.[25]

Miller told Indian Harbor's counsel that he was "'always happy to speak with [insurer's counsel] to answer any questions you may have [regarding potential liability and damages/value of the RRGC action].'"[26]

Throughout the RRGC action, the Maplewood parties treated their interests as aligned, never discussing any allocation of responsibility among themselves.[27] Indian Harbor was included in settlement discussions.[28] It consented to the settlement and contributed to it. But another insurer, Travelers, and some of the Maplewood parties paid all defense expenses. They and Travelers paid the bulk of the settlement.[29] The Maplewood parties now sought reimbursement for some of the defense expenses and settlement costs they paid.

In the Shashy matter, all of the Maplewood parties were represented by Miller. The claims were resolved in a mediation, at which Indian Harbor was present. The Maplewood parties now sought reimbursement of defense expenses.[30]

The Green claim originated as a counterclaim in the Shashy matter and was resolved by arbitration. The Maplewood parties now sought reimbursement of defense costs.[31]

The court concluded that all of the Maplewood parties were joint clients of Miller and his

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US/FL—
295 F.R.D. at 563–65 (footnotes omitted).

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US/FL—
295 F.R.D. at 565 n.54.

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US/FL—
295 F.R.D. at 565–66.

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US/FL—
295 F.R.D. at 566.

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US/FL—
295 F.R.D. at 567–68.

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US/FL—
295 F.R.D. at 569.

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US/FL—
295 F.R.D. at 569.

legal team, and then inquired whether Indian Harbor was also a client, observing that " '[a]s a general matter, no co-client is entitled to have a lawyer withhold material information from another. There is no reason to make insurance defense representations an exception to this rule.' "[32]

The court relied on the fact that defense counsel provided extensive confidential information to Indian Harbor's monitoring counsel, without ever seeking a waiver from the Maplewood parties permitting such disclosure.[33] It also relied on cases allowing policyholders to discover communications between the insurer and the defense counsel retained to defend the policyholders.[34]

The court recognized that there were two distinct doctrines that would permit disclosure of privileged material without waiving the privilege:

> The confidentiality element of the attorney-client privilege can be viewed as a limit on the scope of the privilege, i.e., the privilege does not extend past the boundary within which the attorney and client maintain confidentiality in common. Two doctrines protect from disclosure those items as to which a court might otherwise conclude that the privilege had been waived by a failure to maintain confidentiality: the "joint client" and the "common legal interest" doctrines. These two doctrines are distinct and do not overlap.[35]

The court accurately described the common interest doctrine as follows:

> The "common legal interest" rule is an exception to the general rule that disclosure of otherwise privileged communications eliminates, or waives, the privileged status of those communications. This rule "enables litigants who share unified interests to exchange this privileged information to adequately prepare their cases without losing the protection afforded by the privilege." … .

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US/FL—
295 F.R.D. at 595, *quoting Defense Lawyers' Professional Responsibilities: Part II—Contested Coverage Cases*, 15 GEO. J. LEGAL ETHICS 29, 86 (2001) (citations and notes omitted).
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US/FL—
295 F.R.D. at 597.
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US/FL—
295 F.R.D. at 599–600.
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US/FL—
295 F.R.D. at 594 (footnote omitted).

> Pursuant to this doctrine, attorneys representing clients with similar legal interests can share information without risk of being compelled to disclose such information generally. Interests of the members of the joint defense group need not be entirely congruent. One member of a joint defense group cannot waive the privilege that attached to the information shared by another member of the group without the consent of that member, but any defendant could, of course, testify as to her own statements at any time. By agreeing to be a part of a joint defense, she only agrees not to disclose anything learned from her co-defendants through that joint arrangement, nor could any of those co-defendants disclose what she had told them or their attorneys in confidence. However, if the parties to that agreement are later in opposition with each other, statements which were made by one co-defendant to another defendant's attorney are not protected by privilege.[36]

The court expressed "a healthy skepticism as to the doctrine's worth" and an intent to "rein in what may be considered an overly broad interpretation of the 'common legal interest' (formerly 'joint defense group') exception to traditional concepts of waiver of the attorney-client privilege."[37] Nonetheless, the court concluded that the doctrine "provides an alternative basis to support my conclusion that [the Maplewood parties] must disclose the documents listed in the privilege log."[38]

The court agreed that that the parties had a common legal interest in the underlying litigation:

> [Indian Harbor] also was engaged in [the Maplewood parties'] settlement discussions, as required by the Policy's explicit terms which [the Maplewood parties] accepted when purchasing the Policy. It is evident that [Indian Harbor] shared a common legal interest in defending its insured in the underlying proceedings. This interest was legal, and not just financial, because of the multiple additional issues—including, e.g., the question of whether other entities might proceed against the insurer in the event of an unsatisfactory result.[39]

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US/FL—
295 F.R.D. at 605–06.
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US/FL—
295 F.R.D. at 606–07 & n.232.
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US/FL—
295 F.R.D. at 607 n.232.
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But even while analyzing application of the common interest doctrine, the court relied on its conclusion that Indian Harbor was a co-client:

> The interests of [the Maplewood parties] (and their entire joint defense group) were aligned with Indian Harbor as all had an interest in minimizing liability in the Underlying Matters. [The Maplewood parties] have declared that: "No legal effort was made in connection with the prosecution of Maplewood's counterclaims in RRGC or Shashy that did not operate to minimize the potential liability of an insured on a claim made against the insured." In other words, all of Miller's efforts were geared toward minimizing liability, which would be the goal of Indian Harbor as well. The law provides that *all of these joint clients, including Indian Harbor*, could freely communicate (without waiving any privilege) in order to prepare a successful defense.[40]

The joint client conclusion cannot be right in connection with a common-interest arrangement. The common interest doctrine applies only when the cooperating parties do *not* share an attorney (typically because they have conflicting interests on matters related to the one in which they share a common interest). As the court itself recognized, the two rules do not overlap.[41]

The court continued by reasoning that

> if it is assumed that the insurer shares a "common legal interest" with [the Maplewood parties], then Miller's communications to Defendant on behalf of all of his clients and as to all details of the RRGC settlement are construed to be two client's "consulting in common" of an attorney. Miller communicated, presumably, at all times with the permission of Maplewood Partners, acting through Glaser. The other clients cannot now claim that certain aspects were privileged, as they apparently raised no objection at the time and, in any event, Glaser apparently granted permission for the disclosures on behalf of the corporate entity holding the privilege.

US/FL—
295 F.R.D. at 610.
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US/FL—
295 F.R.D. at 607 (emphasis added, footnote and citation omitted).
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US/FL—
295 F.R.D. at 594.

That is true enough *as to information that was voluntarily shared* pursuant to the common-interest arrangement. It is wrong, as it applies to information and documents not voluntarily shared. If two clients were indeed consulting the lawyer in common, the lawyer would have a fiduciary duty to each client to provide full information as to all matters within the scope of the relationship. Clients who permit their lawyers to share certain matters bearing on their common interests do not thereby assume any duty to share other information which, while related to their common interest, may also pertain to matters where there are conflicting interests. Thus, except in Illinois,[42] existence of a common legal interest does not provide a basis for one party to demand access to information about another party's privileged communications that were not voluntarily shared with it.[43]

The discovery request pursuant to which the court ordered production was not limited to information that had been voluntarily shared, but rather demanded:

> 3. All documents and communications between You and any of Your Agents, including but not limited to [defense counsel], pertaining to the Underlying Matters.
>
> 4. All documents and communications pertaining to estimates, evaluations and/or assessments of your potential legal liability and/or settlement values in the Underlying Matters made by You and/or Your Agents.[44]

Nonetheless, having concluded that the parties "consulted [defense counsel] in common, the court applied what it thought to be the applicable Florida rule: " 'There is no lawyer-client privilege … [as to] a matter of common interest between two or more clients … or their successors in interest, if the communication was made by any of them to a lawyer retained or consulted in common when offered in a civil action between the clients.' "[45] But that statute, on

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[42] *See*

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Waste Mgmt., Inc. v. Int'l Surplus Lines Ins. Co., 144 Ill. 2d 178, 193–95 (1991), criticized in § 2.06[2], above. The court based the requirement of disclosure, alternatively, on the insured's duty to cooperate and on the common-interest doctrine. The discussion in § 2.06[2] specifically addresses the cooperation clause rationale. But, the criticism expressed there applies equally to the common-interest rationale. Additional reasons to reject the cooperation-clause rationale are set forth in this sub-subsection.

[43] *E.g.*,

US/CT—
Remington Arms Co. v. Liberty Mut. Ins. Co., 142 F.R.D. 408, 418 (D. Del. 1992) (" 'the rationale which supports the 'common interest' exception to the attorney-client privilege simply doesn't apply if the attorney never represented the party seeking the allegedly privileged materials.' "), *quoting* Bituminous Casualty Corp. v. Tonka Corp., 140 F.R.D. 381, 386 (D. Minn. 1992).

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US/FL—
Maplewood, 295 F.R.D. at 580.

[45]

its face, applies to joint client relationships, not common-interest arrangements, where the parties have separate attorneys and do not "consult in common" with either of those attorneys in the way joint clients would do.

The court supported its analysis by concluding that it would be difficult, burdensome, and potentially complicated for defense counsel to distinguish and separately treat coverage sensitive information, while freely sharing information relating only to the defense:

> As defense counsel, Miller is not charged with knowledge of coverage issues. To effectively defend his clients, Miller needed the trust and confidence of his clients, and his primary objective was loss minimization in the Underlying Matters, an objective shared by the clients who hired him and the "client" who was potentially responsible for any judgment, and for Miller's fees. Miller was not being compensated to establish coverage (or lack thereof), but rather was contracted to advance his clients' interests, as they defined them, in the Underlying Matters. Nor should Miller, or any defense counsel, need to spend much time deciding who they represent as a client. Miller could get a waiver from [the Maplewood parties] as to his ability to communicate with the insurer and, if his clients are not willing, then perhaps they need other counsel. If Miller is going to disclose information to Indian Harbor that might be adverse to the coverage question, then Miller needs to tell his clients in advance. If the clients object to the disclosure, then they face the risk that the cooperation clause of the insurance policy will have been breached and there will be no coverage. If the clients agree to the disclosure, then Miller might need to withdraw as defense counsel rather than straddle the line between two sets of interests. There is no rational basis to burden Miller or other defense attorneys with the dual role of protecting privileged items while also trying to obtain reimbursement for defense expenses as to underlying claims defended before the insured ends up in litigation against its own insurer. Thus, the conception of a joint client relationship as to all communications relating to the Underlying Matters provides clear guidance as to boundaries of privilege.[46]

The Maplewood parties and defense counsel certainly could have proceeded in that way, if they were willing to accept the duties of disclosure which would flow from making Indian

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US/FL—
295 F.R.D. at 594 n.189, *quoting* FLA. STAT. § 90.502(4)(e).
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US/FL—
295 F.R.D. at 609–10 (footnote omitted). Of course, there would be no need for Miller to straddle any line if Miller never undertook any duties to Indian Harbor, beyond the general legal duty to refrain from misrepresentation.

Harbor a joint client. But if the Maplewood parties desired to retain discretion as to what information would be shared (perhaps at the cost of facing accusations of noncooperation), they were free to accept the difficulties, burdens, and complexities of a common-interest arrangement without the duties of disclosure which would flow from making Indian Harbor a joint client. The court improperly conflated the common-interest doctrine with the joint client rules, thereby depriving the Maplewood parties of the benefits of their choice not to be joint clients with Indian Harbor. Other courts should not make that mistake.

[4] Honesty and Avoidance of Fraud

[a] Deceptive Statements or Omissions

Representation of a policyholder by independent counsel typically takes place in a context where the policyholder and the insurer are adversaries with respect to coverage. As a result, both policyholder and counsel are entitled to withhold from the insurer information relating to the defense representation that is coverage sensitive. But even in the context of an adversarial relationship, the lawyer is not permitted to lie to the insurer. Model Rule 4.1 provides that "[i]n the course of representing a client, a lawyer shall not knowingly … make a false statement of material fact or law to a third person"[47] (*i.e.*, someone other than the client). Moreover, Model Rule 8.4 provides that "[i]t is professional misconduct for a lawyer to … (c) engage in conduct involving dishonesty, fraud, deceit, or misrepresentation."[48]

Professor Fischer has noted the following implications of these rules:

> An attorney may not make a misrepresentation and may not use the rule of confidentiality to justify the speaking of untruths. When the attorney speaks, the attorney must speak honestly. A statement that is a half-truth because it omits material facts needed to put the statement in its proper context may be deemed a misrepresentation subjecting the speaker to civil liability. As recently noted by the Montana Supreme Court, the privilege to withhold client confidential information does not provide a license or justification for misleading utterances. An attorney who discloses information to the insurer to enable the insurer to determine its duties and obligations under the insurance contract must take care to disclose accurately and truthfully or not disclose at all. Even a negligent statement may be actionable if it contains a material misrepresentation on which the recipient of the information (the insurer) reasonably relies to its detriment. The scope of a lawyer's liability for negligent misrepresentation has been hotly debated and disputed. The fact that the identity of the recipient of the information is known and the specific end and aim of the communication is to induce action by the insurer are factors enhancing the likelihood that the court would find *Cumis* counsel owed a duty of candor to the insurer. *Cumis* counsel must be careful not to confuse the absence of a duty of care owed to the insurer with the existing duty to avoid making

[47] MODEL RULES OF PROF'L COND. Rule 4.1 (ABA 2011).
[48] MODEL RULES OF PROF'L COND. Rule 8.4 (ABA 2011).

material misrepresentations to the insurer.[49]

The lawyer need not even be the source of the false statement. Douglas Richmond notes that "a lawyer may violate Rule 4.1(a) by knowingly affirming or ratifying another person's false statement, or by failing to correct it."[50]

These rules can be triggered by very limited culpability. The Rule 4.1 requirement that the misrepresentation be made "knowingly" requires only actual knowledge of the falsity, not any "evil intent or a bad purpose."[51] Many courts require knowing falsehood to establish violation of Rule 8.4(c).[52] But others hold that even statements made with reckless disregard for their truth or falsity can constitute violations.[53] Indeed, at least one jurisdiction will find a violation based on grossly negligent misstatements.[54]

Nor does a violation of these rules require that anyone be misled or harmed by the

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[49] James M. Fischer, *The Professional Obligations of Cumis Counsel Retained for the Policyholder but not Subject to Insurer Control*, 43 TORT TRIAL & INS. PRAC. L.J. 173, 187–88 (2008) (footnotes omitted).

[50] Douglas R. Richmond, *A Professional Responsibility Perspective on Independent Counsel in Insurance*, 33 No. 1 INS. LITIG. REP. 5, 18 (2011).

[51]

ND—
In re Edison, 724 N.W.2d 579, 584 (N.D. 2006).

[52] *See, e.g.*:

FL—
Fla. Bar v. Mogil, 763 So. 2d 303, 309–11 (Fla. 2000);

MA—
In re Firstenberger, 878 N.E.2d 912, 913–14 (Mass. 2007);

OR—
In re Conduct of Skagen, 149 P.3d 1171, 1184 (Or. 2006).

[53] *E.g.*:

DC—
In re Ukwu, 926 A.2d 1106, 1113–14 (D.C. 2007);

IA—
Iowa Supreme Court Atty. Disciplinary Bd. v. Gottschalk, 729 N.W.2d 812, 818 (Iowa 2007);

PA—
Office of Disciplinary Counsel v. Surrick, 749 A.2d 441, 445 (Pa. 2000).

[54]

AR—
Walker v. Supreme Court Comm. on Prof'l Conduct, 246 S.W.3d 418, 424 (Ark. 2007).

misrepresentation.[55] Rule 8.4(c) contains no express requirement of materiality, though some courts will imply one.[56]

Thus, independent counsel must take care to avoid false or misleading statements or omissions in communicating with the insurer. Moreover, independent counsel must be careful in advocating the policyholder's position to the insurer. Thus, in trying to induce the insurer to settle, it may be useful to argue that there is a great risk of excess liability if the case is tried. And it may be possible to argue that the likelihood or likely magnitude of the judgment is greater than counsel personally believes it to be. If so, counsel must avoid stating any opinion regarding the risk that does not reflect counsel's actual beliefs.

[b] Assisting Fraud

Model Rule 1.2(d) forbids a lawyer to "counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent."[57] If independent counsel learns that the policyholder is perpetrating a fraud, counsel may not assist in doing so. The first step will usually involve remonstration with the policyholder to correct any prior misrepresentations and refrain from any in the future. If the policyholder will not do so, it may sometimes be sufficient for independent counsel to withdraw from the representation. But, as Prof. Fischer points out, in some instances

> [o]ne may even argue that counsel has affirmative disclosure obligations here and may not simply remain silent if counsel is aware that the policyholder client is perpetrating a fraud on the insurer. Rule 4.1(b) provides that an attorney must disclose a material fact when necessary to prevent assisting a criminal or fraudulent act by the client, unless disclosure is prohibited by Rule 1.6. Traditionally, the Rule 1.6 confidentiality exception swallowed the rule. Recent amendments to Rule 1.6 have, however, added exceptions that "permit" the attorney to disclose client confidential information to prevent "the client from committing a crime or fraud reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services." Disclosure is no longer "prohibited," as that term is used in Rule 4.1(b) because Rule 1.6(b)(2)–(3) permits disclosure; therefore, the exception no longer significantly constrains the duties set forth in Rule 4.1(b), i.e., disclose material facts "to avoid assisting a criminal or fraudulent act by a

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CT—
Ansell v. Statewide Grievance Comm., 865 A.2d 1215, 1223 (Conn. App. Ct. 2005).
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OR—
In re Conduct of Skagen, 149 P.3d 1171, 1184 (Or. 2006).
57 MODEL RULES OF PROF'L COND. Rule 1.2(d) (ABA 2011). *Accord* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 94(2) (2000).

> client."[58]

Of course, even if that argument is accepted, it would still be necessary to determine when disclosure is necessary to prevent assisting a fraud.

[5] Involvement in Policyholder Disputes with the Insurer

[a] Disputes Regarding the Representation

If there are disagreements with the insurer on conduct of the defense, the policyholder will require advice on the risks and benefits of acceding to the insurer's wishes or proceeding contrary to those wishes. Defense counsel is better positioned than any other lawyer in evaluating the impact on the lawsuit being defended of proceeding one way or another. After all, defense counsel may have considered both alternatives before making a recommendation and certainly considered both alternatives before concluding that another course was preferable to the one recommended by the insurer. Defense counsel might not be competent to advise on the risks of breaching insurance policy duties by proceeding contrary to the insurer's wishes. But the insured will require advice on this subject, and if defense counsel is competent to provide that advice, defense counsel is the most logical person to do so.

Such advice might be considered coverage advice, for which the policyholder, rather than the insurer, should pay. But it might not be separable from advice regarding the defense or any separable component might be too small to be worth trying to break out.

[b] Disputes Regarding Coverage and Claim Handling

Because the insurer is not a client of independent counsel, there is no ethical obstacle to

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[58] James M. Fischer, *The Professional Obligations of* Cumis *Counsel Retained for the Policyholder but not Subject to Insurer Control*, 43 TORT TRIAL & INS. PRAC. L.J. 173, 189 (2008) (footnotes omitted). *See* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 67(1)–(2) (2000) (authorizing disclosure on the same basis as Model Rule 1.6(b)(2)-(3). The Restatement explains that these exceptions to the duty of confidentiality

> reflect a balance between the competing considerations of protecting interests in client confidentiality and lawyer loyalty to clients, on the one hand, and protecting the interests of society and third persons in avoiding substantial financial consequences of crimes or frauds, on the other … . The exceptions are … justified on the ground that the client is not entitled to the protection of confidentiality when the client knowingly causes substantial financial harm through a crime or fraud and when … the client has in effect misused the client-lawyer relationship for that purpose. In most instances of unlawful client acts that threaten such consequences to others, it may be hoped that the client's own sober reflection and the lawyer's counseling will lead the client to refrain from the act or to prevent or mitigate its consequences. [RESTATEMENT, § 67, cmt. *b.*]

counsel also representing the policyholder on coverage and other disputes with the insurer.[59] But there is an argument that, as a matter of insurance law, "an insurer is within its rights to insist that lawyers serving as independent counsel not advise insureds on coverage."[60]

This argument is not very strong. It relies on two cases,[61] which both take the position that the insurer is entitled to approve the policyholder's selection of defense counsel, such approval not to be unreasonably withheld.[62] Those cases are therefore unlikely to be followed in jurisdictions holding that the policyholder is entitled to select independent counsel unilaterally. (See § 14.02 above.)

More importantly, both cases proceed on the basis that the insurer

> is under a duty to provide only an impartial defense—not to sacrifice its own interests. [The policyholder's] defense counsel must not be motivated to slant the defense in any manner relating to whether a claim is or is not in the scope of coverage. Allowing [the policyholder] to appoint as "independent counsel" a firm that bears its loyalty to [the policyholder] or any animus to [the insurer] would reintroduce, albeit in a converse manner, the very difficulties that necessitate in the first instance the appointment of independent counsel.[63]

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[59] *See, e.g.*:

US/PA—
Maddox v. St. Paul Fire & Mar. Ins. Co., 2002 U.S. Dist. LEXIS 26686, at *10 n.6 (W.D. Pa. May 29, 2002), *appeal dismissed*, 2003 U.S. App. LEXIS 14715 (3d Cir. Jul. 22, 2003);

US/NY—
Emons Indus, Inc. v. Liberty Mut. Ins. Co., 747 F. Supp. 1079. 1083–84 (S.D.N.Y. 1990).

See also Douglas R. Richmond, *Independent Counsel in Insurance*, 48 SAN DIEGO L. REV. 857, 894 (2011).

[60] 48 SAN DIEGO L. REV. at 895.

[61] *See*:

US/NY—
N.Y. State Urban Dev. Corp. v. VSL Corp., 563 F. Supp. 187 (S.D.N.Y. 1983), *aff'd in pertinent part*, 738 F.2d 61, 65–66 (2d Cir. 1984);

US/PA—
Maddox v. St. Paul Fire & Mar. Ins. Co., No. 01-1264, 2002 U.S. Dist. LEXIS 26686 (W.D. Pa. May 29, 2002), *appeal dismissed*, 2003 U.S. App. LEXIS 14715 (3d Cir. Jul. 22, 2003).

[62]

US/NY—
In *VSL Corp.*, that position was based, in part, on policy language found to reserve that right. 738 F.2d at 65. That makes the case even less likely to be followed in the absence of such policy language.

[63]

But this ignores the fact that defense counsel often must advocate a position on coverage sensitive issues. Thus, when the policyholder is alleged to have harmed the plaintiff either negligently or intentionally, the policyholder surely does not receive a complete defense unless defense counsel argues that the injury was no more than negligent. A policyholder defended other than in this way could be subjected to both an unjustified finding of intentional injury (with the resulting increased damages) and, in consequence, a loss of coverage. Such a policyholder could wind up worse off than had there been no insurance The insurer's protection is not some artificial "impartial" defense; it is the right not to be bound on coverage by the findings made in a case where control of the defense rested in the hands of a policyholder with coverage interests adverse to those of the insurer.[64]

More generally, the right to independent counsel exists only because of a conflict arising out of the manner in which the defense can be conducted. The point of giving the insured independent counsel is to ensure that judgment calls relating to the defense are made in the way that benefits the policyholder rather than the insurer. Independent counsel must therefore be able to advise the policyholder as to how different defense choices could impact coverage.

The insurer is entitled to have bills limited to services required to defend the policyholder, so it does not pay for the policyholder's representation in coverage disputes. But there is no reason to deny the policyholder the right to the economies of using one law firm for both defense and coverage, if the lawyers in that firm are competent to render both types of service and the policyholder wishes them to do so.[65]

A different view was taken in *General Insurance Co. of America v. Walter E. Campbell Co.*[3] Walter E. Campbell Co. ("WECCO") had, "for decades, engaged in the business of handling, installing, disturbing, removing, and selling asbestos-containing insulation materials."[4] This was a coverage action regarding defense and indemnification of many underlying asbestos-personal-injury cases.[5] The principal coverage issues were (1) when the claimant in each case was exposed to asbestos (which affected allocation of coverage) and (2) whether and when the claimant had been exposed to asbestos during WECCO's ongoing operations (to which only per-occurrence limits applied) as opposed to injury resulting from completed operations (to which aggregate limits applied.).[6]

WECCO settled with two of its insurers, agreeing to assume their obligations and to reduce any claims against non-settling insurers by any amounts allocable to settling insurers.[7] By

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US/NY—
563 F. Supp. at 190 n.1, *followed by* 2002 U.S. Dist. LEXIS 26686, at *8–9.

[64] RESTATEMENT (SECOND) OF JUDGMENTS § 58(2) (1982).

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US/NY—
Emons Indus, Inc. v. Liberty Mut. Ins. Co., 747 F. Supp. 1079 (S.D.N.Y. 1990).

[3] Gen. Ins. Co. of Am. v. Walter E. Campbell Co., 2016 U.S. Dist. LEXIS 62842 (D. Md. May 12, 2016).

[4] 2016 U.S. Dist. LEXIS 62842, at *7.

[5] Gen. Ins. Co. of Am. v. Walter E. Campbell Co., 107 F. Supp. 3d 466 (d. Md. 2015).

[6] 107 F. Supp. 3d at 473.

[7] 107 F. Supp. 3d at 480.

stepping into the shoes of the settling insurers, WECCO had the largest share of the defense obligation, so the court agreed that it should take the lead in managing the defense.[8]

WECCO had substituted its coverage counsel, Morgan Lewis & Bockius ("MLB") as defense counsel in the underlying actions and the non-settling insurers objected, arguing that it had a conflict of interest, and the court agreed: "Given the long and protracted efforts of [MLB] to pull cases into coverage under the Non-Settled Insurers' policies, [MLB] cannot also be placed into the position where it can slant the defense in a manner that could render the claims covered claims.'[9] Accordingly, so long as MLB remained counsel, the non-settled Insurers would have "no defense or indemnity obligations with respect to those suits."[10]

But this would appear to be an ordinary situation in which a pivotal issue (when exposure occurred and in what circumstances) is involved in both defense of the underlying action and the coverage dispute. If so, WECCO would have a right to independent counsel, even had it not assumed the rights of the settling insurers to defend. For the reasons stated above, WECCO would have had the right to have its counsel defend in a manner that maximized its interests, including its coverage interests.

If WECCO did not have a right to independent counsel, then the claim of the non-settling insurers would have depended on some right to have the settling insurers defend impartially on behalf of all insurers. We are not aware of any authority on whether such a right would exist. But even if it did, MLB would not have been conflicted. It would defend in whatever manner its client, WECCO directed. If that defense were improperly conducted, the responsibility would have rested on WECCO, not MLB.

[8] 2016 U.S. Dist. LEXIS 62842, at *14-15.
[9] 2016 U.S. Dist. LEXIS 62842, at *15.
[10] 2016 U.S. Dist. LEXIS 62842, at *15.

Independence and Ethical Obligations of “Independent Counsel”

2017 American College of Coverage and Extracontractual Counsel Law School Seminar

U.C. Hastings College of the Law
San Francisco, California
February 10, 2017

Sara M. Thorpe
Nicolaides Fink Thorpe Michaelides Sullivan LLP
San Francisco, California
sthorpe@nicolaidesllp.com

Carl Metzger
Goodwin Procter LLP
Boston, Massachusetts
cmetzger@goodwinlaw.com

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Ethical Obligations of Independent Counsel – Handout

- ABA Model Rules of Professional Conduct
- California Rules of Professional Conduct
- California Civil Doe 2860
- California B&PC
- California Opinion No. 1995-139
- ABA Opinion No. 01-421
- *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc.*, 162 Cal.App.3d 358 (1984)
- William T. Barker, Rights of Insurers and Duties of Independent Counsel

American Bar Association Model Rules of Professional Conduct

Client-Lawyer Relationship
Rule 1.1 Competence

A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.

. . .

Client Lawyer Relationship
Rule 1.4 Communications

(a) A lawyer shall:

(1) Promptly inform the client of any decision or circumstance with respect to which the client's informed consent, as defined in Rule 1.0(e), is required by these Rules;

(2) Reasonably consult with the client about the means by which the client's objectives are to be accomplished;

(3) Keep the client reasonably informed about the status of the matter;

(4) Promptly comply with reasonable requests for information; and

(5) Consult with the client about any relevant limitation on the lawyer's conduct when the lawyer knows that the client expects assistance not permitted by the Rules of Professional Conduct or other law.

(b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.

…

Client-Lawyer Relationship
Rule 1.6 Confidentiality of Information

(a) 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 the disclosure is permitted by paragraph (b).

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

(1) To prevent reasonably certain death or substantial bodily harm;

(2) To prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;

(3) To prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;

(4) To secure legal advice about the lawyer's compliance with these Rules;

(5) To establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client;

(6) To comply with other law or a court order; or

(7) To detect and resolve conflicts of interest arising from the lawyer’s change of employment or from changes in the composition or ownership of a firm, but only if the revealed information would not compromise the attorney-client privilege or otherwise prejudice the client.

(c) A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client.

…

Client-Lawyer Relationship
Rule 1.7 Conflict Of Interest: Current Clients

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client; or

(2) There is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) Each affected client gives informed consent, confirmed in writing.

…

Client-Lawyer Relationship

Rule 1.8 Conflict Of Interest: Current Clients: Specific Rules

(a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:

(1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client;

(2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel on the transaction; and

(3) The client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction.

(b) A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client gives informed consent, except as permitted or required by these Rules.

(c) A lawyer shall not solicit any substantial gift from a client, including a testamentary gift, or prepare on behalf of a client an instrument giving the lawyer or a person related to the lawyer any substantial gift unless the lawyer or other recipient of the gift is related to the client. For purposes of this paragraph, related persons include a spouse, child, grandchild, parent, grandparent or other relative or individual with whom the lawyer or the client maintains a close, familial relationship.

(d) Prior to the conclusion of representation of a client, a lawyer shall not make or negotiate an agreement giving the lawyer literary or media rights to a portrayal or account based in substantial part on information relating to the representation.

(e) A lawyer shall not provide financial assistance to a client in connection with pending or contemplated litigation, except that:

(1) A lawyer may advance court costs and expenses of litigation, the repayment of which may be contingent on the outcome of the matter; and

(2) a lawyer representing an indigent client may pay court costs and expenses of litigation on behalf of the client.

(f) A lawyer shall not accept compensation for representing a client from one other than the client unless:

(1) the client gives informed consent;

(2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and

(3) Information relating to representation of a client is protected as required by Rule 1.6.

(g) A lawyer who represents two or more clients shall not participate in making an aggregate settlement of the claims of or against the clients, or in a criminal case an aggregated agreement as to guilty or nolo contendere pleas, unless each client gives informed consent, in a writing signed by the client. The lawyer's disclosure shall include the existence and nature of all the claims or pleas involved and of the participation of each person in the settlement.

(h) A lawyer shall not:

(1) Make an agreement prospectively limiting the lawyer's liability to a client for malpractice unless the client is independently represented in making the agreement; or

(2) Settle a claim or potential claim for such liability with an unrepresented client or former client unless that person is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel in connection therewith.

(i) A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client, except that the lawyer may:

(1) Acquire a lien authorized by law to secure the lawyer's fee or expenses; and

(2) Contract with a client for a reasonable contingent fee in a civil case.

(j) A lawyer shall not have sexual relations with a client unless a consensual sexual relationship existed between them when the client-lawyer relationship commenced.

(k) While lawyers are associated in a firm, a prohibition in the foregoing paragraphs (a) through (i) that applies to any one of them shall apply to all of them.

…

Client-Lawyer Relationship
Rule 1.16 Declining Or Terminating Representation

(a) Except as stated in paragraph (c), a lawyer shall not represent a client or, where representation has commenced, shall withdraw from the representation of a client if:

(1) The representation will result in violation of the rules of professional conduct or other law;

(2) The lawyer's physical or mental condition materially impairs the lawyer's ability to represent the client; or

(3) The lawyer is discharged.

(b) Except as stated in paragraph (c), a lawyer may withdraw from representing a client if:

…

(c) A lawyer must comply with applicable law requiring notice to or permission of a tribunal when terminating a representation. When ordered to do so by a tribunal, a lawyer shall continue representation notwithstanding good cause for terminating the representation.

(d) Upon termination of representation, a lawyer shall take steps to the extent reasonably practicable to protect a client's interests, such as giving reasonable notice to the client, allowing time for employment of other counsel, surrendering papers and property to which the client is entitled and refunding any advance payment of fee or expense that has not been earned or incurred. The lawyer may retain papers relating to the client to the extent permitted by other law.

…

Law Firms and Associations
Rule 5.4 Professional Independence of a Lawyer

(a) A lawyer or law firm shall not share legal fees with a non-lawyer, except that:

(1) An agreement by a lawyer with the lawyer's firm, partner, or associate may provide for the payment of money, over a reasonable period of time after the lawyer's death, to the lawyer's estate or to one or more specified persons;

(2) A lawyer who purchases the practice of a deceased, disabled, or disappeared lawyer may, pursuant to the provisions of Rule 1.17, pay to the estate or other representative of that lawyer the agreed-upon purchase price;

(3) A lawyer or law firm may include non-lawyer employees in a compensation or retirement plan, even though the plan is based in whole or in part on a profit-sharing arrangement; and

(4) A lawyer may share court-awarded legal fees with a nonprofit organization that employed, retained or recommended employment of the lawyer in the matter.

(b) A lawyer shall not form a partnership with a non-lawyer if any of the activities of the partnership consist of the practice of law.

(c) A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services.

California Rules of Professional Conduct

…

Rule 3-100 Confidential Information of a Client

(A) A member shall not reveal information protected from disclosure by Business and Professions Code section 6068, subdivision (e)(1) without the informed consent of the client, or as provided in paragraph (B) of this rule.

(B) A member may, but is not required to, reveal confidential information relating to the representation of a client to the extent that the member reasonably believes the disclosure is necessary to prevent a criminal act that the member reasonably believes is likely to result in death of, or substantial bodily harm to, an individual.

(C) Before revealing confidential information to prevent a criminal act as provided in paragraph (B), a member shall, if reasonable under the circumstances:

> (1) make a good faith effort to persuade the client: (i) not to commit or to continue the criminal act or (ii) to pursue a course of conduct that will prevent the threatened death or substantial bodily harm; or do both (i) and (ii); and
>
> (2) inform the client, at an appropriate time, of the member's ability or decision to reveal information as provided in paragraph (B).

(D) In revealing confidential information as provided in paragraph (B), the member's disclosure must be no more than is necessary to prevent the criminal act, given the information known to the member at the time of the disclosure.

(E) A member who does not reveal information permitted by paragraph (B) does not violate this rule.

Rule 3-110 Failing to Act Competently

(A) A member shall not intentionally, recklessly, or repeatedly fail to perform legal services with competence.

(B) For purposes of this rule, "competence" in any legal service shall mean to apply the 1) diligence, 2) learning and skill, and 3) mental, emotional, and physical ability reasonably necessary for the performance of such service.

(C) If a member does not have sufficient learning and skill when the legal service is undertaken, the member may nonetheless perform such services competently by 1) associating with or, where appropriate, professionally consulting another lawyer reasonably believed to be competent, or 2) by acquiring sufficient learning and skill before performance is required.

…

Rule 3-310 Avoiding the Representation of Adverse Interests

(A) For purposes of this rule:

> (1) "Disclosure" means informing the client or former client of the relevant circumstances and of the actual a reasonably foreseeable adverse consequences to the client or former client;
>
> (2) "Informed written consent" means the client's or former client's written agreement to the representation following written disclosure;
>
> (3) "Written" means any writing as defined in Evidence Code section 250.

(B) A member shall not accept or continue representation of a client without providing written disclosure to the client where:

> (1) The member has a legal, business, financial, professional, or personal relationship with a party or witness in the same matter; or
>
> (2) The member knows or reasonably should know that:
>
>> (a) the member previously had a legal, business, financial, professional, or personal relationship with a party or witness in the same matter; and
>>
>> (b) the previous relationship would substantially affect the member's representation; or
>
> (3) The member has or had a legal, business, financial, professional, or personal relationship with another person or entity the member knows or reasonably should know would be affected substantially by resolution of the matter; or
>
> (4) The member has or had a legal, business, financial, or professional interest in the subject matter of the representation.

(C) A member shall not, without the informed written consent of each client:

(1) Accept representation of more than one client in a matter in which the interests of the clients potentially conflict; or

(2) Accept or continue representation of more than one client in a matter in which the interests of the clients actually conflict; or

(3) Represent a client in a matter and at the same time in a separate matter accept as a client a person or entity whose interest in the first matter is adverse to the client in the first matter.

(D) A member who represents two or more clients shall not enter into an aggregate settlement of the claims of or against the clients without the informed written consent of each client.

(E) A member shall not, without the informed written consent of the client or former client, accept employment adverse to the client or former client where, by reason of the representation of the client or former client, the member has obtained confidential information material to the employment.

(F) A member shall not accept compensation for representing a client from one other than the client unless:

(1) There is no interference with the member's independence of professional judgment or with the client-lawyer relationship; and

(2) Information relating to representation of the client is protected as required by Business and Professions Code section 6068, subdivision (e); and

(3) The member obtains the client's informed written consent, provided that no disclosure or consent is required if:

(a) such nondisclosure is otherwise authorized by law; or

(b) the member is rendering legal services on behalf of any public agency which provides legal services to other public agencies or the public.

…

Rule 3-500 Communication

A member shall keep a client reasonably informed about significant developments relating to the employment or representation, including promptly complying with reasonable requests for information and copies of significant documents when necessary to keep the client so informed.

…

Rule 3-700 Termination of Employment

(A) In General.

(1) If permission for termination of employment is required by the rules of a tribunal, a member shall not withdraw from employment in a proceeding before that tribunal without its permission.

(2) A member shall not withdraw from employment until the member has taken reasonable steps to avoid reasonably foreseeable prejudice to the rights of the client, including giving due notice to the client, allowing time for employment of other counsel, complying with rule 3-700(D), and complying with applicable laws and rules.

(B) Mandatory Withdrawal.

A member representing a client before a tribunal shall withdraw from employment with the permission of the tribunal, if required by its rules, and a member representing a client in other matters shall withdraw from employment, if:

(1) The member knows or should know that the client is bringing an action, conducting a defense, asserting a position in litigation, or taking an appeal, without probable cause and for the purpose of harassing or maliciously injuring any person; or

(2) The member knows or should know that continued employment will result in violation of these rules or of the State Bar Act; or

(3) The member's mental or physical condition renders it unreasonably difficult to carry out the employment effectively.

…

CALIFORNIA CIVIL CODE

§ 2860. Provision of independent counsel to insured; Conflicts of interest; Selection of counsel; Waiver of right to counsel

(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. An insurance contract may contain a provision which sets forth the method of selecting that counsel consistent with this section.

(b) For purposes of this section, a conflict of interest does not exist as to allegations or facts in the litigation for which the insurer denies coverage; however, when an insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim, a conflict of interest may exist. No conflict of interest shall be deemed to exist as to allegations of punitive damages or be deemed to exist solely because an insured is sued for an amount in excess of the insurance policy limits.

(c) 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. 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. This subdivision does not invalidate other different or additional policy provisions pertaining to attorney's fees or providing for methods of settlement of disputes concerning those fees. Any 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.

(d) 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.

(e) 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."

(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.

CALIFORNIA BUSINESS AND PROFESSIONS CODE

§ 6068. It is the duty of an attorney to do all of the following:

…

(e)(1) To maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client.

(2) Notwithstanding paragraph (1), an attorney may, but is not required to, reveal confidential information relating to the representation of a client to the extent that the attorney reasonably believes the disclosure is necessary to prevent a criminal act that the attorney reasonably believes is likely to result in death of, or substantial bodily harm to, an individual.

…

(m) To respond promptly to reasonable status inquires of clients and to keep clients reasonably informed of significant development in matters with regard to which the attorney has agreed to provide legal services.

Editor's Note:

State Bar Ethics Opinions cite the applicable California Rules of Professional Conduct in effect at the time of the writing of the opinion. Please refer to the California Rules of Professional Conduct Cross Reference Chart for a table indicating the corresponding current operative rule. There, you can also link to the text of the current rule.

THE STATE BAR OF CALIFORNIA
STANDING COMMITTEE ON
PROFESSIONAL RESPONSIBILITY AND CONDUCT

FORMAL OPINION NO. 1995-139

ISSUE:

To whom does an attorney owe duties when he or she acts as insurance defense counsel and is hired by an insurer to represent an insured in the substantive defense of the insured's case? Specifically, to whom are the duties owed: (a) where counsel discovers information that demonstrates the insured has or may have no coverage; or (b) where the attorney learns the insured has perpetrated a fraud for the purpose of obtaining coverage?

DIGEST:

The attorney owes his or her loyalty to the insured, even where there are duties which are ordinarily owed by the attorney to the insurer. This means that in situations where matters adverse to the insurer are discovered, even where the insured has failed to be candid with the insurer or the attorney, the attorney may not reveal these matters to insurer, and may be required to withdraw.

AUTHORITIES INTERPRETED:

Rules 3-310, 3-500 and 3-700 of the California Rules of Professional Conduct.

Business and Professions Code section 6068, subdivision (e) and 6068, subdivision (m).

Civil Code section 2860.

DISCUSSION

Representation of an insured by an attorney hired by the insurer is a common litigation event. In most of these cases, no overt conflict of interest exists between insurer and insured. In State Bar Formal Opinion No. 1987-91, this committee quoted from *American Mutual Liability Insurance Co. v. Superior Court* (1974) 38 Cal.App.3d 579, 592 [113 Cal.Rptr. 561, 571]:

> In such a situation, the attorney has two clients whose primary, overlapping and common interest is the speedy and successful resolution of the claim and litigation. Conceptually, each member of the trio . . . has corresponding rights and obligations founded largely on contract, and as to the attorney, by the Rules of Professional Conduct, as well.

Case law predating rule 3-310 of the California Rules of Professional Conduct[1] assumes, as the above quote indicates, that the insured may ordinarily be represented without a separate, specific written disclosure to insurer and insured -- or a written consent from insurer and insured -- other than the insurance contract itself. Rule 3-310(B)(3), however, requires written disclosure to all clients where, inter alia, "[t]he member has or had a legal, business, financial, professional, or personal relationship with another person or entity the member knows or reasonably should know would be affected substantially by resolution of the matter." Moreover rule 3-310(C)(1) requires that the informed written consent of each client be obtained where there is ". . . representation of more than one client in a matter in which the interests of the clients potentially conflict."

Rule 3-310 may seem at odds with some case law dicta. Clearly, insurer is denominated a "client" by case law -- albeit in dicta as discussed *infra* -- and is substantially affected by the insured's matter. But while insurer is indeed a client in some respects -- the ongoing relationship with the member, the payment of fees, etc. -- it is a client whose rights under case law are clearly limited. (See *infra*.)

Where a member complies with the mandates of this opinion to protect the interests of the insured, his or her additional compliance with rule 3-310 is not necessary for two reasons: First, given the unusual, perhaps unique, interrelationship of insurer, insured and counsel, the contract of insurance itself, drafted by the insurer for its own benefit, provides more than adequate disclosure under rule 3-310(B)(3) to the insurer.[2] Second, the "potential conflict" trigger of rule 3-310(C)(1) is never pulled because, as seen *infra*, when such a conflict manifests itself, case law resolves any potential conflict in that matter by mandating a resolution in favor of the represented insured and against the non-represented, non-party insurer. Put another way, case law instructs that ultimately, there can be no conflict between insurer and insured since, as discussed *infra*, the insured will always prevail where an [illegible] is created between them. (See L.A. Cty. Bar Formal Opn. No. 464.) Thus, the notice to and waiver by the insured is superfluous.[3]

Where a known conflict of interest does exist, the insured may be entitled to independent counsel. (*San Diego Federal Credit Union v. Cumis Insurance Society, Inc.* (1984) 162 Cal.App.3d 358 [208 Cal.Rptr. 494].) Civil Code section 2860 dictates guidelines for when an insurer owes a duty to an insured to provide independent counsel. When there are separate, independent counsel for both insurer and insured, they "shall cooperate fully in the exchange of information that is consistent with each counsel's ethical and legal obligation to the insured." (Civ. Code, § 2860 (f).) But the insured's independent counsel, freed from serving two clients, owes his or her fiduciary duties entirely to the insured and should maintain decision-making control over the litigation on the insured's behalf. (See L.A. Cty. Bar Formal Opn. No. 464.)

The issue is more complex in evaluating the responsibilities of a lawyer where a conflict between insurer and insured arises, and there is *not* independent counsel for both insurer and insured. This can occur, inter alia, where a coverage problem is known to exist,[4] or where counsel becomes aware of problems during the course of the representation.

Although insurance defense counsel's representation of divergent interests can be attempted "provided there is full disclosure and consent," this dual role cannot diminish counsel's responsibility to the insured. (*Betts v. Allstate Insurance Co.* (1984) 154 Cal.App.3d 688, 715-716 [201 Cal.Rptr. 528].) The attorney is obligated at all times to protect the insured/client and may not act in any way which prevents "devoting his entire energies to his client's interest." (*Ibid.* quoting from *Anderson v. Eaton* (1931) 211 Cal. 113, 116 and *Klemm v. Superior Court* (1977) 75 Cal.App.3d 893, 901-902 [142 Cal.Rptr. 509].)[5]

It is the obligation of any attorney to keep clients "reasonably informed about significant developments" relating to the case. (Rule 3-500; Bus. & Prof. Code, § 6068, subd. (m).) For the insurance defense counsel, this communication must include a duty to disclose "all facts and circumstances . . . necessary to enable each of his clients to make free and intelligent decisions regarding the subject matter of the representation." (*Lysick v. Walcom* (1968) 258 Cal.App.2d 136, 151 [65 Cal.Rptr. 406] [criticizing a lawyer who communicated a third party demand in excess of policy limits only to insurer, and not to insured].)

It is also the duty of any attorney to maintain inviolate the confidences of a client and to preserve at every peril to himself or herself the client's secrets. (Bus. & Prof. Code, § 6068, subd. (e).) Thus, if an insured reveals matters to the attorney in confidence, and these matters are not intended to be heard by the insurer, the attorney may not reveal them to the insurer, regardless of the relationship between them. (*American Mutual Liability Insurance Co. v. Superior Court*, *supra*, 38 Cal.App.3d at p. 592.) The same analysis applies to any secrets of the insured/client learned by the attorney during the course of the representation.[6]

This means that, even where the attorney has a close ongoing relationship with an insurer, and from a business perspective considers insurer an important "client," in any particular representation it is the obligation to protect the *insured's* confidences and secrets which is paramount. Thus, if, for example, the attorney gains information during the course of representation which the attorney believes demonstrates that the insured is actually not entitled to coverage, the attorney nevertheless owes a duty to the insured/client not to reveal this information to the insurer.

This is true even where the attorney comes to believe that the insured has fraudulently created a situation in which coverage appears to exist where it actually does not. For example, an insured might claim to be driving a vehicle when the actual driving was done by a friend or family member who was not insured. Even in these relatively extreme situations, the requirements of Business and Professions Code section 6068, subdivision (e) prevent disclosure to anyone, including the insurer, of material harmful to the insured. (*Price v. Giles* (1987) 196 Cal.App.3d 1469, 1473 [242 Cal.Rptr. 55[illegible] *Pennix v. Winton* (1943) 61 Cal.App.2d 761 [143 P.2d 940].)

In coverage question situations where there has not been a Civil Code section 2860 disclosure and consent to the representation, or where subsequent to disclosure and consent, new information has come to light which affects the question of coverage, the attorney may be required to withdraw. Such withdrawal is governed by rule 3-700. In any matter which is pending in litigation, permission must be obtained by the tribunal before withdrawal may be accomplished. (Rule 3-700(A).) Depending on the circumstances and the reasons for withdrawal, termination of employment may be permissive or mandatory. The line between mandatory and permissive withdrawal is not always a clear one.

Where insurance defense counsel is confronted by new information which changes the apparent coverage situation of insurer in a way not contemplated in an initial disclosure and consent between insurer and insured, continued representation may place counsel in the position of representing conflicting interests. This may best be understood if counsel evaluates the information he or she cannot reveal to insurer from the point of view of that insurer -- that is, is the information something which counsel devoted to *insurer's* interests would ordinarily be obligated to reveal, but for the dual loyalties involved? Withdrawal in such situations is best viewed as being mandatory, as continued representation would place counsel in the position of representing conflicting interests in violation of rule 3-310(C)(2).

Where counsel learns that the intentional wrongful acts of insured have damaged insurer, such as where insurer has accepted coverage based on insured's fraudulent assertions, or where the insured has concealed material facts from the insurer, not only does a conflict of interest exist, but the member has learned that the insured/client has acted in a manner injurious to the insurer. When these circumstances are viewed together, withdrawal is required. (Rules 3-700(B)(1) & 3-700(B)(2).) Moreover, in such circumstances, failure to withdraw would involve the lawyer, who is billing the insurer, in the perpetuation of insured's fraudulent efforts to have insurer pay defense costs.

Where such withdrawal is necessary, however, it may be done only with express court approval (rule 3-700(A)(1)), and only where it is accomplished in a manner which does not prejudice the rights of the insured, while protecting confidential communications. (Rule 3-700(A)(2).) It is imperative that, although withdrawal may be required, assiduous effort be made to accomplish it in such a way as does not disclose the very information which caused the attorney to seek withdrawal in the first place. Moreover, given the ongoing relationship between the attorney and the insurer, special care must be taken by the attorney during the withdrawal process to protect the reasons for withdrawal.

This opinion is issued by the Standing Committee on Professional Responsibility and Conduct of the State Bar of California. It is advisory only. It is not binding upon the courts, the State Bar of California, its Board of Governors, any persons or tribunals charged with regulatory responsibilities, or a member of the State Bar.

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[1] All rule references are to the Rules of Professional Conduct of the State Bar of California.

[2] We speak here of those situations where the lawyer's role is as counsel providing substantive defense to the insured, and thus not "coverage counsel" responsible for addressing coverage issues. This limited scope of representation should be clearly delineated and understood between attorney and insurer to avoid requiring further compliance with rule 3-310(B).

[3] Counsel has an obligation, however, to be circumspect in communications with the insurer, which continues to "hold the purse strings" under the insurance contract, so that matters are not disclosed to insurer which could be adverse to insured.

[4] *San Diego Federal Credit Union v. Cumis Insurance Society,Inc., supra*, 162 Cal.App.3d at p. 358, implies that the existence of insurance coverage issues gives rise to the insured's right to independent counsel. Other courts disagreed that this is always the case (see, e.g., *McGee v. Superior Court* (1985) 176 Cal.App.3d 1265 [221 Cal.Rptr. 421]), and Civil Code section 2860 (b), passed subsequently, also expresses a narrower view. After stating that the insurer's outright denial of coverage presents no conflict, the statute continues: "[H]owever, when an insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim, a conflict of interest *may* exist". (Emphasis added.)

[5] The conclusions expressed in this opinion apply generally to an insurer's in-house defense counsel retained to defend an insured. However, additional considerations not addressed in this opinion may also be applicable.

[6] The term "secrets" is defined in Business and Professions Code section 6068, subdivision (e), and interpreted, inter alia, in California State Bar Formal Opinion Number 1980-52 and Los Angeles County Bar Formal Opinion Number 456. The existence of such secrets necessarily limits the communication that insurer/client would ordinarily be entitled to, as described above. This is best viewed by understanding that at the point at which a conflict develops, the insurer is no longer a client in the usual sense, because the "overlapping and common" interest described in *American Mutual Liability Insurance Co., supra*, 38 Cal.App.3d at pages 591-592, no longer exists. Thus, when courts in insurance conflict cases have referred to duties owed to "the client," they necessarily mean the insured/client. Indeed, it is the insured who is to be "protect[ed] . . . in every possible way," (*Betts v. Allstate Ins. Co., supra*, 154 Cal.App.3d at p. 715), and who is entitled to the same efforts from counsel that would be owed had insured personally hired the attorney. (*Lysick v. Walcom, supra*, 258 Cal.App.2d at p. 136.) Indeed, it is worth noting that both *American Mutual Liability Insurance Co.* and *Betts v. Allstate Insurance Co.*, as well as other cases which refer to both the insured and insurer as clients do so for the sole purpose of emphasizing the protections that must be afforded the insured/client. Thus, the reference, in dicta, to the insurer as a client, is a use of the term "client" which is materially different from the traditional use of that term.

AMERICAN BAR ASSOCIATION
STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

Formal Opinion 01-421 **February 16, 2001**
Ethical Obligations of a Lawyer Working Under Insurance Company Guidelines and Other Restrictions

A lawyer must not permit compliance with "guidelines" and other directives of an insurer relating to the lawyer's services to impair materially the lawyer's independent professional judgment in representing an insured. A lawyer may disclose the insured's confidential information, including detailed work descriptions and legal bills, to the insurer if the lawyer reasonably believes that doing so will advance the interests of the insured. A lawyer may not, however, disclose the insured's confidential information to a third-party auditor hired by the insurer without the informed consent of the insured. Moreover, if the lawyer reasonably believes that disclosure of the insured's confidential information to the insurer will affect a material interest of the insured adversely, the lawyer must not disclose such information without the informed consent of the insured.

The Committee addresses the ethical issues that arise under the Model Rules of Professional Conduct when a lawyer retained by an insurance company to defend an insured is required to work under litigation management guidelines or other restrictions imposed by the insurer. The Committee also addresses the ethical issues associated with insurance companies requiring a lawyer to submit detailed billing information to the insurer or an independent auditor so that the insurer can determine whether the lawyer's charges conform to the insurer's general requirements and guidelines.

For the reasons discussed below, we conclude that lawyers representing insured clients must not permit the client's insurance company to require compliance with litigation management guidelines the lawyer reasonably believes will compromise materially the lawyer's professional judgment or result in his inability to provide competent representation to the insured. A lawyer may not disclose

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This opinion is based on the Model Rules of Professional Conduct and, to the extent indicated, the predecessor Model Code of Professional Responsibility of the American Bar Association. The laws, court rules, regulations, codes of professional responsibility, and opinions promulgated in the individual jurisdictions are controlling.

AMERICAN BAR ASSOCIATION STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY, 541 North Fairbanks Court, 14th Floor, Chicago, Illinois 60611-3314 Telephone (312)988-5300 CHAIR: Donald B. Hilliker, Chicago, IL ❑ Loretta C. Argrett, Washington, DC ❑ Jackson M. Bruce, Jr., Milwaukee, WI ❑ William B. Dunn, Detroit, MI ❑ James W. Durham, Philadelphia, PA ❑ Mark I. Harrison, Phoenix, AZ ❑ Daniel W. Hildebrand, Madison, WI ❑ William H. Jeffress, Jr., Washington, DC ❑ M. Peter Moser, Baltimore, MD ❑ CENTER FOR PROFESSIONAL RESPONSIBILITY: George A. Kuhlman, Ethics Counsel; Eileen B. Libby, Associate Ethics Counsel

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the insured's confidential information[1] to a third-party auditor hired by the insurer without the informed consent[2] of the insured, but a lawyer may submit a client's detailed bills that contain confidential information to the client's insurer if the lawyer reasonably believes that disclosure: (1) impliedly is authorized and will advance the interests of the insured in the representation, and (2) will not affect a material interest of the insured adversely. If the lawyer believes that disclosure of billing statements or other confidential information to the insurer adversely will affect a material interest of the insured, the lawyer must not disclose such information without informing the client about the nature and potential consequences of both making and not making the requested disclosure and obtaining the client's informed consent to the release of the information.

I. Tripartite Relationship Among Lawyers, the Insurer and Insured

A. Background

By entering into a liability insurance contract with an insurance company, the insured gives certain contractual rights to the insurer and consents to giving the company some control over the direction of the defense and any settlement of the matter.[3] Pressured by increased litigation costs,[4] some insurance companies have implemented programs to monitor the services and fees of lawyers they retain.[5] Among the cost-saving strategies employed by these companies are the imposition of guidelines and procedures, regulation of expenses, and audits of legal bills. Insurance companies have a legitimate interest in lawyer billing practices and in controlling expenses. Some litigation management guidelines, however, go beyond describing the rights and duties of the insurer, the insured, and defense

1. The term "confidential information" is used to denote information relating to the representation of a client as used in Rule 1.6 and elsewhere in the Model Rules of Professional Conduct.

2. "Informed consent" and "consent after consultation" often are used interchangeably. The term "consultation" is defined to mean "communication of information reasonably sufficient to permit the client to appreciate the significance of the matter in question." "Informed consent" will be used throughout the balance of this opinion. *See* MODEL RULES OF PROFESSIONAL CONDUCT Terminology (2001); ABA Comm. on Ethics and Professional Responsibility, Formal Op. 94-388 (Relationships Among Law Firms), *in* FORMAL AND INFORMAL ETHICS OPINIONS 1983-1998 262, 266 n. 4 (ABA 2000).

3. *See* 7c JOHN ALAN APPLEMAN AND JEAN APPLEMAN, INSURANCE LAW AND PRACTICE, § 4681 at 203 (1979).

4. Costs of defense can consume nearly 55 cents of every claim dollar. C. David Sullivan and Patrick T. Muldowney, *Changing Times in the Insurance Industry*, FOR THE DEFENSE (DRI Supp., February 1998).

5. Some of the practices targeted by insurance companies include frequent and obvious billing abuses such as charging for doing extensive legal research on marginal issues and charging for "file review" unconnected to any particular objective. *See generally* J. Stratton Shartel, *Tensions Between Insurers, Outside Counsel Remain Near the Boiling Point*, 10 INSIDE LITIGATION 7, 20 (October 1993).

counsel and give the insurance company the right to control the defense to the degree that the lawyer's professional judgment in rendering legal services may be materially impaired.

B. The Ethical Implications of the Tripartite Relationship

The tripartite relationship among defense lawyer, insured, and insurer requires a delicate balance of rights and duties. Some jurisdictions regard both the insured and insurer as clients in the absence of a conflict of interest.[6] Other jurisdictions regard only the insured as the client.[7] In ABA Formal Opinion 96-403 (1996)

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6. One court has held that "if there is no conflict, an attorney-client relationship can be created between an insurer hiring an attorney to represent an insured, despite the lack of an express agreement." Paradigm Ins. Co. v. Langerman Law Offices, 196 Ariz. 573, 576, 2 P.3d 663, 666 (Ariz. App. 1999) (citing Home Indem. Co. v. Lane Powell Moss and Miller, 43 F.3d 1322, 1330-31 (9th Cir.1995)). *See* MGIC Indem. Corp. v. Weisman, 803 F.2d 500, 504 (9th Cir.1986); Unigard Ins. Group v. O'Flaherty & Belgum, 38 Cal.App.4th 1229, 1236-37, 45 Cal.Rptr.2d 565, 568-69 (Cal. Ct. App. 1995); Nandorf, Inc. v. CNA Ins. Cos., 134 Ill.App.3d 134, 136-37, 479 N.E.2d 988, 991 (1985). *See also* State Farm Mut. Auto. Ins. Co. v. Federal Ins. Co., 86 Cal. Rptr.2d 20, 24-25, 72 Cal.App.4th 1422, 1428 (Cal. Ct. App. 1999) (lawyer represents two clients, the insured and the insurer but, "as a practical matter, the attorney may have closer ties with the insurer than with the insured"); Gray v. Commercial Union Ins. Co., 191 N.J.Super. 590, 596, 468 A.2d 721, 725 (1983) ("There is no dispute that as a fundamental proposition a defense lawyer is counsel to both the insurer and the insured."); Charles Silver, *Does Insurance Defense Counsel Represent the Company or the Insured?*, 72 TEX. L. REV. 1583 (1994) (lawyer represents both insured and insurer if retainer agreement so provides); Scott L. Machanic, *Insurance Defense Counsel: Who Is the Client?*, 43 FED'N INS. & CORP. COUNS. Q. 45 (1992) (parties and courts typically assume the lawyer represents both insured and insurer); Richard L. Neumeier, *Serving Two Masters: Problems Facing Insurance Defense Counsel and Some Proposed Solutions*, 77 MASS. L. REV. 66, 69 (1992) ("the law firm is attorney for the insured as well as the insurer. This is the majority rule.") (quoting McCourt Co. v. FPC Properties, Inc., 386 Mass. 145, 145, 434 N.E.2d 1234, 1235 (1982)).

7. *See, e.g.,* In the Matter of the Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedures, 2 P.3d 806, 814 (Mont. 2000); Atlanta Int'l Ins. Co. v. Bell, 438 Mich. 512, 519, 475 N.W.2d 294, 297 (Mich. 1991); Supreme Court of Washington v. Tank, 105 Wash.2d 381, 388, 715 P.2d 1133, 1137 (Wash. 1986). *See also* Colorado Bar Association Ethics Committee Formal Op.107 (September 18, 1999); Florida Bar Staff Op. 20591 (December 31, 1997); Maine Professional Ethics Commission of the Board of Overseers Op. 164 (December 2, 1998); Pennsylvania Bar Association Committee on Legal Ethics and Professional Responsibility Informal Op. No. 97-119, 1997 WL 816708 *1 (Pa.Bar.Assn.Comm.Leg.Eth.Prof.Resp. October 7, 1997); Washington State Bar Association Formal Op. 195 (1999). THE RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS, § (1)(a) (2000) ("the Restatement") acknowledges that a relationship arises when a "person manifests to a lawyer the person's intent that the lawyer provide legal services for the person" and "the lawyer manifests to the person consent to do so." Section 14(1)(b) states that a lawyer-client relationship can arise

(Obligations Of A Lawyer Representing An Insured Who Objects To A Proposed Settlement Within Policy Limits),[8] the Committee observed, "[t]he Model Rules of Professional Conduct offer virtually no guidance as to whether a lawyer retained and paid by an insurer to defend its insured represents the insured, the insurer, or both."[9] As was the case in Formal Opinion 96-403, we take no position as to whom the lawyer represents absent an express agreement as to the identity of the client.

Rule 1.2(a) requires a lawyer to abide by a client's decisions concerning the objectives of the representation and to consult with the client concerning the means by which those objectives shall be pursued. Comment [1] states that "the lawyer should defer to the client regarding such questions as the expense to be incurred." The question whether the insurance company may be deemed a "client" who can direct the scope and extent of the representation is unsettled although a majority of the jurisdictions that have addressed the issue have concluded that in the absence of a conflict, a lawyer concurrently may represent both the insurer and the insurer. Regardless of whether the insurer is a client, Rule 5.4(c) states that a lawyer "shall not permit a person who recommends, employs or pays a lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering . . . legal services."

II. The Effect of Insurer Guidelines on the Lawyer's Ethical Obligations

The interests of the insurance company and the insured may diverge if the insurance company has a paramount interest in controlling or reducing its defense costs and the insured's main interest is to receive the best possible defense. Although defense lawyers must be sensitive to the economic interests of the insurance companies that employ them and cognizant of the fact that costs of litigation ultimately are borne by insureds through premiums, they must not allow their professional judgment or the quality of their legal services to be compromised materially by the insurer.

If the lawyer is hired to defend an insured pursuant to an insurance policy that authorizes the insurer to control the defense and, in its sole discretion, to settle within policy limits, the lawyer must communicate these limitations on his representa-

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when "a person manifests to a lawyer the person's intent that the lawyer provide legal services for the person" and "the lawyer fails to manifest lack of consent to do so, and the lawyer knows or reasonably should know that the person reasonably relies on the lawyer to provide the services." The Comment to § 134 states that whether a lawyer-client relationship exists between the lawyer and the insurer is determined under § 14. *See also* Debra A. Winiarski, *Walking the Fine Line: A Defense Counsel's Perspective*, 28 TORT & INS. L.J. 596-97 (1993); Robert E. O'Malley, *Ethics Principles for the Insurer, the Insured, and Defense Counsel: The Eternal Triangle Reformed*, 66 TUL. L. REV. 511, 512 (1991); RONALD E. MALLEN & JEFFREY M. SMITH, LEGAL MALPRACTICE § 28.3-5 (4th ed. 1996) (collecting authorities).

8. FORMAL AND INFORMAL ETHICS OPINIONS 1983-1998 at 403.

9. *Id.* at 404.

tion of the insured to the insured, preferably early in the representation. The lawyer should "make appropriate disclosures sufficient to apprise the insured of the limited nature of his representation as well as the insurer's right to control the defense in accordance with the terms of the insurance contract . . . . No formal acceptance or written consent is necessary. The insured manifests consent to the limited representation by accepting the defense offered by the insurer after being advised of the terms of the representation being offered."[10] Once this communication takes place, the lawyer is free to settle the claim at the direction of the insurer.[11]

Because it is paying both the costs of defense and any resulting judgment or settlement up to the limits of the policy, the insurance company normally has the primary financial stake in the matter. Pursuant to the liability insurance contract, the insured delegates to the insurance company the right to defend the case and is required to cooperate in the insured's defense. However, the rules of professional conduct—and not the liability insurance contract—govern the lawyer's ethical obligations to his client, whether the client is the insured, the insurer, or both. To the extent that the insurance company and the insured seek an expeditious and favorable outcome to the litigation, their interests converge. Indeed, in Formal Opinion 282 (1950),[12] we stated that "a community of interest exists between the company and the insured growing out of the contract of insurance with respect to any action brought by a third person against the insured within the policy limitations. The company and the insured are virtually one in their common interest. The requirement that the insurance company shall defend an action contemplates that the company, because of its contractual liability and community of interest, shall take charge of the incidents of such defense including the supervising of the litigation."[13]

In most cases, undivided loyalty to the insured thus would be fully consistent with undivided loyalty to the insurance company and its directives without regard to whether both insured and insurer are clients of the lawyer. In the vast majority of cases, litigation management guidelines do not raise ethical concerns. The insured no doubt is willing to entrust the litigation against him to the insurance company, which has risk management and litigation experience in similar matters. The insurance company usually is in the best position to manage the litigation to

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10. *Id.* at 406-07. In Opinion 96-403, we further stated that a lawyer could satisfy the requirements of Rule 1.2(c) by sending the insured a short letter clearly apprising the insured "of the limitations on the representation being offered by the insurer and that the lawyer intends to proceed in accordance with the directions of the insurer." *Id.* at 406.

11. Some states hold that even if a settlement authority has been conferred on the insurer by the insurance policy, the lawyer's ethical obligations require the insured's informed consent before a settlement can occur. *See, e.g.,* Rogers v. Robson, Masters, Ryan, Brumund and Belom, 81 Ill. 2d 201, 205, 407 N.E. 2d 47, 49 (1980); Miller v. Byrne, 916 P.2d 566, 574 (Colo. App. 1996). This view is also consistent with Rules 1.2(a) and 1.4.

12. Opinions of the Committee on Professional Ethics 621 (ABA 1967).

13. *Id.* at 622-23.

the advantage of both the insured and itself in the most cost-effective way. There are rare situations when the lawyer believes a limitation imposed by the insurer's litigation management guidelines is compromising the lawyer's ability to provide competent representation to both the insured and insurer clients.

If the lawyer reasonably believes his representation of the insured will be impaired materially by the insurer's guidelines or if the insured objects to the defense provided by a lawyer working under insurance company guidelines, the lawyer must consult with both the insured and the insurer concerning the means by which the objectives of the representation are being pursued. "If the lawyer is to proceed with the representation of the insured at the direction of the insurer, the lawyer must make appropriate disclosure sufficient to apprise the insured of the limited nature of his representation as well as the insurer's right to control the defense in accordance with the terms of the insurance contract."[14] If the insurer does not withdraw or modify the limitation on the lawyer's representation and the insured refuses to consent to the limited representation, the resulting conflict implicates Rule 1.7(b) and unless the lawyer is willing to represent the insured without compensation from the insurer, requires the lawyer to terminate the representation of both clients.[15]

In such situations, the lawyer has few alternatives available to him. The lawyer can try to persuade the insurer to withdraw the limitation. If the lawyer is unable to persuade the insurer-client to withdraw the limitation, the resulting conflict between the insurer's directives and the insured's immediate interests requires the lawyer to withdraw from representing the insurer and to protect the immediate interests of the insured in the litigation.[16] In this unlikely situation, the lawyer must, in contemplation of his immediate resignation from representation of the insured, protect the immediate interests of the insured in order to assure that his withdrawal can be accomplished without material adverse affect on the insured's interests, as contemplated by 1.16(b). Thereafter, if the lawyer is unable satisfactorily to resolve the conflict implicated by the insurer's guidelines, the lawyer may seek to withdraw pursuant to Rule 1.7 or 1.16(b).

III. Lawyer's Submission of Client Billing Records to the Insurer or to the Insurer's Third-Party Auditor

Another cost-containment measure used by the insurance industry is review of client billing information by third-party auditors. The phrase "legal bill audit" "encompasses a range of services, from an examination of the face of the legal bill for improper charges or errors to a detailed analysis of original time records,

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14. *Id. See also* Rule 1.8(f)(2); Board of Professional Responsibility of the Supreme Court of Tennessee Ethics Op. 2000-F-145, 2000 WL 1687507 (Sept. 8, 1999).

15. Rule 1.7 Comment [2].

16. Comment [4] to Rule 1.8(f) states that when a lawyer's services are being paid for by a third party, "[s]uch an arrangement must also conform to the requirements of Rule 1.6 . . . and Rule 1.7 . . . ."

17. *See generally* John Toothman, *Surviving a Legal Bill Audit*, 15 COMPLEAT LAWYER 45 (Winter 1998).

attorney work product, expenses and hourly rate benchmarks, and more.[17] In submitting a claim to the insurance company, the insured may be subject to the provisions of the contract of insurance that grant the insurance company access to confidential information. Moreover, most of the confidential information disclosed to the insurer usually will advance the interests of the insured as well as the interests of the insurer and will not affect a material interest of the insured adversely.[18]

An audit may include an examination of hourly rates and background information about the legal matters for which the bill was submitted, including examination of the lawyer's work product and opposing counsel's work product in order to gauge "quality, tactic, strategy, and performance in context."[19] A detailed bill review might include "verification of raw data, interviews of key personnel, examination of firm billing systems, checking the original time records against time entries in invoices, and reconciling receipts for expenses with the bill.[20] Most of the information supplied to insurers through billing records is of a general nature, is publicly known (e.g. the lawyer's court appearances), or already known as a result of the insured having forwarded it to the insurer to facilitate the defense (e.g. medical information). Although this information may be subject to the protections of Rule 1.6(a) as "confidential information," its disclosure to the insurer nonetheless would be authorized impliedly either to comply with the insurance contract or to carry out the representation, or both.[21] Billing records and underlying documentation may, however, reveal the motive of the client in seeking representation, litigation strategy, or the specific nature of the services provided to the insured. This information generally is protected by the confidentiality rule or the attorney-client privilege or both.[22] In addition to the foregoing justifications for disclosure of otherwise confidential and/or privileged information to the insurer, disclosure to the insurer may be appropriate when both the insured and insurer are regarded as clients of the lawyer.[23]

Rule 1.8(f) prohibits a lawyer from accepting compensation for representing a client from one other than the client unless the client has given informed consent, there is no interference with the lawyer's independence of professional judgment

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18. In Formal Opinion 95-398 (Access of Nonlawyers to a Lawyer's Data Base), we stated that a law firm may give independent contractors access to the insured's confidential information to assist it in representing its clients. FORMAL AND INFORMAL ETHICS OPINIONS 1983-1998 at 366, 367.

19. Toothman, *supra*, note 17 at 49.

20. *Id.*

21. *See* Stephen Gillers, *Ethical Issues in Monitoring Insurance Defense Fees: Confidentiality, Privilege and Billing Guidelines* 4-6 (Law Audit Services, Inc. 1998).

22. *See* Clarke v. American Commerce Nat'l Bank, 974 F.2d 127, 129 (9th Cir.1992), *reh'g denied*, 977 F.2d 1533 (9th Cir. 1992); Licensing Corp. of America v. National Hockey League Players Ass'n, 153 Misc.2d 126, 127-28, 580 N.Y.S.2d 128, 130 (N.Y. Sup.Ct. 1992).

23. Although the right to share confidential information between co-clients may be implied, *see, e.g.*, Brennan's Inc. v. Brennan's Restaurant, Inc., 590 F.2d 168, 173 (5th Cir. 1979), some jurisdictions have condemned the sharing of confidential information between and among co-clients in the absence of each client's informed consent. *See, e.g.*, D.C. Bar Opinion 296 (2000); Florida Bar Ethics Opinion 95-4 (May 30, 1997).

or with the client-lawyer relationship, and information relating to a client's representation is protected as is required by Rule 1.6. Comment [4] to the Rule states that when a lawyer's services are paid for by a third party, such an arrangement must protect the client's confidences and secrets from unauthorized disclosure as required by Rule 1.6 and that a lawyer may not represent a client under such circumstances if the representation is prohibited under Rule 1.7.[24]

Under Rule 1.6, a lawyer may not reveal information relating to representation of a client in the absence of the client's informed consent, except for disclosures that are impliedly authorized in order to carry out the representation. Informing the insurer about the litigation through periodic status reports, detailed billing statements and the submission of other information usually is required, explicitly or implicitly, by the contract between the insurer and the insured and also is appropriate in those jurisdictions where the insurer is regarded as a client and there is no conflict between the insurer and insured. The disclosure of such information usually advances the interests of both the insured and the insurer in the representation and such disclosures are, therefore, "impliedly authorized to carry out the representation."[25] In those relatively rare situations when the lawyer reasonably believes that disclosure of confidential information to the insurer will affect a material interest of the client-insured adversely, the lawyer may not disclose such confidential information without first obtaining the informed consent of the client-insured.[26]

Nor may the lawyer disclose the insured's confidential information to a third-party auditor designated by the insurer without the insured's informed consent.[27]

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24. *See supra* note 16.

25. Rule 1.6(a); *see* RESTATEMENT § 61 cmt. b, which contains the functional equivalent of the "implied authorization" exception in Rule 1.6(a).

26. *Id.* §§ 61 and 60(1)(a).

27. A majority of jurisdictions have concluded that it is not ethically proper for a lawyer to disclose billing information to a third-party billing review company at the request of an insurance company unless he has obtained the client's consent. *See, e.g.,* Office of the General Counsel of the Alabama State Bar Op. RO-98-02 (November 9, 1998); Alaska State Bar Ass'n Ethics Committee Op. No. 99-1 1999, 1999 WL 1494993 (October 22, 1999); Arizona State Bar Formal Op. 99-08 (September 1999); Cincinnati, Ohio Bar Association Op. 98-99-02 (February 1999): Colorado Bar Association Ethics Committee Formal Op.107 (September 18, 1999); Connecticut Bar Association Committee on Professional Ethics Informal Op. 00-20 (Sept. 26, 2000); District of Columbia Legal Ethics Committee Op. No. 290 (April 20, 1999); Florida Bar Professional Ethics Committee Proposed Advisory Op. 99-2 (March 31, 1999); Florida Bar Staff Op. 20762 (March 9, 1998); Florida Bar Staff Op. 20591 (December 31, 1997); Georgia State Bar Proposed Advisory Op. No. 99-R2 (January 2000); Hawaii Bar Office of Disciplinary Conduct Op. 36 (March 25, 1999); Idaho State Bar Association Formal Op. 136 (January 2000); Indiana State Bar Association Op. 98-4 (1998); Iowa Supreme Court Board of Professional Ethics and Conduct Op. 99-01 (September 8, 1999); Kentucky Bar Association Op.E-404 (June 1998); Louisiana State Bar Association Ethics Advisory Service Committee Op. 45, *as reported in* LOUISIANA BAR JOURNAL 438 (February, 1998); Maine Professional Ethics Commission of the Board of Overseers Op. 164 (December 2, 1998); Maryland State

Unlike the disclosure of the insured's confidential information to secretaries and interpreters, the disclosure of such information to a third-party auditor, a vendor with whom the lawyer has no employment or direct contractual relationship,[28] may not be deemed essential to the representation and may, therefore, result in a waiver—albeit unintended—of the privilege.[29] Therefore, since such disclosures always involve the risk of loss of privilege, the lawyer must obtain the insured's informed consent before sending bills with such information to a third party hired by the insurer to audit the bills.[30]

Bar Association Committee on Ethics Op. No. 99-7 (January 1999); Massachusetts Bar Association Committee on Professional Ethics Op. 2000-4 (September 13, 2000); Mississippi State Bar Association Ethics Op. 246 (April 8, 1999); Chief Disciplinary Counsel of the Supreme Court of Missouri Informal Advisory Op. 980188 (September 9, 1998); New Mexico State Bar Formal Advisory Op. 2000-02 (June 20, 2000); New York State Bar Association Committee on Professional Ethics Op. 716 (March 3, 1999); North Carolina State Bar Proposed Formal Ethics Op.10, 1998 WL 609887 (N.C.St.Bar October 16, 1998); Oklahoma Bar Association Board of Governors Legal Ethics Advisory Op. No. 309 (March 27, 1998) (representation of insureds by lawyers who are employees of a liability insurer); Oregon State Bar Association Ethics Op. 1999-157, 1999 WL 521543 (June 1999); Pennsylvania Bar Association Committee on Legal Ethics and Professional Responsibility Informal Op. No. 97-119, 1997 WL 816708 (October 7, 1997); Rhode Island Ethics Advisory Panel Op. 99-17 (October 27, 1999); South Carolina Bar Ethics Advisory Committee Op. 97-22; 1997 WL 861963 (December 1997); State Bar of South Dakota Ethics Op. 99-2 (April 16, 1998); Board of Professional Responsibility of the Supreme Court of Tennessee Ethics Op. 99-F-143, 1999 WL 406886 (June 14, 1999); Utah State Bar Ethics Advisory Op. No. 98-03 (April 17, 1998); Vermont Bar Association Ethics Op. 98-7 (October 1998); Virginia Bar Legal Ethics Op. 1723 (November 23, 1998); Washington State Bar Association Formal Op. 195 (1999); West Virginia Lawyer Disciplinary Board Op. LEI 99-02 (April 30, 1999); Wisconsin State Bar Ethics Op. E-99-1 (October 1999).

28. In ABA Formal Opinion 95-398, this Committee recognized that "in this era of rapidly developing technology," lawyers frequently use outside agencies for numerous functions such as accounting, data processing, photocopying, computer servicing, storage and paper disposal and that lawyers retaining such outside service providers are required to make reasonable efforts to prevent unauthorized disclosures of client information. FORMAL AND INFORMAL ETHICS OPINIONS 1983-1998 at 367. The present inquiry is clearly distinguishable because the lawyer has neither a contract with nor any right to control the conduct of the third-party auditor retained by the insurer.

29. In the Matter of the Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedures, 2 P.3d at 817-22; United States v. Massachusetts Institute of Technology, 129 F.3d 681, 684-687 (1st Cir. 1997) ("an intent to maintain confidentiality is ordinarily necessary to continued protection, but it is not sufficient").

30. In the Matter of the Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedures, 2 P.3d at 818-19 (The relationship between the insured and third-party auditor does not involve the kind of common interest in which information can be exchanged without loss of privilege. Disclosure to persons needed in the representation or appropriate to a consultation also does not justify disclosure to a potential

In order to obtain the insured's informed consent to such disclosures, the lawyer should at least discuss the nature of the information sought as well as the relevant legal and non-legal consequences of the client's decision. This would include giving advice concerning the extent of the client's obligation under the insurance contract to authorize such disclosures. The lawyer must evaluate the reasonably foreseeable adverse consequences of disclosure and inform the client of the adverse effects that may result, including communicating with the client about the consequences of not consenting to disclosure where the insurance contract requires the insured to cooperate in the defense of the claim and where failure to agree to disclosure could risk loss of insurance coverage. The client also should be informed that the insurance company may interpret the "duty to cooperate" clause in its contract with the insured as meaning that it has the right to give an independent contractor access to the client's confidential information to aid it in representing clients.

The lawyer should inform the client of the risk that the information to be disclosed to the auditor could be obtained by others directly or indirectly as a result of the disclosure, the risk that a disclosure could involve a waiver of the lawyer-client privilege, and that the disclosure could be used to the client's disadvantage.

"Consent" may be influenced heavily by the client's desire to take advantage of the insurance company's duty to defend. Where the client's interests would be placed at risk by disclosing information to the auditor, the lawyer reasonably must believe that the client's consent is uncoerced even after consultation, and the lawyer then must respond to the auditor's requests in a manner that safeguards the client's interests. This would include minimizing the extent to which information relating to the representation is disclosed to the auditor and avoiding, if at all possible, disclosures that could result in a waiver of the attorney-client privilege or otherwise adversely affect a material interest of the client-insured.

Although Rule 1.6 expresses the broad principle that all information relating to representation of a client is confidential, there is an exception when the disclosure is impliedly authorized in order to carry out the representation, see Rule 1.6(a), or in the specific and limited circumstances set forth in Rule 1.6(b). Comment [7] explains: "A lawyer is impliedly authorized to make disclosures about a client when appropriate in carrying out the representation, except to the extent that the client's instructions or special circumstances limit that authority." In the context

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adversary.) (citing U.S. v. M.I.T., *supra* note 29 and accompanying text); *In re* Columbia/HCA Healthcare Corporation, 192 F.R.D. 575, 576, 579 (M.D. Tenn. 2000) ("[T]he privilege is narrowly construed because it reduces the amount of information discoverable during the course of a lawsuit . . . . [C]lients who wish to selectively disclose privilege documents and the entity to whom they wish to disclose the documents cannot negate a waiver simply by agreeing to do so.") (internal citation omitted). Other cases rejecting selective waiver include *In re* Steinhardt Partners, L.P., 9 F.3d 230, 235 (2d Cir. 1993); Westinghouse Elec. Corp. v. Republic of the Philippines, 951 F.2d 1414, 1424-26 (3d Cir. 1991); *In re* Martin Marietta Corp., 856 F.2d 619, 623-24 (4th Cir.), *cert. denied*, 490 U.S. 1011, 109 S. Ct. 1655 (1989); Permean Corp. v. United States, 665 F.2d 1214, 1220-21 (D.C. Cir. 1981).

of the tripartite relationship involving the lawyer, the insurer and the insured, the routine transmission of confidential information to the insurer from the lawyer retained by the insurer to represent the insured usually is necessary to advance the interests of both the insurer and the insured and is, therefore, impliedly authorized in order to carry out the representation without regard to whether only the insured or both the insured and insurer are clients. Moreover, we construed Comment [7] similarly in our Opinion 98-411 when we recognized that in the context of lawyer-to-lawyer consultations, the disclosure of confidential information is permitted to lawyers outside the consulting lawyer's firm "when the consulting lawyer reasonably believes the disclosure will further the representation by obtaining the consulted lawyer's experience or expertise for the benefit of the consulting lawyer's client."[31]

As noted above, there may be occasions when the lawyer reasonably believes that disclosure of confidential information to the insurer may affect a material interest of the client-insured adversely.[32] Such occasions may arise when the information to be disclosed jeopardizes the insured's coverage under the insurance policy; reveals extremely sensitive or personal, irrelevant information about the insured; or otherwise implicates a conflict between the insurer and insured. In these relatively infrequent situations, it is essential that the lawyer obtain the informed consent of the client-insured before disclosing the confidential information in question.[33]

The disclosure to the client-insured in order to obtain informed consent within the meaning of Rule 1.6 must adequately and fairly identify the effects of disclosure and non-disclosure on the client's interests. Although the Model Rules do not specify the nature of the information that must be told to the client to obtain "consent after consultation," we stated in Formal Opinion 98-411 that in lawyer-to-lawyer consultations, the lawyer seeking his client's permission to consult another lawyer should inform his client of the possibility that privileges may be waived under applicable law and of the potential adverse effect of disclosure on the client's interest in the matter.[34]

The rules of professional conduct are, of course, inapplicable to insurance companies but they are applicable to lawyers who represent insurance companies, both in-house and in private practice. When representing an insured client, a lawyer should identify with the insurance company and any potentially involved third-party auditor the type of information that would be requested during the representation. The lawyer also should discuss with both the insured and insurer clients the legal effects of disclosing or not disclosing such information. In assessing these legal effects, the lawyer should evaluate any agreement between the

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31. ABA Formal Opinion 98-411 (Ethical Issues in Lawyer-to-Lawyer Consultation) in FORMAL AND INFORMAL ETHICS OPINIONS 1983-1998 at 491, 493.

32. The Restatement precludes the disclosure of confidential information if there is a reasonable prospect that disclosure will affect a material interest of the client adversely. *See* § 60(1)(a).

33. *Id.*

34. FORMAL AND INFORMAL ETHICS OPINIONS 1983-1998 at 494.

insurance company and the auditor regarding procedures for protecting confidential materials. Before disclosing client information to an insurance company, the insured's lawyer should satisfy herself that the insurance company will not release confidential client information and should designate all such information clearly. Identifying each party's interests and providing full disclosure to both the insured and insurer clients from the outset of the representation should result in a relationship that meets the needs of both the insurance company and the insured as well as one that satisfies the ethical obligations of the lawyer. If there is reason to believe that the insurer will disregard this instruction, then the lawyer should so advise the insured, prior to disclosure, explaining any additional risks that would result from disclosure by the insurance company to a third party.

Conclusion

In representing an insured, a lawyer must not permit compliance with "guidelines" or other insurer directives relating to the lawyer's services to impair materially the lawyer's independent professional judgment. There may be rare instances when the lawyer reasonably believes a limitation imposed by the insurer's directives is materially compromising the lawyer's ability to provide competent representation to both the insured and insurer. In such situations, if the lawyer is unable to persuade the insurer to withdraw the limitation, the resulting conflict between the insurer's directives and the insured's interests requires the lawyer to protect the immediate interests of the insured while preparing to withdraw from representing both the insured and the insurer.

A lawyer may disclose the insured's confidential information, including detailed work descriptions and legal bills, to the insurer if the lawyer reasonably believes that doing so will advance the interests of the insured. However, the lawyer may not disclose the insured's confidential information to a third-party auditor without the informed consent of the insured. It is also the opinion of the Committee that unless the lawyer reasonably believes that disclosure of the insured's confidential information to the insurer will not affect a material interest of the insured adversely, the lawyer must not disclose such information without the informed consent of the insured.

KeyCite Red Flag - Severe Negative Treatment
Superseded by Statute as Stated in United Enterprises, Inc. v. Superior Court, Cal.App. 4 Dist., March 24, 2010

162 Cal.App.3d 358
Court of Appeal, Fourth District, Division 1, California.

SAN DIEGO NAVY FEDERAL CREDIT UNION, et al., Plaintiffs and Respondents,
v.
CUMIS INSURANCE SOCIETY, INC., Defendant and Appellant.

D000911.
|
Civ. 31043.
|
Dec. 3, 1984.
|
Hearing Denied Feb. 21, 1985.

Insurer appealed a judgment of the Superior Court, San Diego County, G. Dennis Adams, J., requiring it to pay its insureds all reasonable past and future expenses of their independent counsel retained for defense of a law suit filed against them. The Court of Appeal, Gamer, J., assigned, held that where insurer retained counsel to defend the third-party lawsuit but reserved its right to assert noncoverage at a later date, a conflict of interest existed between the insurer and insureds, and thus, insureds had right to independent counsel paid for by the insurer.

Judgment affirmed.

West Headnotes (15)

[1] **Attorney and Client**
Representing Adverse Interests

An attorney who has dual agency status is subject to the rule that a conflict of interest between jointly represented clients occurs whenever their common lawyer's representation of the one is rendered less effective by reason of his representation of the other.

2 Cases that cite this headnote

[2] **Attorney and Client**
Disclosure, Waiver, or Consent

While an insurance policy provision requiring an insured to permit insurer to employ an attorney to defend a third party suit may amount to a consent in advance to a conflict of interest, where the insured affirmatively withdraws that consent by hiring independent counsel, no doubt motivated by the insurer's reservation of rights, any such consent may be deemed withdrawn.

10 Cases that cite this headnote

[3] **Attorney and Client**
Insurance

Law firm hired by insurance company to defend action brought against its insureds represented clients with conflicting interests on the advisability of settlement, where it was uncontested that basis for liability, if any, might rest on conduct excluded by terms of the insurance policy.

6 Cases that cite this headnote

[4] **Insurance**
Conflicts of Interest;Independent Counsel

An insurer has to pay for an insured's independent counsel where a conflict of interest exists in that multiple theories of recovery are alleged and some theories involve uncovered conduct under the policy, since if an insurer must pay for cost of defense and, when a conflict exists, the insurer may have control of the defense if he wishes, it follows the insurer must pay for such defense conducted by independent counsel.

57 Cases that cite this headnote

[5] **Attorney and Client**
Insurance

A conflict of interest arises when an attorney represents both an insurer and the insured in a third-party action once the insurer takes the view a coverage issue is present.

2 Cases that cite this headnote

[6] **Attorney and Client**
Insurance

A serious conflict of interest occurs between an insurer and an insured when an insurer's retained counsel obtains information bearing directly on issue of coverage during course of preparation of a third-party suit.

17 Cases that cite this headnote

[7] **Attorney and Client**
Insurance

When an insurer's retained counsel represents both the insurer and the insured in a third-party action, recognition of a conflict in interest cannot wait until moment a tactical decision must be made during trial, but rather, existence of such a conflict of interest should be identified early in the proceeding so it can be treated effectively before prejudice has occurred to either party.

14 Cases that cite this headnote

[8] **Insurance**
Conflicts of Interest;Independent Counsel

Where insurer retained counsel to defend a third-party suit against insureds in which punitive damages were sought, with a potential result that there would be no coverage under the policy, a plain conflict of interest existed in attorney's representation of both the insurer and the insureds, for purposes of determining whether insurer was liable to pay attorney fees for independent counsel hired by insureds; disagreeing with *Zieman Mfg. Co. v. St. Paul Fire & Marine Ins. Co.*, 724 F.2d 1343.

155 Cases that cite this headnote

[9] **Attorney and Client**
Skill and Care Required

Counsel representing an insurer and the insured owes both a high duty of care and unswerving allegiance.

7 Cases that cite this headnote

[10] **Attorney and Client**
Disclosure, Waiver, or Consent

When two clients have diverging interests, counsel who represents both must disclose all facts and circumstances to both clients to enable them to make intelligent decisions regarding continuing representation. ABA Code of Prof.Resp., EC5–14 to EC5–17.

1 Cases that cite this headnote

[11] **Attorney and Client**
Disclosure, Waiver, or Consent

Canons of Ethics impose upon lawyers hired by an 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. Prof.Conduct Rule 5–102(B); ABA Code of Prof.Resp., EC5–14 to EC5–17.

4 Cases that cite this headnote

[12] **Attorney and Client**
Insurance

If an insured does not give an informed consent to an attorney's continued joint representation of insurer and the insured in situations where the insurer has reserved its rights to deny coverage, counsel must cease to represent both. Prof.Conduct Rule 5–102(B); ABA Code of Prof.Resp., EC5–14 to EC5–17.

26 Cases that cite this headnote

[13] **Insurance**
Conflicts of Interest;Independent Counsel

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In the absence of insured's consent to an attorney's joint representation of the insurer and the insured, where there are divergent interests of the insured and the insurer brought about by the insurer's reservation of rights based on possible noncoverage under the insurance policy, the insurer must pay insured's reasonable costs for hiring independent counsel.

103 Cases that cite this headnote

[14] **Insurance**
Right to Control Defense

An insurer may not compel an insured to surrender control of litigation where insurer has reserved its rights to deny coverage.

1 Cases that cite this headnote

[15] **Attorney and Client**
Insurance

Insurance
Conflicts of Interest;Independent Counsel

Disregarding common interest of both insurer and insureds in finding total nonliability in third-party action for tortious wrongful discharge, breach of covenant of good faith and fair dealing, and other claims against insureds, remaining interests of the insurer and the insureds diverged to such an extent as to create an actual, ethical conflict of interest in same attorney representing both the insureds and their insurer, warranting payment by insurer for insureds' independent counsel.

32 Cases that cite this headnote

Attorneys and Law Firms

****495** ***360** Hardin, Cook, Loper, Engel & Bergez, Gennaro A. Filice III, Oakland, and Roberta E. Nalbandian, Sacramento, for defendant and appellant.

Breidenbach, Swainston, Yokaitis & Crispo, Los Angeles, Bronson, Bronson & McKinnon, San Francisco, W.F. Rylaarsdam, Los Angeles, Jeanne E. Emrich, Long Beach, Ronald E. Mallen, San Francisco, Michael J. Brady, Redwood City, David R. Fuller, Chico, Raoul D. Kennedy, Oakland, Paul H. Cyril and David W. Gordon, San Francisco, as amici curiae on behalf of defendant and appellant.

***361** Saxon, Alt, Brewer & Kincannon and Mark A. Saxon, San Diego, for plaintiffs and respondents.

Leonard Sacks, Northridge, Robert E. Cartwright, Harvey R. Levine, San Diego, Wylie A. Aitken, Santa Ana, Harlan Arnold, Beverly Hills, Glen T. Bashore, North Fork, Ray Bourhis, San Francisco, Richard D. Bridgman, Oakland, Edwin Train Caldwell, San Francisco, David S. Casey, Jr., San Diego, Victoria DeGoff, Berkeley, ****496** Douglas K. deVries, Sacramento, H. Grieg Fowler, San Francisco, Sanford M. Gage, Beverly Hills, Ian Herzog, Los Angeles, G. Dana Hobart, Marina Del Rey, Stanley K. Jacobs, Los Angeles, John C. McCarthy, Claremont, Timothy W. Peach, San Bernardino, R.H. Sulnick, Los Angeles, Arne Werchick, Sausalito, and Stephen Zetterberg, Claremont, as amici curiae on behalf of plaintiffs and respondents.

Opinion

GAMER, Associate Justice. [*]

Cumis Insurance Society, Inc. (Cumis) appeals a judgment requiring Cumis to pay the San Diego Navy Federal Credit Union, J.W. Jamieson and Larry R. Sharp (insureds) all reasonable past and future expenses of their independent counsel retained for the defense of a lawsuit filed against the insureds by Magdaline S. Eisenmann (Eisenmann action). [1]

The issue presented to this court by the appeal is whether an insurer is required to pay for independent counsel for an insured when the insurer provides its own counsel but reserves its right to assert noncoverage at a later date. We conclude under these circumstances there is a conflict of interest between the insurer and the insured, and therefore the insured has a right to independent counsel paid for by the insurer.

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The Eisenmann action against the insureds seeks $750,000 general and $6.5 million punitive damages for tortious wrongful discharge, breach of the covenant of good faith and fair dealing, wrongful interference with and inducing breach of contract, breach of contract and intentional infliction of emotional distress. Under insurance policies issued by Cumis, the insureds tendered the defense of the Eisenmann action to Cumis. Cumis associate counsel Willis E. McAllister reviewed the complaint in the Eisenmann action and concluded Cumis had a duty to provide a defense to the insureds. McAllister selected and retained, at Cumis' expense, the San Diego law firm of Goebel & Monaghan to represent the interests of the insureds in the ***362** Eisenmann action. McAllister informed Goebel & Monaghan it was to represent the insureds as to all claims in the Eisenmann action, including the punitive damages claim. He also told Goebel & Monaghan Cumis was reserving its right to deny coverage at a later date and the insurance policies did not cover punitive damages.

McAllister sent Goebel & Monaghan copies of the insurance policies in effect and letters accepting the defense and reserving rights which were delivered to the insureds. McAllister never asked Goebel & Monaghan for an opinion whether coverage existed under the insurance policies, nor did Goebel & Monaghan give any coverage advice to either Cumis or the insureds.

McAllister believed if the Eisenmann action resulted in a finding of wilful conduct or an award of punitive damages, the Cumis policies did not provide coverage for those damages. Moreover, his view was if the Eisenmann action resulted in a finding of breach of contract as against any of the insureds, there might be no coverage under the relevant Cumis policies. Accordingly, on behalf of Cumis, McAllister notified each insured by letter Cumis was reserving its rights to disclaim coverage and denying any coverage for punitive damages. [2]

****497** The Credit Union retained the San Diego law firm of Saxon, Alt & Brewer (independent counsel) to provide independent representation to protect the insureds' interests. Independent counsel notified Cumis it was retained to act as co-counsel with Goebel & Monaghan and presented Cumis a claim for its attorneys' fees and costs. McAllister was persuaded California law required Cumis to pay the fees, and he agreed to pay the fees and costs ***363** incurred by independent counsel as co-counsel for the insureds. Cumis paid two separate invoices for legal services of independent counsel but additional invoices were not paid. After independent counsel sent a demand letter to Cumis and further discussed the matter with McAllister, McAllister sought a separate opinion on the question from Cumis' home office and asked Goebel & Monaghan if it felt there was a conflict of interest in representing the insureds such that Cumis would be required to pay the expenses of separate counsel. Goebel & Monaghan told McAllister it did not see a conflict of interest. Cumis' home office came to the same conclusion and McAllister notified independent counsel Cumis would pay no further invoices.

In the Eisenmann action settlement conference, the case did not settle after a demand within the Cumis policy limits. Cumis authorized Goebel & Monaghan to make an offer at the settlement conference but in an amount lower than Eisenmann's demand. Goebel & Monaghan did not contact the Credit Union before or during the settlement conference, but informed the Credit Union about the conference afterward.

In this action, the trial court ruled Cumis is required to pay for the insureds' hiring of independent counsel, rejecting Cumis' argument the court was bound by *Gray v. Zurich Insurance Co.* (1966) 65 Cal.2d 263, 54 Cal.Rptr. 104, 419 P.2d 168, and reasoning:

> "1. *Gray* involved a question of the duty to defend in an assault and battery case rather than the extent and scope of that duty. The reasoning thus used to support *Gray* is not controlling, especially if it makes little sense.
>
> "2. The reasoning of *Gray,* '[s]ince ... the court in the third party suit does not adjudicate the issue of coverage the insurer's argument (as to a conflict of interest) collapses,' just does not stand scrutiny. What the defense attorney in the third party case does impacts the coverage case, in that, the questions of coverage depends [sic] on the development of facts in the third party case and their proper development is left to the attorney paid for by the Carrier. *Gray* recognized that a finding in the third party action would effect the issues of coverage in a subsequent case but analyzed the question from the point of view of the carrier. *Gray* recognized a possible conflict from the point of view of the insured in footnote 18, where it stated: 'In rare cases the issue of punitive damages or a special verdict might present a conflict of interest, but such possibility does

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> not outweigh the advantages of the general rule. Even in such cases, however, the insurer will still be bound ethically and legally, to litigate in the interests of the insured.' Additionally, *Gray* was looking for a way to avoid a conflict of interest, to hold that it was excluding all other approaches just does not make common ***364** sense."

The court further explained its ruling:

> "The Carrier is required to hire independent counsel because an attorney in actual ****498** trial would be tempted to develop the facts to help his real client, the Carrier Company, as opposed to the Insured, for whom he will never likely work again. In such a case as this, the Insured is placed in an impossible position; on the one hand the Carrier says it will happily defend him and on the other it says it may dispute paying any judgment, but trust us. The dictum in *Gray* flies in the face of the reality of insurance defense work. Insurance companies hire relatively few lawyers and concentrate their business. A lawyer who does not look out for the Carrier's best interest might soon find himself out of work."

[1] **[2]** In the usual tripartite relationship existing between insurer, insured and counsel, there is a single, common interest shared among them. Dual representation by counsel is beneficial since the shared goal of minimizing or eliminating liability to a third party is the same. A different situation is presented, however, when some or all of the allegations in the complaint do not fall within the scope of coverage under the policy. In such a case, the standard practice of an insurer is to defend under a reservation of rights where the insurer promises to defend but states it may not indemnify the insured if liability is found. In this situation, there may be little commonality of interest. [3] Opposing poles of interest are represented on the one hand in the insurer's desire to establish in the third party suit the insured's "liability rested on intentional conduct" (*Gray, supra,* 65 Cal.2d 263, 279, 54 Cal.Rptr. 104, 419 P.2d 168), and thus no coverage under the policy, and on the other hand in the insured's desire to "obtain a ruling ... such liability emanated from the nonintentional conduct within his insurance coverage" (*ibid.*). Although issues of coverage under the policy are not actually litigated in the third party suit, this does not detract from the force of these opposing interests as they operate on the attorney selected by the insurer, who has a dual ***365** agency status (see *Tomerlin v. Canadian Indemnity Co.* (1964) 61 Cal.2d 638, 647, 39 Cal.Rptr. 731, 394 P.2d 571). [4]

Here, it is uncontested the basis for liability, if any, might rest on conduct excluded by the terms of the insurance policy. Goebel & Monaghan will have to make certain decisions at the trial of the Eisenmann action which may either benefit or harm the insureds. For example, it will have to seek or oppose special verdicts, the answers to which may benefit the insureds ****499** by finding nonexcluded conduct and harm either Cumis' position on coverage or the insureds by finding excluded conduct. These decisions are numerous and varied. Each time one of them must be made, the lawyer is placed in the dilemma of helping one of his clients concerning insurance coverage and harming the other.

The conflict may appear before trial. Goebel & Monaghan represented the insureds in the Eisenmann action settlement conference and the case did not settle although a demand was made within policy limits. Before and during the settlement conference, Goebel & Monaghan was in contact with Cumis but had no contact with the insureds about settlement until after the conference ended. The insureds then wrote a letter to counsel:

> "You should know that the Credit Union desires the lawsuit to be settled without trial. Our insurance coverages, duly paid and contracted for, are precisely for such cases and any settlement liability that may arise therefrom. Your confidence in the defensibility of the case is appreciated. Should trial prove you wrong, however, and the jury awards damages, the insurance may no longer cover the Credit Union's possible losses. As you know, such losses would considerably exceed any possible settlement amount. It is clear that trial in lieu of settlement in this case subjects the Credit Union to a considerably additional risk while possibly lowering or eliminating a claim payout by CUMIS.

Such is not the basic premise upon which we contracted for insurance with CUMIS.

"I urge you to work for an appropriate settlement before trial in this case so that CUMIS will have provided the risk protection for which the Credit Union has contracted."

[3] ***366** On the advisability of settlement, Goebel & Monaghan represented clients with conflicting interests (*Tomerlin v. Canadian Indemnity Co., supra,* 61 Cal.2d 638, 647, 39 Cal.Rptr. 731, 394 P.2d 571). No matter how honest the intentions, counsel cannot discharge inconsistent duties.

The potential problems may develop during pretrial discovery which must go beyond simple preparation for a favorable verdict to develop alternate strategies minimizing exposure. Goebel & Monaghan was bound to investigate all conceivable bases on which liability might attach. These investigations and client communications may provide information relating directly to the coverage issue. Furthermore, counsel may form an opinion about the insureds' credibility. As between counsel's two clients, there is no confidentiality regarding communications intended to promote common goals (Evid.Code, § 962). But confidentiality is essential where communication can affect coverage. Thus, the lawyer is forced to walk an ethical tightrope, and not communicate relevant information which is beneficial to one or the other of his clients. [5]

The ABA Code Ethical Considerations 5–1 reads:

> "The professional judgment of a lawyer should be exercised, within the bounds of the new law, solely for the benefit of his client and free of compromising influences ****500** and loyalties. Neither his personal interests, the interests of other clients, nor the desires of third persons should be permitted to dilute his loyalty to his client."

ABA Code Ethical Considerations 5–15 states, in pertinent part:

> "If a lawyer is requested to undertake or to continue representation of multiple clients having potentially differing interests, he must weigh carefully the possibility that his judgment may be impaired or his loyalty divided if he accepts or continues the employment. He should resolve all doubts against the propriety of the representation. A lawyer should never represent in litigation ***367** multiple clients with differing interests, and there are few situations in which he would be justified in representing in litigation multiple clients with potentially differing interests. If a lawyer accepted such employment and the interests did become actually differing, he would have to withdraw from employment with likelihood of resulting hardship on the clients; and for this reason it is preferable that he refuse the employment initially."

The standard of care expressed in the ABA canons underscores the existing conflict.

Cumis contends *Gray v. Zurich Insurance Co., supra,* 65 Cal.2d 263, 54 Cal.Rptr. 104, 419 P.2d 168, is controlling and asserts Cumis fully met its duty to defend when it retained counsel at its expense and instructed counsel to defend the insureds in the underlying action.

Gray dealt with an insurer's duty to defend in the face of a third party complaint against the insured alleging the insured caused intentional injury which by the policy's terms is not within its coverage. The insured, Gray, was sued on the basis he "wilfully, maliciously, brutally and intentionally assaulted" the third party who prayed for both actual and punitive damages. The insurer refused to defend and the third party action went to judgment against the insured for actual damages. Gray then sued the insurer for breach of its duty to defend. Holding the insurer breached its duty to defend and was liable for the amount of the judgment in the third party suit, plus costs, expenses and attorney's fees for defending that suit, the Supreme Court said, in part, the insurer "bears a duty to defend its insured whenever it ascertains facts which give rise to the potential of liability under the policy" (*Gray,* *supra,* 65 Cal.2d 263, 276–277, 54 Cal.Rptr. 104, 419 P.2d 168). *Gray* pointed out the third party suit did not necessarily mean a recovery by the third party would be outside the policy's coverage [6] and it emphasized this "potential" or "possibility" of coverage in concluding the insurer "should have defended because the loss could have fallen within that liability" (*id.* at p. 277, 54 Cal.Rptr. 104, 419 P.2d 168).

The insurer argued it had no duty to defend because its interests and those of its insured were opposed. The insurer asserted, had it defended the third ***368** party suit,

> "it would have sought to establish either that the insured was free from any liability or that such liability rested on intentional conduct. The insured, of course, would also seek a verdict holding him not liable but, if found liable, would attempt to obtain a ruling that such liability emanated from the nonintentional conduct within his insurance coverage. Thus, defendant contends, an insurer, if obligated to defend in this situation, faces an insoluable ****501** ethical problem." (*Gray, supra,* 65 Cal.2d at pp. 278–279, 54 Cal.Rptr. 104, 419 P.2d 168.)

The court rejected the argument.

> "Since, however, the court in the third party suit does not adjudicate the issue of coverage, the insurer's argument collapses. The only question there litigated is the insured's *liability.* The alleged victim does not concern himself with the theory of liability; he desires only the largest possible judgment. Similarly, the insured and insurer seek only to avoid, or at least to minimize, the judgment. As we have noted, modern procedural rules focus on whether, on a given set of facts, the plaintiff, regardless of the theory, may recover. Thus the question of whether or not the insured engaged in intentional conduct does not normally formulate an issue which is resolved in that litigation." (*Gray, supra,* 65 Cal.3d at p. 279, 54 Cal.Rptr. 104, 419 P.2d 168; emphasis by the court.)

At the same time, however, the court recognized, in the footnote to this passage, "[i]n rare cases the issue of punitive damages or a special verdict might present a potential conflict of interests, but such a possibility does not outweigh the advantages of the general rule. Even in such cases, however, the insurer will still be bound, ethically and legally, to litigate in the interests of the insured." (*Gray, supra,* 65 Cal.2d at p. 279, fn. 18, 54 Cal.Rptr. 104, 419 P.2d 168.)

Gray found the insurer's contractual duty to defend cannot be avoided by creating a conflict of interest. *Gray* is not controlling here because it does not address whether the scope of the duty to defend includes payment for the insured's independent counsel where a conflict of interest exists.

We find authority for that proposition in an earlier case, *Tomerlin v. Canadian Indemnity Co., supra,* 61 Cal.2d 638, 39 Cal.Rptr. 731, 394 P.2d 571, which involved a coverage problem arising out of a third party complaint alleging conduct partially excluded under the policy. *Tomerlin* stated:

> "Similarly, in cases involving multiple claims against the insured, some of which fall within the policy coverage and some of which do not, the insurer may be subject to substantial temptation to shape its defense so as to place the risk of loss entirely upon the insured....
>
> "It is true, of course, that defendant's attorney owes to the insured a legal duty to defend in good faith, but as Professor Keeton points out 'On the ***369** other hand [the] company has no duty to sacrifice its own interests when they conflict with those of the insured.' (Keeton, *Liability Insurance & Responsibility for Settlement, supra,* 67 Harv.L.Rev. 1136, 1170.)
>
> "Customarily, insurers, in cases involving tort claims in excess of policy limits, notify the insured that he may employ his own attorney to participate in the defense. (*Id.* at p. 1169.) A like duty must arise in the instant case in which potential conflict stemmed not only from the multiple theories of the Villines complaint and the propriety of settlement, but from the total absence in defendant of any economic interest in the outcome of the suit." (*Tomerlin, supra,* 61 Cal.2d at p. 647, 39 Cal.Rptr. 731, 394 P.2d 571.)

[4] Thus, the California Supreme Court recognized where, as here, multiple theories of recovery are alleged and some theories involve uncovered conduct under the policy, a conflict of interest exists. *Tomerlin* concluded: "In actions in which ... the insurer and insured have conflicting interests, the insurer may not compel the insured to surrender control of the litigation. [Citations.]" (*Tomerlin, supra,* 61 Cal.2d at p. 648, 39

Cal.Rptr. 731, 394 P.2d 571.) Although *Tomerlin* did not expressly state the insurer had to pay for the insured's independent counsel under such circumstances, this is necessarily implicit in the decision. If the insurer must pay for the cost of defense and, when a conflict exists, the insured may have control of the defense if he wishes, it follows the insurer ****502** must pay for such defense conducted by independent counsel.

Other decisions following *Tomerlin* have developed its reasoning further. For example, *Industrial Indemnity Co. v. Great American Ins. Co., supra,* 73 Cal.App.3d 529, 140 Cal.Rptr. 806, held a coverage dispute between insurer and insured, similar to that here, created a conflict of interest. In *Industrial,* an employee of one of the insured's subcontractors was killed on the job. The employee's heirs sued, among others, the insured, Tomei, and the city which had contracted to have the insured do the work. The insurance policy named the city as an additional insured but coverage applied to the city only if its negligence was secondary, passive and vicarious, i.e., only if it was not actively negligent. Tomei was fully covered under the policy. The insurer retained counsel to defend both Tomei and the city. In December 1970, about two months before trial, counsel acquired knowledge the city was actively negligent and, on the eve of trial, he sent a reservation of rights letter to the city and hired independent counsel to represent it. One day later, the case was settled with the insurer apportioning $100,000 of the liability to the city where coverage was in question, and only $62,000 to the fully insured Tomei. The city was never consulted about the insurer's apportionment. After the insurer paid the settlement, it sued the city and its ***370** other insurer in declaratory relief for reimbursement, using the same counsel it had retained to defend the third party suit. The city did not respond directly but filed a cross-complaint alleging breach of the insurer's duty to defend as a result of the insurer's retaining one attorney with conflicting interests in the third party suit.

Industrial spoke of the conflicts of interest in the third party action as follows:

> "In the Sanchez [third party] action Runkle [counsel retained by insurer] had three clients: Industrial, Tomei and the City. We assume that there was no conflict between Industrial and Tomei, whose protection under the Industrial policy appears to have been as broad as its exposure to liability in the Sanchez action. There were, however, obvious conflicts between Industrial and the City, as well as between Tomei and the City.... The Industrial-City conflict arises from the simple fact that, as Industrial sees it, the City's coverage under the endorsements to the Tomei policy was not as broad as the City's exposure to the Sanchez heirs. Essentially, the less 'vicarious' the City's liability, if any, turned out to be, the less was the danger that the Industrial policy would cover.
>
> "......................
>
> "That Runkle represented conflicting interests in the Sanchez action is now plain. (See Rules of Prof. Conduct, rule 5–102(b).) As far as the record shows, the consent of the City to Runkle's representation of conflicting interests was never obtained. (See *Lysick v. Walcom,* 258 Cal.App.2d 136, 147 [65 Cal.Rptr. 406] ....) It may well be that the conflict was not apparent when Runkle assumed the defense of the Sanchez action. It must, however, have become obvious sometime before December 1970, when Industrial first asserted its position with respect to the City's coverage under its endorsements. Even then Runkle did not discontinue the relationship. (See *Ishmael v. Millington,* 241 Cal.App.2d 520, 526–527 [50 Cal.Rptr. 592] ....)" (Fns. omitted; *Industrial Indemnity Co. v. Great American Ins. Co., supra,* 73 Cal.App.3d 529, 536–537, 140 Cal.Rptr. 806.)

[5] [6] [7] Although the issue before the court in *Industrial* pertained to the conflict of interest problem in the later action in which coverage was in issue, the court recognized retained counsel is bound to learn about coverage issues as he prepares the earlier suit (*Industrial, supra,* 73 Cal.App.3d at p. 535, 140 Cal.Rptr. 806). A conflict arises once the insurer takes the view a coverage issue is present. In *Industrial,* the retained counsel's recently acquired knowledge of the City's active negligence, combined with its reservation of rights, made the conflict "obvious sometime ****503** before December 1970" (*Industrial, supra,* 73 Cal.App.3d at p. 537, 140 Cal.Rptr. 806). Thus, *Industrial* recognizes a serious conflict of interest occurs when insurer's retained counsel obtains information bearing ***371** directly on the issue of coverage during the course of preparation of the third party suit. There is no room under *Industrial* for labeling the conflict there described as merely a "potential" one. [7]

In *Executive Aviation, Inc. v. National Ins. Underwriters* (1971) 16 Cal.App.3d 799, 94 Cal.Rptr. 347, the same insurer-selected attorney represented the insurer in a property coverage action by the insured against the insurer and represented the insured and insurer in a third party suit against the insured. Both actions arose from the same accident, a plane crash during a flight where there was a question whether the plane was being used in "common carriage." If the plane was ultimately found to have been used in common carriage, there would be no coverage under the terms of the policy. The attorney defending the property damage action against the insurer on this basis would be operating directly against the insured's interest in obtaining coverage for the third party suit.

The appellate court stated:

> "A reasonable solution was proposed by the New York Court of Appeals in *Prashker v. United States Guarantee Company* (1956) 1 N.Y.2d 584 [154 N.Y.S.2d 910, 136 N.E.2d 871] ..., namely, that where a conflict of interest has arisen between an insurer and its insured, the attorney to defend the insured in the tort suit should be selected by the insured and the reasonable value of the professional services rendered assumed by the insurer. If the insured and the insurer are represented by two different attorneys, each of whom is pledged to promote and protect the prime interests of his client, adequate representation is guaranteed and the deleterious effect of the conflict of interest imposed on an attorney who attempts the difficult task of representing both parties is averted." (*Executive Aviation, supra,* 16 Cal.App.3d at p. 809, 94 Cal.Rptr. 347.)

The court concluded:

> "We hold, therefore, that in a conflict of interest situation, the insurer's desire to exclusively control the defense must yield to its obligation to defend its policy holder. Accordingly, the insurer's obligation to defend extends to paying the reasonable value of the legal services and costs performed by independent counsel, selected by the insured [citation].... We conclude that the insured here is entitled to the reasonable value of the legal services rendered by its independent counsel ***372** and the costs in the Dakin action." (*Executive Aviation, supra,* 16 Cal.App.3d at p. 810, 94 Cal.Rptr. 347.)

The conflict in *Executive Aviation* is no more "real and existing" than the conflict in Cumis' case. In both instances, the interests of insured and insurer diverge and conflict, differing only in degree of immediacy. The result of the existing conflict is the same in each instance.

In *Previews, Inc. v. California Union Ins. Co.* (9th Cir.1981) 640 F.2d 1026, the Court of Appeals decided the insurer was required to pay for independent counsel due in part to a claim for punitive damages. The Court of Appeals said in applying California law:

> ****504** "This case presents a plain conflict of interest.... [The insurer's] best interests are served by a finding of willful conduct because it thus may not be deemed liable. Previews, on the other hand, could suffer greater loss by a finding of willful conduct because Previews would then be liable for punitive damages. Thus, the district court properly decided that Previews was entitled to engage outside counsel." (*Previews, supra,* 640 F.2d at p. 1028.)

[8] The point *Previews* makes about the insurer's interests being served by a finding of wilful conduct and resultant punitive damages fully applies to this case. Cumis retained counsel for a third party suit, the Eisenmann action, in which punitive damages were sought with a potential result there would be no coverage under the policy. The "plain conflict of interest" language of *Previews,* applies equally to this aspect of the case. Entitlement to independent counsel paid for by the insurer under its duty to defend is an order *Previews* directly supports. [8]

***373** In *Purdy v. Pacific Automobile Insurance Co., supra,* 157 Cal.App.3d 59, 203 Cal.Rptr. 524, the plaintiff offered to settle his third party action within policy limits under circumstances where counsel retained by the insurer knew an excess verdict was probable. The insurer refused the offer. The court stated retained counsel was in a conflict of interest situation and the insured had a right to independent counsel paid for by the insurer. Further, the court stated:

> "[T]he record discloses that Purdy had in fact employed independent counsel as of December 1972, prior to the last offer of settlement; and that counsel strongly urged settlement of the Partin suit. Pacific, however, retained control of the litigation—to Purdy's disadvantage. The fact that Purdy did have independent counsel at a crucial stage of the settlement negotiations undoubtedly explains why the causes of action against the lawyer defending herein were not refined to charges of failing to

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disclose a conflict between the insurer and the insured." (*Id.* at p. 77.)

Other jurisdictions reach varying conclusions on the issue before us (see *Employers' Fire Insurance Company v. Beals, supra,* 103 R.I. 623, 240 A.2d 397, 404, and works cited). [9]

****505** The lawyer's duties in the conflict of interest situation presented here are correlative to the insurer's contractual duty to pay for an independent lawyer ***374** when it reserves its rights to deny coverage under the policy. California Rules of Professional Conduct rule 5–102(B) states: "A member of the State Bar shall not represent conflicting interests, except with the written consent of all parties concerned."

[9] **[10]** Counsel representing the insurer and the insured owes both a high duty of care (*Lysick v. Walcom, supra,* 258 Cal.App.2d 136, 146, 65 Cal.Rptr. 406) and unswerving allegiance (*Betts v. Allstate Ins. Co.* (1984) 154 Cal.App.3d 688, 715–716, 201 Cal.Rptr. 528). When two clients have diverging interests, counsel must disclose all facts and circumstances to both clients to enable them to make intelligent decisions regarding continuing representation (*Ishmael v. Millington* (1966) 241 Cal.App.2d 520, 528, 50 Cal.Rptr. 592). The ABA Model Code EC 5–14, 5–15, 5–16 and 5–17 reinforce these constrictions, EC 5–16 stating in part: "[B]efore a lawyer may represent multiple clients he should explain fully to each client the implications of the common representation and should accept or continue employment only if the clients consent."

One commentator analyzing these Ethical Considerations concluded:

> "The emphasis of the ... Rules suggests a functional means of resolving the conflicts which confront counsel hired by an insurer to defend its insured. The best course is for an attorney to beware of the potential for conflict at the outset.... Where a question exists as to whether an occurrence is within coverage, independent counsel representing the insured's interests is required. The insurer is contractually obligated to pay for insured's independent counsel." (Dondaville, 1982, *Defense Counsel Beware: The Perils of Conflicts of Interest,* 26 Trial Lawyer's Guide, 408, 415.)

The Committee on Professional Responsibility of the State Bar of Louisiana reaches the same conclusion.

> "Under the circumstances presented, the Committee is of the opinion that it would be improper, with or without the consent of all parties concerned, for the same attorney to represent both the insurer and the insured.
>
> "The Committee is compelled to this conclusion based upon its belief that once the insurer decides to assert a coverage defense, the same attorney may not represent both the insured and the insurer. Canon 5 and, to some extent, Canon 7, would militate against such dual representation. EC 5–1 provides that the attorney's professional judgment should be exercised 'solely for the benefit of his client and free of compromising influences and loyalties,' including 'interests of other clients.' EC 5–14 states that an attorney cannot represent two clients with 'conflicting, inconsistent, diverse, ***375** or otherwise discordant' interests. And EC 5–15 indicates that counsel 'should resolve all doubts against the propriety of the representation.'
>
> "The Committee feels that when coverage is disputed, the interests of the insured and the insurer are always divergent. The attorney should not be placed ****506** in the position of divided loyalties. Such an arrangement would be adverse to the best interests of the insured, the insurer, the attorney, and the profession." (Opn. No. 342, 22 La.Bar J. (July 1974).)

[11] **[12]** **[13]** **[14]** **[15]** We conclude the Canons of Ethics 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. If the insured does not give an informed consent to continued representation, counsel must cease to represent both. Moreover, in the absence of such consent, where there are divergent interests of the insured and the insurer brought about by the insurer's reservation of rights based on possible noncoverage under the insurance policy, the insurer must pay the reasonable cost for hiring independent counsel by the insured. The insurer may not compel the insured to surrender control of the litigation (*Tomerlin v. Canadian Indemnity Co., supra,* 61 Cal.2d 638, 648, 39 Cal.Rptr. 731, 394 P.2d 571; and see *Nike, Inc. v. Atlantic Mut. Ins. Co.* (1983) 578 F.Supp. 948, 949). Disregarding the common interests of both insured and insurer in finding total nonliability in the third party action, the remaining interests of the two diverge to

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such an extent as to create an actual, ethical conflict of interest warranting payment for the insureds' independent counsel.

Judgment affirmed.

GERALD BROWN, P.J., and STANIFORTH, J., concur.

Hearing denied; BROUSSARD AND LUCAS JJ., dissenting.

All Citations

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Footnotes

* Assigned by the Chairperson of the Judicial Council.

1 *Magdaline S. Eisenmann v. San Diego Navy Federal Credit Union,* et al., San Diego Superior Court case number 469823.

2 The reservation of rights letter explained:

"Because of the nature of the case and the present lack of factual information relative to the allegations of the plaintiff, it is necessary for CUMIS Insurance Society, Inc. to reserve its rights to disclaim coverage on the ground that the actions complained of by the plaintiff are not covered under the Directors and Officers Endorsement to the CUMIS Discovery Bond, or any other coverage provided by CUMIS to you. CUMIS specifically denies any coverage for punitive damages in the above-mentioned legal action.

"On behalf of CUMIS Insurance Society, Inc., we will conduct an investigation of this case, and provide the defense to you under a full reservation of the Society's rights. In addition, if CUMIS settles the above-mentioned legal action, CUMIS reserves its right to seek reimbursement from you for such settlement amount if noncoverage by CUMIS is subsequently established. Such investigation, defense or settlement shall not prejudice the rights of CUMIS Insurance Society, Inc. to disclaim coverage at a later date.

"Although CUMIS is not now denying coverage, we are sending this Reservation of Rights letter to you so that we may proceed to investigate the case, defend you or arrange settlement of this suit pending a decision of whether or not the actions complained of by the plaintiff are covered by CUMIS. In the meantime, your rights and interests are being protected as though coverage does extend to the fact situation involved."

3 See *Purdy v. Pacific Automobile Insurance Co.* (1984) 157 Cal.App.3d 59, 76, 203 Cal.Rptr. 524, which states in part:

"[T]he 'triangular' aspect of the representation afforded the insured by the insurer's lawyers is described as a coalition for a common purpose, a favorable disposition of the claim—with the attorney owing duties to both clients. As a practical matter, however, there has been recognition that, in reality, the insurer's attorneys may have closer ties with the insurer and a more compelling interest in protecting the insurer's position, whether or not it coincides with what is best for the insured. [Citation.]

"The problem arises when the attorney knows, or should know, when a conflict has appeared between the insurer and the insured as to the most beneficial course of action indicated by the developing circumstances. It has long been the law in this state that when a conflict develops, the insurer cannot compel the insured to surrender control of the litigation, and must, if necessary, secure independent counsel for the insured, [citations] and, as was explained in *Previews, Inc. v. California Union Ins. Co.* (9th Cir.1981) 640 F.2d 1026, 1028, the insurer's obligation [to defend, after the appearance of a conflict] 'extends to paying the reasonable value of legal services and costs performed by independent counsel selected by the insured.' [Citations.]"

4 An attorney having dual agency status is subject to the rule a "[c]onflict of interest between jointly represented clients occurs whenever their common lawyer's representation of the one is rendered less effective by reason of his representation of the other" (*Spindle v. Chubb/Pacific Indemnity Group* (1979) 89 Cal.App.3d 706, 713, 152 Cal.Rptr. 776). While it has been said a policy provision requiring the insured to permit the insurer to employ the attorney to defend the third party suit amounts to a consent in advance to the conflict of interest (see *Lysick v. Walcom* (1968) 258 Cal.App.2d 136, 146, 65 Cal.Rptr. 406), where the insured affirmatively withdraws that consent by hiring independent counsel, no doubt motivated by the insurer's reservation of rights, any such consent may be deemed withdrawn (see *Employers' Fire Insurance Company v. Beals* (1968) 103 R.I. 623, 240 A.2d 397, 403).

5 The court in *Industrial Indem. Co. v. Great American Ins. Co.* (1977) 73 Cal.App.3d 529 at 536 in footnote 5, 140 Cal.Rptr. 806, cited *E.F. Hutton & Company v. Brown,* 305 F.Supp. 371, 393–394, on a related issue. The *Hutton* court stated:

" '[T]he basis for the rule against representing conflicting interests is broader than the basis for the attorney-client evidentiary privilege [Bus. & Prof.Code, § 6068]. The evidentiary privilege and the ethical duty not to disclose confidences both arise from the need to encourage clients to disclose all possibly pertinent information to their attorneys, and both protect only the confidential information disclosed. The duty not to represent conflicting interests, on the other hand, is an outgrowth of the attorney-client relationship itself, which is confidential, or fiduciary, in a broader sense. Not only do clients at times disclose confidential information to their attorneys; they also repose confidence in them. The privilege is bottomed only on the first of these attributes, the conflicting-interests rule, on both.' (Fns. omitted. *Id.* at p. 394.)" (See also *Parsons v. Continental National American Group* (1976) 113 Ariz. 223, 550 P.2d 94, 98–99.)

6 "Jones' [third party] complaint clearly presented the possibility that he might obtain damages that were covered by the indemnity provisions of the policy. Even conduct that is traditionally classified as 'intentional' or 'wilful' has been held to fall within indemnification coverage. [Fn. omitted.] Moreover, despite Jones' pleading of intentional and wilful conduct, he could have amended his complaint to allege merely negligent conduct. Further, plaintiff [Gray] might have been able to show that in physically defending himself, even if he exceeded the reasonable bounds of self-defense, he did not commit wilful and intended injury, but engaged only in nonintentional tortious conduct." (*Gray, supra,* 65 Cal.2d 263, 277, 54 Cal.Rptr. 104, 419 P.2d 168.)

7 Cumis makes a distinction between "potential" and "actual" conflicts of interest which is invalid and unworkable. Recognition of a conflict cannot wait until the moment a tactical decision must be made during trial. It would be unfair to the insured and generally unworkable to bring in counsel midstream during the course of trial expecting the new counsel to control the litigation. Contrary to Cumis' argument, the existence of a conflict of interest should be identified early in the proceedings so it can be treated effectively before prejudice has occurred to either party. It may well be in a given case special verdicts will not be requested or given, and other indicators of the basis of liability such as punitive damages will not come into play. Nevertheless, this often cannot be known until shortly before the case is submitted to the jury. By that time, it is normally too late to prevent prejudice.

8 Cumis cites a recent Ninth Circuit case, *Zieman Mfg. Co. v. St. Paul Fire & Marine Ins. Co.* (9th Cir.1983) 724 F.2d 1343, which summarily approved the district court's denial of fees for independent counsel. According to the decision of the district court approved by the Court of Appeals, the insured hired independent counsel after the third party amended his complaint to claim punitive damages and the insurer notified the insured there was no coverage for wilful actions. The insurer provided a defense to the third party suit.

Reviewing a summary judgment in favor of the insurer in the insured's action for breach of the duty to defend (and the implied covenant of good faith) the Court of Appeals sought only to determine whether any genuine issues of material fact existed (*Zieman, supra,* 724 F.2d at p. 1344). Doing so, the Court of Appeals gave the following analysis:

"Zieman [insured] alleges that a conflict of interest arose when the punitive damage claim was filed in addition to the damage claim. Zieman characterizes this as a genuine issue of material fact; however, it fails to point to any facts in dispute relating to this issue. Nor does Zieman present any evidence that an actual conflict of interest existed which would prevent St. Paul's retained counsel from defending Zieman. St. Paul (by providing the legal services of Hillsinger and Costanza) fulfilled its contractual duty to defend Zieman on all claims against it." (*Zieman, supra,* 724 F.2d at pp. 1344–1345.)

It is apparent *Zieman's* dominant concern was whether an issue of material fact was present. The court said no to this question. It made no analysis of the presence or absence of a conflict of interest, merely pointing to the absence of any facts in dispute relating to the conflict of interest issue and the absence of evidence of actual conflict of interest. It is apparent the Court of Appeals did not address the merits of the conflict of interest issue. Thus, *Zieman* does not represent a holding on the issue we consider. Moreover, to the extent *Zieman* could be read as deciding the issue we consider, it does not reflect California law.

9 Among the cases from other jurisdictions which are generally supportive of the view we take are the following:

Alaska *Continental Ins. Co. v. Bayless & Roberts, Inc.* (1980) 608 P.2d 281;

Ariz. *Fulton v. Woodford* (1976) 26 Ariz.App. 17, 545 P.2d 979;

Ill. *Maryland Casualty Co. v. Peppers* (1976) 64 Ill.2d 187, 355 N.E.2d 24, 30;

Md. *Southern Md. Agr. Ass'n v. Bituminous Cas. Corp.* (D.Md.1982) 539 F.Supp. 1295;

Mass. *Magoun v. Liberty Mutual Insurance Company* (1964) 346 Mass. 677, 195 N.E.2d 514, 519;

N.Y. *Prashker v. United States Guarantee Co.* (1956) 1 N.Y.2d 584, 154 N.Y.S.2d 910, 136 N.E.2d 871; and see *Utica Mutual Insurance Co. v. Cherry* (1974), 38 N.Y.2d 735, 381 N.Y.S.2d 40, 343 N.E.2d 758; *Public Service Mutual Ins. Co. v. Goldfarb* (1981), 53 N.Y.2d 392, 442 N.Y.S.2d 422, 425 N.E.2d 810;

R.I. *Employers' Fire Insurance Company v. Beals, supra,* 103 R.I. 623, 240 A.2d 397;

Tex. *Steel Erection Co., Inc. v. Travelers Indemnity Co.* (Tex.Civ.App.1965) 392 S.W.2d 713; and see *Satterwhite v. Stolz* (1968) 79 N.M. 320, 442 P.2d 810;.

Jurisdictions ruling to the contrary include:

Ohio *Motorists Mutual Insurance Co. v. Trainor* (1973) 33 Ohio St.2d 41, 294 N.E.2d 874;

Va. *Norman v. Insurance Company of North America* (1978) 218 Va. 718, 239 S.E.2d 902.

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Telling the Truth without Inappropriate Revelations: What May and Must Defense Counsel Report Under the Policy and the Rules of Professional Conduct

By William T. Barker
Dentons U.S., L.L.P.
233 South Wacker Drive, Suite 7800
Chicago IL 60611
312-876-8140

Fax 312-876-7934
william.barker @dentons.com

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William T. Barker is a partner in the Chicago office of Dentons U.S. LLP, with a nationwide practice representing insurers in complex litigation, including matters relating to coverage, claims handling, sales practices, risk classification and selection, agent relationships, and regulatory matters. He sometimes serves as an expert witness on matters of insurance, professional responsibility and standard of care He is a co-author (with Ronald D. Kent) of INSURANCE BAD FAITH LITIGATION, SECOND EDITION and (with Charles Silver) of PROFESSIONAL RESPONSIBILITIES OF INSURANCE DEFENSE COUNSEL. He has been described as the leading lawyer-commentator on the connections between procedure and insurance. See Charles Silver & Kent Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 DUKE L.J. 255, 257 n.4 (1995).

Mr. Barker is a member of the American Law Institute and an Adviser to its project on the Restatement of the Law of Liability Insurance. He is a Special Advisor to the ABA Standing Committee on Ethics & Professional Responsibility. He is a past Director of the Association of Professional Responsibility Lawyers. He is Co-Chair of the Subcommittee on Ethics of the ABA Section of the Litigation Insurance Coverage Litigation Committee and a Vice Chair of the ABA Tort Trial & Insurance Practice Section ("TIPS") Committee on Insurance Coverage Litigation. He is TIPS Liason to the ABA Standing Committee on Lawyers' Professional Liability, a past Chair of the TIPS General Committee Board, the TIPS Ethics & Professionalism Committee, the TIPS Appellate Advocacy Committee, and the TIPS Robert B. McKay Law Professor Committee.

Chapter 10 Confidentiality and Sharing of Information Among Carrier, Policyholder, and Defense Counsel

SYNOPSIS

§ 10.01 Confidentiality Generally and Implied Authority To Disclose

All lawyers have an obligation to keep most client-related information confidential. This obligation becomes more complex than usual when a lawyer represents a policyholder defendant at the behest of a liability carrier obliged to defend the policyholder.

Model Rule 1.6(a) states this duty as follows:

> 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 the disclosure is permitted by paragraph

(b) [whose terms are not relevant here].[1]

Model Rule 1.8(b) supplements this prohibition on disclosure of information by prohibiting its use "to the disadvantage of the client unless the client gives informed consent, [with exceptions not relevant here]."[2]

> It is important to remember that these limits on use or disclosure of confidential information are not limited to the types of information protected from *compelled* disclosure by the attorney client privilege. They broadly limit *voluntary* use or disclosure of *any* nonpublic information derived from the representation for purposes other than carrying out the representation. That is, confidentiality is broader than privilege.

While the Model Rule states the duty of nondisclosure broadly and absolutely, interpretation has qualified it slightly. The Restatement limits the rule to prohibiting disclosures "if there is a reasonable prospect that [disclosure] will adversely affect a material interest of the client."[3] As the Restatement explains:

> The duty of confidentiality is defined in terms of the risk of harm … . Although the lawyer codes do not express this limitation, such is the accepted interpretation. For example, under a literal reading of [Model Rule 1.6(a)], a lawyer would commit a disciplinary violation by telling an unassociated lawyer in casual conversation the identity of a firm client, even if mention of the client's identity creates no possible risk of harm. Such a strict interpretation goes beyond the proper interpretation of the rule.[4]

In particular, this permits (1) disclosures to personnel (secretaries, paralegals, etc.) assisting the lawyer in representing the client and (2) disclosures to facilitate operation of the law practice (e.g. to clerical personnel keeping time records or supervisors outside the lawyer's office), so long as there is no reasonable prospect of harm to the client and reasonable safeguards are employed to prevent further disclosure.[5] While disclosures to facilitate the lawyer's practice do not directly advance the client's objectives, they do assist in "carrying out the representation" in a broader sense.[6]

Implied authority to disclose generally arises when utility to the representation combines with lack of any apparent risk to the interests of the client.[7] "Except to the extent that the client's

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[1] MODEL RULES OF PROF'L CONDUCT, R. 1.6(a) (2012).

[2] MODEL RULES OF PROF'L CONDUCT, R. 1.8(b).

[3] RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 60(1)(a) (2000).

[4] RESTATEMENT § 60 cmt. *c(i)*.

[5] RESTATEMENT § 60 cmts. *f, g*.

[6] RESTATEMENT § 60 cmt. *f*.

[7] *See* RESTATEMENT § 61 (2000). The test stated there has been approved by the ABA as the equivalent of the standard under Model Rule 1.6. ABA STANDING COMM. ON ETHICS & PROF'L RESPONSIBILITY, Formal Op. 01-421 n.25 (2001).

instructions or special circumstances limit that authority, a lawyer is impliedly authorized to make disclosures about a client when appropriate in carrying out the representation."[8] This standard is taken from the law of agency, under which implied authority is inferred from the nature of the representation, the "general usages" of similar relationships, and those acts which "usually accompany" or are "reasonably necessary" to the representation.[9] For example, attorneys do not ask client consent in sharing their confidential information with non-attorneys within a law firm such as secretaries, copy clerks, and accountants, because such disclosure is a necessary and usual part of any representation. The same is true of potential expert witnesses. ABA Opinion 95-398 extended this reasoning to outside copy services and data processing services used to produce billing statements from firm time records.

The authorization for disclosures "impliedly authorized in order to carry out the representation" most obviously permit disclosure "when the lawyer reasonably believes doing so will advance the interests of the client in the representation."[10] The policyholder has contractually committed management of the defense to the carrier, a commitment confirmed when the policyholder acquiesces in counsel's explanation of the way in which the representation is to be conducted. (See § 9.02[8], above.) Moreover, the carrier needs full information about the progress and prospects for the case to perform its duties to the policyholder regarding settlement. On this basis, disclosure to the claim representative of most information regarding the defense is impliedly authorized.

Implied authorization (by the policyholder) for such disclosure normally would not exist, however, if counsel knows of a reasonable prospect that disclosure could be injurious to the policyholder or if the policyholder requested that the information not be disclosed.

There is a special overlay on the confidentiality rule in those situations where the client is an organization. The first point there is that, absent an agreement providing otherwise, "[a] lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents."[11] Thus, the duty of confidentiality is owed to the organization, not to any particular constituent who communicates with the lawyer. Whenever there is or may be some divergence between the interests of a constituent and the organization, the lawyer should clarify the lawyer's role by advising the constituent that the lawyer represents only the organization, not the constituent.[12]

The lawyer's duty to the organizational client includes a duty to take steps to protect the organization against misconduct by its agents that threaten injury to the organization:

> If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, and that is likely to result in

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[8] MODEL RULES OF PROF'L CONDUCT, R. 1.6 cmt.[5] (2012).

[9] RESTATEMENT (SECOND) OF AGENCY §§ 34–35 (1958).

[10] RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 61 (2000).

[11] MODEL RULES OF PROF'L CONDUCT, R. 1.13(a).

[12] MODEL RULES OF PROF'L CONDUCT, R. 1.13(f) & cmt. [10].

> substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances, to the highest authority that can act on behalf of the organization as determined by applicable law.[13]

In some circumstances, the lawyer may be authorized to disclose information outside the organization if that is necessary to protect the organization:

> Except as provided in paragraph (d), if
>
> (1) despite the lawyer's efforts in accordance with paragraph (b) the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action or a refusal to act, that is clearly a violation of law, and
>
> (2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization,
>
> then the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.[14]

That authorization for disclosure outside the organization does not "apply with respect to information relating to a lawyer's representation of an organization to investigate an alleged violation of law, or to defend the organization or an officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law."[15]

§ 10.02 General Rule for Joint Representations: No Secrets on Matters Relating to the Joint Representation

Because most jurisdictions regard the carrier as a co-client with the policyholder (absent a conflict requiring independent counsel), this implied authorization analysis is supplemented in such jurisdictions by special rules governing joint representations. Every client has a right to full information about the representation.[1] Where there are two clients represented jointly, this right is

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[13] MODEL RULES OF PROF'L CONDUCT, R. 1.13(b).

[14] MODEL RULES OF PROF'L CONDUCT, R. 1.13(c).

[15] MODEL RULES OF PROF'L CONDUCT, R. 1.13(d).

[1] MODEL RULES OF PROF'L CONDUCT, R. 1.4 (2011). *See* MODEL RULES OF PROF'L CONDUCT, R. 1.7 cmt. [31] ("As to the duty of confidentiality, continued common representation will almost certainly be inadequate if one client asks the lawyer not to disclose to the other client information relevant to the common representation. This is so because the lawyer has an equal duty of loyalty to each client, and *each client has the right to be informed of anything bearing on the representation that might affect that client's interests and the right to expect that the lawyer will use that information to that client's benefit.*" (emphasis

inconsistent with a duty to one client to refrain from disclosures to the other. Thus, the normal rule is that (unless the clients agree otherwise) all information may be shared with both clients.[2] This corresponds with the rule that communications of either client with the attorney are not privileged against the other in any subsequent dispute between the two.[3] This limitation on confidentiality is something that the policyholder must be told near the outset of the

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added)).

[2] RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 60 cmt. l ("[T]he common lawyer is required to keep each of the co-clients informed of all information reasonably necessary for the co-client to make decisions in connection with the matter … . The lawyer's duty extends to communicating information to other co-clients that is adverse to a co-client, whether learned from the lawyer's own investigation or learned in confidence from that co-client."); Geoffrey C. Hazard, Jr., W. William Hodes, & Peter R. Jarvis, THE LAW OF LAWYERING, § 9.12 (as between co-clients, "[t]he default rule … is that there is no confidentiality, because b[y] definition all clients are confiding in the same lawyer or lawyers"). *Accord* THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL, COMMENTARIES ON THE MODEL RULES OF PROFESSIONAL CONDUCT, Commentary on MPRC 1.6, at 75 (4th ed. 2006) ("In the absence of any agreement to the contrary (usually in writing), a lawyer is presumed to represent multiple clients with regard to related legal matters jointly with resulting full sharing of information between the clients."), *available at* http://www.actec.org/Documents/misc/ACTEC_Commentaries_4th_02_14_06.pdf. *But see*

NY—
In re H Children, 160 Misc. 2d 298, 300–01 (N.Y. Family Ct. 1994) (where there was reasonable probability that law guardian for two minor children received confidential information from one that would be useful to the other after guardian's withdrawal from relationship with the communicating child, law guardian must withdraw from relationship with noncommunicating child, because improper to use that information for her benefit; obviously children could not have consented to no-secrets rule, but appointing court arguably charged with notice of that rule).

[3] RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 76(2). *See* RESTATEMENT § 75 cmt. d ("Rules governing the co-client privilege are premised on an assumption that co-clients usually understand that all information is to be disclosed to all of them. Courts sometimes refer to this as a presumed intent that there should be no confidentiality between co-clients. Fairness and candor between the co-clients and with the lawyer generally preclude the lawyer from keeping information secret from any one of them, unless they have agreed otherwise."; "Co-clients may agree that the lawyer will not disclose certain confidential communications of one co-client to other co-clients … . In the absence of such an agreement, the lawyer ordinarily is required to convey communications to all interested co-clients.").

representation.[4] Indeed, a lawyer has been reprimanded for failure to so inform his clients.[5] A lawyer who fails to so inform the policyholder might permit a situation to arise in which the lawyer has both a duty to the policyholder to keep a secret and a duty to the carrier to disclose, making the lawyer liable to one or the other, no matter what the lawyer does.[6]

In general, this permits disclosure to the claim representative of anything received from the plaintiff or other third parties and anything disclosed to them, in discovery, pleadings or otherwise. Such information is no longer truly confidential, and it necessarily affects the carrier's decisions on handling of the claim.

This is so even though, in unusual circumstances, disclosure of such information to the

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[4] *See* MODEL RULES OF PROF'L CONDUCT, R. 1.7 cmt. [31] ("The lawyer should, at the outset of the common representation and as part of the process of obtaining each client's informed consent, *advise each client that information will be shared and that the lawyer will have to withdraw if one client decides that some matter material to the representation should be kept from the other*." (emphasis added)). *Accord* THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL, COMMENTARIES ON THE MODEL RULES OF PROFESSIONAL CONDUCT, Commentary on MPRC 1.6, at 75 (4th ed. 2006) ("When the lawyer is first consulted by the multiple potential clients, the lawyer should review with them the terms upon which the lawyer will undertake the representation, including the extent to which information will be shared among them … . The better practice in all cases is to memorialize the clients' instructions in writing and give a copy of the writing to [each] client.");

DC—
D.C. BAR, ETHICS Op. 327 (2005) (considering withdrawal from representation of some jointly represented several clients while continuing to represent other clients: "This underscores how important it is for a lawyer carefully to explain to all clients in a joint representation that, when they agree that any relevant or material information may be shared with one another, they cannot expect that any relevant or material confidential information they may subsequently reveal to the lawyer will be kept from the other co-clients."); D.C. BAR, ETHICS Op. 296 (2000) ("A joint representation in and of itself does not alter the lawyer's ethical duties to each client, including the duty to protect each client's confidences."; concluding that a "lawyer who undertakes representation of two clients in the same matter should address in advance and, where possible in writing, the impact of joint representation on the lawyer's duty to maintain client confidences and to keep each client reasonably informed, and obtain each client's informed consent to the arrangement.");

NY—
N.Y. STATE BAR ASS'N, Op. 778 (Aug. 30, 2004) ("In seeking consent to a joint representation the lawyer should explain to both clients … potential consequences, including (1) the lawyer's obligation, absent each client's agreement to other arrangements, to disclose to one client any confidences and secrets communicated by the lawyer to the other client … .").

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KY—
An Unnamed Atty. v. Ky. Bar Ass'n, 186 S.W.3d 741 (Ky. 2006) (lawyer represented husband and wife to develop evidence that they were not involved in a fatal shooting of the wife's former husband; lawyer discovered evidence implicating husband, but did not disclose to wife).

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KY—
186 S.W.3d at 743 (in the absence of disclosure of the lack of confidentiality, clients could not provide informed consent).

claim representative might adversely affect the policyholder. For example, the policyholder's deposition testimony about prior accidents might disclose a misrepresentation of loss history that could be a ground for seeking rescission. The lawyer would usually have no reason to know the contents of the application, so there would be no reason to withhold this information in reporting on the deposition.

But, if the lawyer knew of the potential adverse impact on the policyholder, consultation with the policyholder should precede any such report. If the policyholder provides confidential information (directly or by providing consent for a third party, such as a doctor, to disclose it) and disclosure to the claim representative of that information could adversely affect the policyholder (or the policyholder requests secrecy), that is a matter of even greater delicacy than when such information comes from a third party or has been rendered nonconfidential by disclosure to the plaintiff or others.

Problems of this sort are rare, but they must be handled with extreme care. Doubts should be resolved in favor of protecting the policyholder by withholding information from the claim representative. But withholding information may create a conflict and require withdrawal from further representation, requiring reassignment of the case to other counsel or even permitting the policyholder to retain independent counsel.

Similar problems can be posed where information received from one policyholder client (e.g. an employee) could adversely affect that client's relationship with another policyholder co-client (here, the employer). But they are usually less delicate, because the carrier would not benefit from disclosure.

§ 10.03 Corollary: No Sharing of Information on Other Subjects

Any disclosure based on implied authorization or on the joint representation rule depends on the information disclosed being pertinent to the subject matter of the representation. There is no duty to communicate information not pertinent to that subject matter and no implied authority to do so.[1] Because counsel is concerned only with defending the suit against the policyholder(s),

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[1] *See also* THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL, COMMENTARIES ON THE MODEL RULES OF PROFESSIONAL CONDUCT, Commentary on MPRC 1.6, at 76 (4th ed. 2006) ("A lawyer who receives information from one joint client (the 'communicating client') that the client does not wish to be shared with the other joint client (the 'other client') is confronted with a situation that may threaten the lawyer's ability to continue to represent one or both of the clients. As soon as practicable after such a communication, the lawyer should consider the relevance and significance of the information and decide upon the appropriate manner in which to proceed. The potential courses of action include, *inter alia*, (1) *taking no action with respect to communications regarding irrelevant (or trivial) matters*; (2) encouraging the communicating client to provide the information to the other client or to allow the lawyer to do so; and (3) withdrawing from the representation if the communication reflects serious adversity between the parties. *For example, a lawyer who represents a husband and wife in estate planning matters might conclude that information imparted by one of the spouses regarding a past act of marital infidelity need not be communicated to the other spouse.* On the other hand, the lawyer might conclude that he or she is required to take some action with respect to a confidential communication that concerns a matter that threatens the interests of the other client or could impair the lawyer's ability to represent the other client effectively (e.g., 'After she signs the trust agreement, I intend to leave her …' or 'All of the insurance policies on my life that name her as beneficiary have lapsed'). Without the informed consent of the other client, the lawyer should not take any action on behalf of the communicating client, such as drafting a codicil or a new will, that might damage the other client's economic interests or otherwise violate the lawyer's duty of loyalty to the other client.") (emphasis added).

information not relevant to the defense need not and should not be disclosed if there is any reasonable possibility it could adversely affect a policyholder. (See § 9.03[1]–[2]) In particular, information bearing on coverage but not relevant to liability or damages in the underlying action should not be disclosed to the claim representative.

#Comment Begins

Example 1:

Policyholder was not sued until long after the injury (because the victim was a minor against whom limitations do not run). No notice of the occurrence was given to the carrier until the suit was filed. In preparation for deposition, the policyholder informs defense counsel of facts indicating the policyholder had notice of the occurrence long before the complaint was filed. *Notice of the occurrence is irrelevant to liability or damages in the underlying action, so this should not be disclosed to the claim representative.*

#Comment Ends#Comment Begins

Example 2:

Counsel is asked to defend a case involving an auto accident in which the policyholder's cousin was injured when the car operated by the policyholder ran into a tree. In interviewing the policyholder, counsel learns that the cousin had been living with the policyholder while attending a nearby school for a semester, but had returned to his parents' home before making the claim. This might provide grounds for denying coverage under the policy's exclusion for relatives residing in the policyholder's household, but the claim representative does not appear to realize where the cousin was living at the time of the accident. *Counsel should not reveal this fact, which has nothing to do with defending the case, to the claim representative.*

#Comment Ends

§ 10.04 Special Rules Where Information May Affect Both Defense and Coverage or Where Secrecy Is Requested

[1] Restatement Approach

As explained in § 10.02, above, the usual rule in joint representations (absent contrary agreement by the clients), is that all information received by the lawyer may be shared with both clients. Even in non-insurance representations, where that rule is fully applicable, one client may still ask the lawyer to keep something secret from the other or may make a disclosure that is manifestly intended to be kept secret. For example, an employee sued along with her employer might reveal that the accident may have been caused by another employee's disregard of the employer's safety procedures. But the client employee may wish to keep this information from the employer to protect the other employee from discipline. Such an instruction withdraws the implied authority to disclose previously provided by an agreement to a no-secrets approach.[1] An instruction (express or implied) to keep something secret from a co-client can create a conflict, if the information is something the lawyer would otherwise be obliged to disclose to the other

[1] It is the fact that each client retains the power to withdraw implied authority to disclose (and that the existence of an apparent risk of harm may terminate that implied authority) that prevents the various relevant provisions of the Model Rules from being internally inconsistent, as some have suggested they are. *See* Thomas E. Spahn, *Keeping Secrets or Telling Tales in Joint Representation: Part I*, 27 LAW. MAN. PROF'L CONDUCT 303 (2011). The Model Rules do not clearly address the consequences of a client's exercise of that power, but that failure is an example of incompleteness, not inconsistency.

client. The conflict exists because the lawyer can neither disclose nor proceed without disclosure.

If unresolved, such a conflict will require the lawyer to withdraw. But before considering withdrawal, the lawyer should consult with the communicating client and urge that disclosure be permitted, so that the joint representation can continue.[2] In such circumstances, the Restatement concludes that, in withdrawing, the lawyer has discretion to warn the other client that "a matter seriously and adversely affecting that person's interests has come to light, which the other client refuses to permit the lawyer to disclose."[3] The lawyer even has discretion to disclose the specific communication "if, in the lawyer's reasonable judgment, the immediacy and magnitude of the risk to the affected co-client outweigh the interest of the communicating client in continued secrecy."[4] So, if a lawyer represents an employer and employee and learns from the employee

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[2] *See* THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL, COMMENTARIES ON THE MODEL RULES OF PROFESSIONAL CONDUCT, Commentary on MPRC 1.6, at 76–77 (4th ed. 2006) ("In order to minimize the risk of harm to the clients' relationship and, possibly, to retain the lawyer's ability to represent both of them, the lawyer may properly urge the communicating client himself or herself to impart the confidential information directly to the other client. In doing so, the lawyer may properly remind the communicating client of the explicit or implicit understanding that relevant information would be shared and of the lawyer's obligation to share the information with the other client. The lawyer may also point out the possible legal consequences of not disclosing the confidence to the other client, including the possibility that the validity of actions previously taken or planned by one or both of the clients may be jeopardized. In addition, the lawyer may mention that the failure to communicate the information to the other client may result in a disciplinary or malpractice action against the lawyer.") (citation omitted).

[3] RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 60 cmt. l. There is little direct support, outside the Restatement itself, for giving the lawyer this sort of discretion, as the Restatement itself notes. RESTATEMENT § 60 cmt. l, Reporter's Note ("The position in the Comment on a lawyer's discretion to disclose hostile communications by a co-client has been the subject of very few decisions. It was approved and followed in *A. v. B.*, 726 A.2d 924 (N.J. 1999). It is also the result favored by the American College of Trusts and Estates Counsel in its *ACTEC Commentaries on the Model Rules of Professional Conduct* 68 (2d ed. 1995) ('In such cases the lawyer should have a reasonable degree of discretion in determining how to respond to any particular case … .'); on the need to withdraw when a disclosing client refuses to permit the lawyer to provide the information to another co-client, see id. at 69; *see generally* Theresa Stanton Collett, *Disclosure, Discretion, or Deception: The Estate Planner's Ethical Dilemma from a Unilateral Confidence*, 28 REAL PROP. PROB. TR. J. 683 (1994). Council Draft No. 11 of the Restatement (1995) took the position that disclosure to an affected, noninformed co-client was mandatory, in view of the common lawyer's duties of competence and communication and the lack of a legally protected right to confidentiality on the part of the disclosing co-client. That position was rejected by the Council at its October 1995 meeting, resulting in the present formulation"). However, indirect support may be drawn from Model Rules 1.6(b)(2) & (3), which give a lawyer discretion to disclose confidential information necessary to prevent or rectify a crime or fraud in which the lawyer's services were used. (Some states mandate disclosure in such circumstances. *E.g.*,

ME—
ME. RULES OF PROF'L CONDUCT, R. 3.3 (disclosure necessary when fraud upon tribunal);

NJ—
N.J. RULES OF PROF'L CONDUCT, RPC 1.6;

TX—
TEX. DISCIPLINARY RULES OF PROF'L CONDUCT, R. 1.05.

[4] RESTATEMENT § 60 cmt. *l*.

that the purported accident was staged, the lawyer might have discretion to disclose that fact if the lawyer knew the employer were about to settle the case.

In light of this provision, language elsewhere in the Restatement appearing to impose a mandatory duty of disclosure may be limited to situations in which the joint representation continues, thus supporting the rule that nondisclosure forces withdrawal. Only § 60, Comment *l*, addresses a lawyer's disclosure duties in connection with such a withdrawal, so that reading prevents this grant of discretion from being inconsistent with that other language.

The Restatement offers three Illustrations of how a lawyer might exercise the discretion to disclose:

> Lawyer has been retained by Husband and Wife to prepare wills pursuant to an arrangement under which each spouse agrees to leave most of their property to the other … . Shortly after the wills are executed, Husband (unknown to Wife) asks Lawyer to prepare an inter vivos trust for an illegitimate child whose existence Husband has kept secret from Wife for many years and about whom Husband had not previously informed Lawyer. Husband states that Wife would be distraught at learning of Husband's infidelity and of Husband's years of silence and that disclosure of the information could destroy their marriage. Husband directs Lawyer not to inform Wife. The inter vivos trust that Husband proposes to create would not materially affect Wife's own estate plan or her expected receipt of property under Husband's will, because Husband proposes to use property designated in Husband's will for a personally favored charity. In view of the lack of material effect on Wife, Lawyer may assist Husband to establish and fund the inter vivos trust and refrain from disclosing Husband's information to Wife.[5]
>
> Same facts as Illustration 2, except that Husband's proposed inter vivos trust would significantly deplete Husband's estate, to Wife's material detriment and in frustration of the Spouses' intended testamentary arrangements. If Husband refuses to inform Wife or to permit Lawyer to do so, Lawyer must withdraw from representing both Husband and Wife. In the light of all relevant circumstances, Lawyer may exercise discretion whether to inform Wife either that circumstances, which Lawyer has been asked not to reveal, indicate that she should revoke her recent will or to inform Wife of some or all the details of the information that Husband has recently provided so that Wife may protect her interests. Alternatively, Lawyer may inform Wife only that Lawyer is withdrawing because Husband will not permit disclosure of relevant information.[6]
>
> Lawyer represents both A and B in forming a business. Before the business is completely formed, A discloses to Lawyer that he

[5] RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 60 cmt. *l*, illus. 2.
[6] RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 60 cmt. *l*, illus. 3.

> has been convicted of defrauding business associates on two recent occasions. The circumstances of the communication from A are such that Lawyer reasonably infers that A believes that B is unaware of that information and does not want it provided to B. Lawyer reasonably believes that B would call off the arrangement with A if B were made aware of the information. Lawyer must first attempt to persuade A either to inform B directly or to permit Lawyer to inform B of the information. Failing that, Lawyer must withdraw from representing both A and B. In doing so, Lawyer has discretion to warn B that Lawyer has learned in confidence information indicating that B is at significant risk in carrying through with the business arrangement, but that A will not permit Lawyer to disclose that information to B. On the other hand, even if the circumstances do not warrant invoking § 67 [Using or Disclosing Information to Prevent, Rectify, or Mitigate Substantial Financial Loss], Lawyer has the further discretion to inform B of the specific nature of A's communication to B if Lawyer reasonably believes this necessary to protect B's interests in view of the immediacy and magnitude of the threat that Lawyer perceives posed to B.[7]

At a minimum, these illustrations suggest that, rather than just silently withdrawing, the lawyer should exercise discretion at least to warn the client who is at risk that something is being concealed. In some cases, that suggestion may be supported by other considerations. When a lawyer who represents joint clients receives material information that, if disclosed to one client, could harm the other, a conflict arises that, unless resolved by the clients, will require the lawyer to withdraw. Whether withdrawal should be "silent" or "noisy" is, however, a question that must be separately resolved. Because the information is material to the defense, the lawyer is in the position of having to violate a duty to one of the clients, regardless of the option chosen. If the withdrawal is "silent," the lawyer will violate the duty to communicate the information to the client who is left in the dark. If the withdrawal is "noisy," the lawyer will violate the duty of confidentiality owed to the client whose interests are jeopardized.

Given that the option of withdrawing without violating any duty is unavailable, the question is, which duty should the lawyer violate? The answer may depend on whether one client or the other bears special responsibility for the conflict. For example, suppose a co-client communicates information to a lawyer knowing that the lawyer cannot keep secrets from the other co-client but insists that the lawyer keep the information secret anyway. In this hypothetical, the communicating client bears special responsibility for the conflict because he or she is asking the lawyer to deviate from the straight and narrow. The communicating client's expectation of confidentiality might therefore be deemed unreasonable, and one might conclude that the communicating client should bear the cost of the lawyer's breach of duty, not the client who is innocent.

The Restatement offers a modified rule for insurance defense representations:

> With respect to events or information that create a conflict of

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[7] RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 60 cmt. *l*, illus. 4.

> interest between insured and insurer, the lawyer must proceed in the best interests of the policyholder, consistent with the lawyer's duty not to assist client fraud … and, if applicable, consistent with the lawyer's duties to the insurer as co-client … . If the designated lawyer finds it impossible to so proceed, the lawyer must withdraw from the representation of both clients … .[8]

Because the quoted passage from § 134, Comment *f*, partially adopts and partially overrides § 60, Comment *l*, it is important to see in what respects it does the latter. It appears that the points on which § 60 may be overridden are those (1) presumptively permitting disclosure of information concerning the representation which is (a) adverse to the policyholder's coverage interests but (b) was received from a source other than the policyholder and (2) conferring discretion to disclose, in connection with withdrawal, adverse information derived from the policyholder if the carrier's need for disclosure outweighed the policyholder's need for continued secrecy. Because § 134, comment *f* does not address what would happen on withdrawal, § 60, comment *l* might still apply to such a withdrawal.

If counsel has properly advised the policyholder that the representation is premised on full sharing of information, the policyholder's acceptance on that basis probably permits disclosure to the claim representative of information received from third parties. After all, the carrier's continued agreement to provide counsel was premised in part on the policyholder's acquiescence in the no-secrets rule. And counsel's receipt of the information from the third party was part of the carrier's own representation and would presumably have been received by its own counsel, had it been separately represented. In such circumstances, the policyholder would seem to have a duty to allow disclosure, even apart from its duty to cooperate in the defense. Withholding that information from the carrier, despite a duty of disclosure, would be a form of fraud, which counsel cannot assist.

Arguably, initial acceptance of representation based on a no-secrets rule might authorize disclosure even of information received from the policyholder. But, if the adverse impact of the information disclosed was not understood by the policyholder at the time of disclosure, the consent to disclosure of that information would not seem to have been informed. If, however, the duty of cooperation requires disclosure, the policyholder's refusal to permit disclosure could be a form of fraud.

In consulting with the policyholder about disclosure of such information, counsel should explain what will happen if the policyholder refuses to permit disclosure. Counsel would then have to withdraw, stating that an undescribed conflict has arisen. If the information whose disclosure is at issue has already become part of the record in the case (e.g. deposition testimony), the claim representative will likely obtain it even if counsel does not disclose. If the claim representative believes or suspects that withdrawal indicates a lack of cooperation, coverage may be disputed. Should that occur, the information would not be privileged in any coverage litigation. On the other hand, the claim representative may not dispute coverage, in which case the information may never come to light.

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[8] RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 134 cmt. *f*.

[2] ABA Opinion 08-450

This issue has been addressed by an ABA ethics opinion that seems, on some points, contrary to the Restatement and otherwise questionable.[9] But any insurance defense lawyer considering confidentiality issues must take that opinion into account.

ABA Formal Opinion 08-450[10] considers the duties of a lawyer who represents multiple clients in the same or related matters and learns information whose disclosure to one client would be damaging to the interests of another client. The Opinion analyzes the following hypothetical:

> A lawyer is retained by an insurance company to defend both an insured employer and an employee of the insured whose conduct is at issue and for which the employer may vicariously be liable. In the course of a conversation with the lawyer, the employee relates facts to the lawyer indicating that the employee may have acted outside the scope of his employment and that, under the terms of the insurance contract, the employee may not be entitled to the protection of the employer's insurance. The employee made the disclosures in the reasonable belief that he was doing so in a lawyer-client relationship, and without understanding the implications of the facts. The lawyer learned similar information when interviewing another witness. The lawyer believes that the insurance company may have a contractual right to deny protection to the employee based on these facts. It also is possible that the employer could invoke scope-of-employment principles to defend against its own liability to the plaintiff.[11]

The opinion points out that the handling of confidential information must be addressed at the outset of the multiple-client representation.[12] Whether or not the carrier is a client will depend on the law of the relevant jurisdiction.[13] But the Opinion concludes that client status does not matter for the issue before it: "The same analysis applies whenever the lawyer is placed in the position of representing multiple clients, or of having duties under contracts such as an insurance policy to an indemnitor with rights affecting the lawyer's provision of a defense to a litigation client."[14]

In particular, the limited scope of an insurance defense representation must be explained to the policyholder at the outset of the representation:

> In the situation of insurer-engaged counsel, the scope of the

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[9] Unlike the Model Rules themselves, ABA ethics opinions are not approved by the ABA House of Delegates. More importantly, courts that adopt the text of the Model Rules do not adopt the gloss placed on those rules by ABA opinions. Those opinions are entitled to weight, but only if their reasoning is persuasive.

[10] ABA STANDING COMM. ON ETHICS & PROF'L RESPONSIBILITY, Formal Op. 08-450 (2008).

[11] ABA Formal Op. 08-450, at 3.

[12] ABA Formal Op. 08-450, at 3. *See* MODEL RULES OF PROF'L CONDUCT, R. 1.7 cmt. [31] (2012) & discussion in § 10.02, above.

[13] ABA Formal Op. 08-450, at 3. (See also ch. 4, above)

[14] ABA Formal Op. 08-450, at 3.

> representation normally is understood by the insurer to be limited to defending the action under the policy, and not to include representing the carrier or the insured in any coverage or other dispute between the two. Insureds may not fully understand those limitations, so counsel retained by an insurer or other third party should ensure that the client(s) are fully informed at the inception of the relationship, preferably in writing, of any limitation inherent in the representation and any area of potential conflict. To the extent the clients' informed consent to any conflicts of interest may be required under Rules 1.7 through 1.9, both clients' expectations related to confidentiality need to be addressed in order for the waiver to be valid.[15]

The lawyer's duty of confidentiality must also be addressed when the lawyer learns information whose disclosure to one client the lawyer recognizes would be adverse to the interests of another client. In the hypothetical, "the insured may not understand the reasons the information may defeat coverage, but the lawyer knows. Resolving what the lawyer should do requires balancing the lawyer's obligations under Rules 1.6 and 1.4(b)."[16] The Opinion notes that there is no privilege as between co-clients but points out that the confidentiality obligation is broader than the privilege.[17] Implied authority to disclose is precluded by the risk of harm to the employee's interests.[18]

The Opinion concludes that disclosure to either the carrier or the employer is ordinarily forbidden:

> Absent an express agreement among the lawyer and the clients that satisfies the "informed consent" standard of Rule 1.6(a), the Committee believes that whenever information related to the representation of a client may be harmful to the client in the hands of another client or a third person, the lawyer is prohibited by Rule 1.6 from revealing that information to any person, including the other client and the third person, unless disclosure is permitted under an exception to Rule 1.6. Whether any agreement made before the lawyer understands the facts giving rise to the conflict may satisfy "informed consent" (which presumes appreciation of "adequate information" about those

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[15] ABA Formal Op. 08-450, at 3–4 (footnotes omitted). The Opinion suggests that it might be appropriate for either the carrier or the employer to give an advance waiver permitting continued representation of the employee without disclosure of any information adverse to the employee that counsel might learn. ABA Formal Op. 08-450, at 3–4. Of course, advance waivers are more likely to be enforceable if the party giving the waiver is an experienced user of legal services. ABA Formal Op. 08-450, at 4 n.10, relying on ABA STANDING COMM. ON ETHICS & PROF'L RESPONSIBILITY, Formal Op. 05-436 (May 11, 2005).

[16] ABA Formal Op. 08-450, at 3–4 (footnote omitted). Rule 1.4(b) requires a lawyer "explain a matter to the extent reasonably necessary to permit a client to make informed decisions regarding the representation." MODEL RULES OF PROF'L CONDUCT, R. 1.4(b) (2012).

[17] ABA Formal Op. 08-450, at 5 & n.14.

[18] ABA Formal Op. 08-450, at. 5–6.

> facts) is highly doubtful. In the event the lawyer is prohibited from revealing the information, and withholding the information from the other client would cause the lawyer to violate Rule 1.4(b), the lawyer must withdraw from representing the other client under Rule 1.16(a)(1).
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> * * * *
>
> The lawyer may not reveal the information gained by the lawyer from either the employee or the witness, or use it to the benefit of the insurance company, when the revelation might result in denial of insurance protection to the employee. Under the circumstances described in the hypothetical, there has been no "informed consent" and it would be difficult to envision either that a lawyer could recommend or that the client would freely authorize disclosure once given an "explanation about the material risks of and reasonably available alternatives to the proposed course of conduct." None of the exceptions of Rule 1.6(b) apply. *The only question, therefore, is whether anything about the multiple representation warrants a conclusion that the lawyer has impliedly been authorized to make the disclosure.*[19]

This is indeed the key question. The opinion uncontroversially notes that when a lawyer represents multiple clients in different matters, the lawyer may not share one client's information with another client.[20] But, "when the lawyer represents multiple clients on the same … matter … [,] the lawyer has a duty to communicate with all of the clients about that matter."[21] Nonetheless, the Opinion asserts that, even in a multiple representation, "[e]ach client is entitled to the benefit of Rule 1.6 with respect to information relating to that client's representation, and a lawyer whose representation of multiple clients is not prohibited by Rule 1.7 is bound to protect the information of each client from disclosure, whether to other clients or otherwise."[22] If the latter point is correct, then it necessarily follows that the lawyer may not reveal facts that would adversely affect the employee's interests.

But, what of the lawyer's duties to communicate with the co-client employer and (if it is a client) the carrier? Those duties, of course, depend on the scope of the representation, and if the lawyer cannot communicate on an issue within the scope of the representation, that inability constitutes a conflict, requiring the lawyer to withdraw.[23] As to the carrier, the Opinion reasons that

> [o]rdinarily, when a lawyer is engaged by an insurer to represent the insured, the substantive law precludes the lawyer from acting

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[19] ABA Formal Op. 08-450, at 4–6 (emphasis added, footnotes omitted). One omitted footnote emphasizes that the need for "informed consent" does not apply in the absence of some apparent risk to the interests of one client, as the disclosure is then impliedly authorized.

[20] ABA Formal Op. 08-450, at 6.

[21] ABA Formal Op. 08-450, at 6.

[22] ABA Formal Op. 08-450, at 6.

[23] ABA Formal Op. 08-450, at 6.

> contrary to the interests of the insured. In that situation, the lawyer has no obligation under Rule 1.4 to communicate to the insurer information contrary to the interests of the insured, but on the contrary, is obliged by Rule 1.6 not to do so.[24]

While recognizing that "the 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," the Opinion concludes that these obligations do not limit in any way the policyholder's right to have the lawyer preserve from disclosure to the carrier any and all information relating to the representation that is damaging to the policyholder's interests.[25]

As to the co-client employer, the Opinion concludes that the lawyer would be unable to pursue a scope of employment defense while representing the employee. While the employer might be willing to forego that defense, the lawyer could not disclose the facts necessary to raise the issue without the employee's informed consent.[26] Moreover, because the parties' interests on waiver differ, the lawyer cannot advise any of them on that issue.[27]

Given the inability to disclose to either the carrier or the employer, the lawyer must consider whether withdrawal is required under Rule 1.16(a):

> If the continued representation of any client would cause the lawyer to violate a Rule, including participation in any fraud, withdrawal from that representation will be required. The lawyer may be able to continue representing the insured, the "primary" client in most jurisdictions, depending in part on whether that topic has been clarified in advance. If the lawyer cannot continue to represent the insured, she should recommend to the insurance company that separate counsel be retained to represent the insured's interest only.[28]

[3] Critique of ABA Opinion 08-450

[a] Narrow Applicability of Analysis

Before questioning some aspects of the Opinion, we want to note that the problem

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[24] ABA Formal Op. 08-450, at 6–7 (footnote omitted).

[25] ABA Formal Op. 08-450, at 7. A California opinion concludes that the lawyer must keep damaging information from the carrier beause the policyholder must be regarded as the primary client. CAL. STATE BAR STANDING COMM. ON PROF'L RESPONSIBILITY & CONDUCT, FORMAL OP. 1995-139, *To Whom Does an Attorney Owe Duties When He or She Acts as Insurance Defense Counsel,* at 9-10. See discussion in § 2.06[2], *above.*

[26] ABA Formal Op. 08-450, at 7.

[27] ABA Formal Op. 08-450, at 7.

[28] ABA Formal Op. 08-450, at 8 (footnote omitted). The omitted footnote quotes Model Rule 1.7 Comment [31] "[t]he lawyer should, at the outset of the common representation … , advise each client that information will be shared and that the lawyer will have to withdraw if one client decides that some matter material to the representation should be kept from the other."

addressed depends on the precise three-party scenario. If only the employee were sued, and the carrier were defending, the information on scope and course would be irrelevant to the defense and, so, outside the scope of the representation.[29] There would be no obligation to disclose. (See § 9.03, above) Alternatively, if there were no insurance (or if coverage did not depend on scope and course), the employer's scope and course defense would create no conflict.[30]

[b] Conflict with the Model Rules and the Restatement

The Opinion construes Model Rule 1.6 to impose on a lawyer engaged in a joint representation a duty to keep any information detrimental to any client from all other clients. It does this regardless of whether the source of the information is the client whose interests are at risk or some other source (such as the witness in the hypo) and even if the lawyer has followed the guidance of Comment [31] to Model Rule 1.7 to "advise each client that information will be shared."

This supposed obligation to keep secrets from other joint clients is squarely contrary to Comment [31] to Model Rule 1.7:

> As to the duty of confidentiality, continued common representation will almost certainly be inadequate if one client asks the lawyer not to disclose to the other client information relevant to the common representation. This is so because the lawyer has an equal duty of loyalty to each client, and *each client has the right to be informed of anything bearing on the representation that might affect that client's interests and the right to expect that the lawyer will use that information to that client's benefit.* [30.1]

The rule of Opinion 08-450 is also contrary to the Restatement's view of confidentiality in joint representations:

> Sharing of information among the co-clients with respect to the matter involved in the representation is normal and typically expected. As between the co-clients, in many such relationships each co-client is under a fiduciary duty to share all information material to the co-clients' joint enterprise. Such is the law, for example, with respect to members of a partnership. Limitation of the attorney-client privilege as applied to communications of co-clients is based on an assumption that each intends that his or her communications with the lawyer will be shared with the other co-clients but otherwise kept in confidence … . Moreover, the common lawyer is required to keep each of the co-clients

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[29] In an action against the employee alone, it would not matter whether the employee was acting in the scope and course of employment. RESTATEMENT (THIRD) OF AGENCY § 7.01 (2006).

[30] The employer would be liable only if the employee were acting in the scope and course of employment. But, if that were true, the employee would be obliged to indemnify the employer against liability resulting from the employee's negligence. RESTATEMENT (THIRD) OF AGENCY § 8.08 cmt. b. So, in the absence of insurance, a finding that the employee was acting in the scope and course of employment would provide no benefit to the employee.

[30.1] MODEL RULES OF PROF'L CONDUCT, R. 1.7 cmt. [31] (emphasis added).

> informed of all information reasonably necessary for the co-client to make decisions in connection with the matter … . *The lawyer's duty extends to communicating information to other co-clients that is adverse to a co-client, whether learned from the lawyer's own investigation or learned in confidence from that co-client.*[31]

In the hypo, the employee is a fiduciary of the employer under the law of agency, obliged to inform the employer of all pertinent facts regarding the employment. Nor is the joint representation of employer and employee subject to the special limitations that may apply to joint representations of carriers and policyholders.[32] So, the premise of the quoted Restatement rule seems fully applicable, at least with regard to the employer.

It might be argued, contrary to the Restatement, that the employee's own disclosure to the lawyer of facts that the employee did not recognize as harmful to insurance coverage should not be regarded as a waiver of the presumptive confidentiality of the attorney-client relationship, even if the employee has been told there will be no secrets. After all, that is information that the employer would not have gotten had the employee not disclosed it, which might not have been done had the employee understood the implications.

However that might be, there is no similar argument that the facts the lawyer learned from the witness should be kept from the employer. The witness interview that developed those facts was as much a part of the employer's representation as of the employee's. The same facts would presumably have been given to the lawyer if the employee were represented by someone else. The risk that joint counsel will discover facts favorable to one client at the expense of the other is an inherent risk of joint representation and (ordinarily) makes the client unfavorably affected no worse off than had there been separate representation. There is no good reason to make the client benefited by such information start over with new counsel (who should be able to find the same third-party information).

Even in the absence of an initial disclosure of the no-secrets rule, the San Diego bar association found an obligation to disclose to the uninformed client. There the joint clients were landowners with boundary disputes with a common adversary. The lawyer received a "confidential" proposal from the common opponent to resolve the dispute Client 1 and then make common cause with Client 1 against Client 2. The lawyer proposed to withdraw from any representation in settlement negotiations but to continue the joint litigation representation as long as no settlement occurred. The opinion concluded that the offer must be disclosed to both clients and that the lawyer must withdraw from representing either unless they both gave informed consent to another arrangement. On disclosure, the opinion concluded:

> Attorney cannot keep the settlement offer secret from Client 2 … . Rule 3-500 of the Rules of Professional conduct mandates that a "member shall keep a client reasonably informed about significant developments relating to the employment or representation." The potential changed position of an ally (or at

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[31] RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 60 cmt. l (emphasis added).

[32] *See* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 134 cmt. f, discussed in § 10.04[1], above.

> least another party whose interests were aligned) to an adversary is potentially "significant." …
>
> One of an attorney's basic functions is to advise. An attorney may violate his ethical duties if the attorney fails to provide appropriate and timely advice to clients. Not only should an attorney provide advice when requested, but he or she should also volunteer opinions when necessary to further clients' objectives … .[32.1]

[c] Incomplete Consideration of Prospective Waiver

Moreover, the Opinion's almost irrebuttable presumption against the efficacy of an advance waiver is contrary to case law that the Opinion does not appear to have considered. In *Zador Corp. v. Kwan*,[33] Zador, owned by the Young family, purchased the Platt Property from a partnership composed of Claitor and Bolton. Kwan was an agent for the Young family in passing title to Zador. Bolton claimed that he was supposed to have wound up with a 15% interest and sued Zador, Kwan, and Claitor. Zador retained Heller to represent it. Kwan sought indemnification from Zador.

Zador offered to allow Heller to also defend Kwan. A letter consenting to multiple representation disclosed the lack of confidentiality, and provided consent to Heller's continued representation of Zador in the event of any dispute or conflict.[34] In reviewing documents produced by Bolton, Heller found evidence of possible improper payments to Kwan. (The facts thus resemble the hypothetical receipt of information from a third party witness in Opinion 08-450.) It withdrew from representing Kwan, who reaffirmed his consent to Heller's continued representation of Zador.[35] Ultimately, Heller represented Zador in filing suit against Kwan. Kwan's motion to disqualify was denied, enforcing the waiver.[36] To be sure, the reaffirmation of the waiver after the information was discovered means that the court did not need to rely only on the prospective waiver. But the reaffirmation was at least in part based on the prospective waiver.[1]

32.1 SAN DIEGO COUNTY BAR ASS'N, LEGAL ETHICS OP. 2013-1.

33

CA—

Zador Corp. v. Kwan, 31 Cal. App. 4th 1285 (1995).

34 The letter is quoted at length in the opinion.

35 While the consent was reaffirmed, the case upheld the original, prospective consent, rather than relying on the reaffirmation. *See*

US/CA—

Visa U.S.A., Inc. v. First Data Corp., 241 F. Supp. 2d 1100, 1106 (N.D. Cal. 2003) (no second consent required unless original consent inadequately informed; construing *Zador*).

36

CA—

Zador, 31 Cal. App. 4th at 1292.

1 Other cases relying on *Zador*-like consents include

The D.C. Bar has concluded that an agreement at the outset of the representation that there will be no secrets *requires* the lawyer to proceed on that basis.[37] It did not regard the elevated standards for prospective waivers to be applicable: "we do not treat the waiver of confidentiality at issue here as an 'advance waiver' because a confidentiality waiver given as part of an agreement for representation by a single lawyer of multiple clients is more in the nature *of a current*, rather than an advance, waiver."[38]

Returning to Opinion 08-450, if one assumes that a prospective waiver was necessary for disclosure and that none was given, the suggestion that the lawyer might be able to continue representing the employee, after withdrawing from representation of the employer, seems incorrect, unless a specific consent to such a continuing representation had been obtained from the employer at the outset. If the employer asserts the scope and course of employment defense, the employee will have an adverse position (to try to preserve coverage), but continued representation of the employee would be substantially related to the former representation of the employer. A consent to sharing of information (which we assume both the employer and employee to have given) does not equate to a consent to future adverse representation in the same matter. So, if the lawyer cannot make sufficient disclosures to seek the employer's informed consent to continued representation of the employee, the lawyer will presumably have to withdraw from further representation of anyone in this matter.

[d] Necessity of Fraud Analysis

Another question that lurks in the background of the hypo is what the employee has said

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US--
SEC v. Tang, 831 F. Supp. 2d 1130, 1134, 1144-47 (N.D. Cal. 2011); In re Rite Aid Corp. Secs. Litig. v. Grass, 139 F. Supp. 2d 649, 652-53, 660 (E.D. Pa. 2001);

NY--
GEM Holdco, LLC v. Changing World Techs., LP, 46 Misc. 3d 1207(A) (N.Y. Sup. Ct. Jan. 9, 2015) (unpublished).

Authorities rejecting such consents by unsophisticated clients or based on inadequate information include:

CA--
LOS ANGEKES COUNTY BAR FORMAL ETHICS OP. 471 (1992);

DC--
D.C. BAR ETHICS OP. 309 (2001);

TX--
TEX. BAR ETHICS OP. 487 (1992);

NY--
N.Y. COUNTY L. ASS'N ETHICS OP. 724 (1998).

[37] D.C. BAR, Op. 327 (Feb. 2005) (law firm that jointly represented multiple clients under an agreement that there would be no secrets learned information from one of them material to the representation but adverse to the communicating client, so it withdrew from representing the others; despite the withdrawal, the firm was obliged to disclose to new counsel for the noncommunicating clients the information received from the communicating client).

[38] D.C. BAR, Op. 327, at n.12 (emphasis original).

about the scope and course issue. Because that issue is so obvious and so important (both in terms of the employer's liability and in terms of coverage), it is hard to imagine that the employee would not have been asked about it by either the employer or the carrier before a defense was provided. If the employee lied, it would appear that a fraud was perpetrated to get the defense and is being perpetrated in seeking to obtain indemnity. As the Opinion recognizes, a lawyer cannot assist in a fraud. At a minimum, this would require the lawyer to withdraw. Because the lawyer's services had been employed in furtherance of the effort to get indemnity, Model Rule 1.6(b)(2) would authorize disclosure if the fraud were "reasonably certain to result in substantial injury to the financial interests … of another."[39] Even if the necessary reasonable certainty were not present when the lawyer withdrew, it would eventually become present if the fraud were not otherwise discovered and neared success. Model Rule 4.1(b) mandates that a lawyer shall not "fail to disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6."[39.1] Because Rule 1.6 would not prohibit disclosure, Rule 4.1 might mandate it.

Moreover, even if the employee never lied, the employee's relationship with the employer would likely subject the employee to a fiduciary duty to tell the employer about facts regarding the employment that would provide the employer with a defense. And the Opinion assumes that the duty to cooperate requires the employee to tell the carrier any facts relevant to the defense. Also, the employee may have innocently made misrepresentations whose falsehood was later discovered, creating a duty to correct. Failure to speak, when there is a duty to do so, is as much a form of fraud as active misrepresentation.[40] This would be an alternate basis for allowing the lawyer to disclose, even if the employee never lied.

Here the fraud threatens injury to one who was the lawyer's client (as the employer was and the carrier may have been) or to whom the lawyer owed a duty of care (as the lawyer probably owed the carrier, even if it were not a client) while the fraud was being perpetrated with the assistance of the lawyer's services. In those circumstances, tort law might impose a duty to disclose, even if the Model Rules do not do so.[41]

In *A. v. B.*,[42] the New Jersey Supreme Court applied fraud analysis to permit disclosure to one client of information adverse to another which the law firm learned from a third party. A law firm represented a husband and wife in planning their estates, resulting in each being the primary beneficiary in the event of the other's death. Unbeknowst to the law firm, the husband had

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[39] MODEL RULES OF PROF'L CONDUCT, R. 1.6(b)(2) (2012).

[39.1] MODEL RULES OF PROF'L CONDUCT, R 4.1(b).

[40] RESTATEMENT (SECOND) OF TORTS § 577 (1965).

[41] *See, e.g.*,

CO—

Bair v. Public Service Employees Credit Union, 709 P.2d 961, 962 (Colo. App. 1985) (adopting provisions of Restatement (Second) of Torts § 551 providing in part that business transaction parties are under duty to exercise reasonable care to disclose basic facts of the transaction, including belief that other party is operating with mistaken beliefs).

42

NJ—

A. v. B., 158 N.J. 51 (1999).

recently fathered an illegitimate child. While the estate-planning representation was proceeding, the mother of the child retained the firm to pursue a paternity claim against the husband. Due to a typographical error in the conflict system, the conflict was not discovered until after the wills had been executed and the husband's paternity confirmed by DNA testing. When the firm learned of the conflict it withdrew from representing the child's mother, but told the husband that it believed it would have to disclose to his wife if he did not do so. The husband obtained an order restraining such disclosure, which the supreme court reversed.[43]

The court noted that the case "concerns the conflict between two fundamental obligations of lawyers: the duty of confidentiality and the duty to inform clients of material facts."[44] New Jersey Rule of Professional Conduct 1.6(c) "permits, but does not require, a lawyer to reveal confidential information to the extent the lawyer reasonably believes necessary 'to rectify the consequences of a client's criminal, illegal or fraudulent act in furtherance of which the lawyer's services had been used.' "[45] The court found that this permitted disclosure:

> We likewise construe broadly the term "fraudulent act" within the meaning of RPC 1.6(c). So construed, the husband's deliberate omission of the existence of his illegitimate child constitutes a fraud on his wife. When discussing their respective

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NJ—
A v. B., 158 N.J. at 52–56 (1999).

44

NJ—
158 N.J. at 56 (citations omitted).

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NJ—
158 N.J. at 57–58. At the time, the Model Rules did not authorize disclosure on that basis, but they do now. MODEL RULES OF PROF'L CONDUCT, R. 1.6(b)(3) (2012).

In the absence of any similar authorization for disclosure in the then-applicable rules and of any agreement with the clients that there would be no confidentiality, a Florida bar committee concluded that the lawyer was precluded from disclosing to the wife her husband's execution of a codicil to his will making a substantial provision for a woman with whom he was having an extramarital relationship.

FL—
FLA. BAR, Op. 95-4 (May 30, 1997) (rejecting Restatement approach). *See also*

DC—
D.C. BAR, Op. 296 (Feb. 2005) (agreeing with Florida approach);

NY—
N.Y. CITY BAR ASS'N, Formal Op. 1999-07 (absent agreement that there are no secrets, lawyer's duties of confidentiality and loyalty forbid lawyer to provide information about one former client to detriment of other client); N.Y. STATE Bar Ass'n, Op. 555 (Jan. 17, 1984) (lawyer representing two partners and learning from one of them that he is breaching fiduciary duties to the other may not tell the other, but must simply withdraw; strong dissent on disclosure issue).

> estates with the firm, the husband and wife reasonably could expect that each would disclose information material to the distribution of their estates, including the existence of children who are contingent residuary beneficiaries. The husband breached that duty. Under the reciprocal wills, the existence of the husband's illegitimate child could affect the distribution of the wife's estate, if she predeceased him. Additionally, the husband's child support payments and other financial responsibilities owed to the illegitimate child could deplete that part of his estate that otherwise would pass to his wife.
>
> From another perspective, it would be "fundamentally unfair" for the husband to reap the "joint planning advantages of access to information and certainty of outcome," while denying those same advantages to his wife.[46]

The facts of that case appear analogous to the hypothetical lawyer in Opinion 08-450 learning facts from the third-party witness. But the fraud analysis would seem to apply even had the facts been learned from the client who now wishes to conceal them.

The point of this analysis of the lawyer's possible discretion (or even obligation) to disclose is this: the Opinion's construction of Model Rule 1.6 may not, in the end, produce a much different result than the Restatement rule, but requires a great deal of extra complexity for all concerned. Even assuming that the employee's own statement should be protected from disclosure (and the fraud analysis may not allow even that), there seems no good public policy reason for protecting the witness's statement. Because Rule 1.6 is at least equally susceptible of the Restatement construction, the construction adopted by the Opinion seems questionable, and lawyers who rely on it risk having a court follow the Restatement.

[e] Failure to Consider Better Analysis of Duties to Carrier

The foregoing analysis has focused primarily on the relationship between employer and employee. As regards the carrier, the analysis is simpler, though not necessarily for the reasons the Opinion offers. Once the lawyer learns of the issue as to scope and course, it becomes apparent that the way in which the employer is defended could impact the employee's coverage. At a minimum (and even if the carrier is not a client), this requires the lawyer to withdraw from representation of the employer (whether or not the issue is disclosed to the employer). If the lawyer also withdraws from representation of the employee, then any representation of the carrier would also cease (and there would be no more duty to disclose to the carrier than to the employer).

This analysis is preferable to the Opinion's reliance on the proposition that insurance law makes the policyholder defense counsel's "primary client" vis-à-vis the carrier. While there are statements to that effect in a number of cases, we believe that those statements are generally (perhaps universally) dicta and, even if not dicta, unsound. (See §§ 2.05, 5.04, above.) So long as

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NJ—
A v. B., 158 N.J. at 58 (1999).

the lawyer can avoid any actual conflict between carrier and policyholder, there is never any need to consider whether one client is "primary." Ordinarily, that can be accomplished by declining representations where a conflict is apparent or withdrawing when one becomes apparent. While it is possible to construct hypothetical cases (like the one addressed by the Opinion) where an unexpected conflict is created by discovery of new facts *and* those are facts relevant to the defense representation, there are simply no decided cases in the whole of American jurisprudence actually dealing with such a situation.[47]

In the absence of such cases, there has been no occasion to determine what limitations insurance law would place on defense counsel's conduct. Certainly, there is no established rule that can be assumed to prevail everywhere and provide a proper basis for the Opinion's casual dismissal of lawyer duties to a carrier assumed to be a client.[48]

Because the circumstances that can require consideration of a possible "primary client" rule are so rare, and because fraud analysis will often permit or require disclosure even if that rule is adopted, it may not matter greatly whether the primary client rule is adopted in those narrow circumstances. But the assumption of a background "primary client" rule may improperly divert attention from the effort to assure that the lawyer can give undivided loyalty to every client, even an insurance carrier. Whenever that can be accomplished, without relying on a "primary client rule," it should be.

[f] Implications of Critique for Defense Counsel

In light of the conflict between the Opinion and the Restatement, defense counsel can have no assurance that a court will agree with the Opinion. So, to the extent possible, counsel ought to look for a course of action that does not depend on whether the Opinion is correct on the issues where it conflicts with the Restatement. Moreover, even if the Opinion is correct on those issues, counsel still needs to engage in a fraud analysis, which the Opinion recognizes as necessary but does not attempt to conduct.

[4] The Special Rules Proposed by the Restatement of the Law of Liability Insurance

The Restatement of the Law of Liability Insurance proposes two insurance-law rules on confidentiality. (See § 2.06[1], above.) One of these is essentially consistent with the rules that would otherwise apply, though its scope is somewhat unclear. (See § 2.06[2], above.) The other, if adopted, would only infrequently be applicable, and its consequences limited. (See § 2.06[2], above.) But defense counsel needs to be aware of those rules and take account of the possibility that they might be adopted in the relevant jurisdiction.

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AZ—

Parsons v. Continental Nat'l Am. Group, 550 P.2d 94 (Ariz. 1976), is often thought to be such a case. But it involved a question of intentional injury that would now be recognized as creating a conflict from the outset and entitling the policyholder to independent counsel.

48 This is so even if one assumes that *Parsons* authoritatively adopted the "primary client" rule as the law of Arizona, despite the lack of any need to do so on the facts there.

GOLDBERG SEGALLA

Bad Faith as a Continuum: From Claim to Trial

Thomas F. Segalla

Goldberg Segalla LLP

665 Main Street, Suite 400
Buffalo, New York 14203
(716) 566-5400
(716) 566-5401 (fax)
tsegalla@goldbergsegalla.com

Note: The following is excerpted from the complete treatise "Bad Faith as a Continuum: From Claim to Trial." Please contact Thomas F. Segalla at tsegalla@goldbergsegalla.com for a copy of the entire article.

THOMAS F. SEGALLA

Thomas F. Segalla is a senior trial partner in the Buffalo office of the firm of Goldberg Segalla LLP where he is chair of the firm's Insurance Litigation Department. Goldberg Segalla LLP has offices in New York (Buffalo, Rochester, Syracuse, Albany, New York, White Plains, and Long Island), New Jersey (Princeton), Pennsylvania (Philadelphia), and Connecticut (Hartford).

Mr. Segalla is a *cum laude* graduate of the State University of New York at Buffalo Law School. He is a member of the Federation of Defense and Corporate Counsel (FDCC) (Chair, Appellate Law Section and Member of the Environmental Law and Toxic Torts; Alternative Disputes Resolution and Insurance Coverage Sections), the Defense Research Institute (DRI) (Chair of the Law Institute), (Past Chair of the Insurance Law Committee for DRI), the International Association of Defense Counsel (IADC), and the New York State Bar Association where he serves on various insurance and environmental committees. Mr. Segalla has lectured and published extensively for these professional organizations in the field of insurance coverage, labor law, environmental law and premises liability.

He is the co-author of the renowned insurance treatise *Couch on Insurance* 3d, where has been and continues to provide practice commentaries to the analytical discussion. He has been retained by numerous insurance carriers and policyholders, and has given extensive expert testimony in the field of Insurance Law. His litigation practice focuses on the defense and insurance coverage aspects of matters involving bad faith, construction site personal injury accidents (Labor Law Sections 200, 240(1) and 241(6), and toxic tort and environmental issues.

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BAD FAITH AS A CONTINUUM:
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I.

INTRODUCTION

The concept of bad faith can only be clearly understood if viewed as a continuum. This requires that the claims handler and defense counsel look forward and backward after receiving notice of a lawsuit. The claims handling field is fraught with dangers; if the claims professional does not understand the impact of action or inaction during the claims handling process, a bad faith claim may result. Similarly, potentially large verdicts can emerge if defense counsel does not fully understand the claims handling process. Specifically, the claims professional must look forward to assess how action or inaction will be viewed by a jury. Defense counsel must look backwards at the process, however, considering how to profile the claims professional before the jury. Counsel also must determine whether to adopt a proactive or reactive approach to the defense process.

This article is divided into three sections and highlights what the claims professional should know about the present bad faith environment, what defense counsel should consider when advising its client about the proper approach to defend a case, and what both should know about potential challenges at the time of trial. Each of these matters must be assessed separately, but should be viewed as interrelated. Absent that approach, bad faith litigation will continue to plague the industry.

II.

BAD FAITH AVOIDANCE: WHO SET THE TRAP?

A. *The Dilemma*

Education, not insensitivity, cynicism or skepticism, is the principal tool in avoiding bad faith. However, even the most educated claims professional can be blind-sided in the claims handling and litigation processes, absent a clear understanding of the bad faith "setup," and an actual awareness of who set the trap. The focal issue can be framed in the alternative: (1) was the trap set by the insured and its counsel and/or the third-party claimant and its counsel, or (2) was it set by the claims handling professional at the adjuster level or at the management level of the insurance company? The purpose of this article is to help identify what prophylactic measures should be taken to prevent setting the trap at the outset; to identify what proactive measures are needed after the trap has been set; to identify who set the trap, and to provide some practical and tactical recommendations to remove the bait from the trap before it is sprung.

Bad faith has been variously described by courts and commentators. It abides many definitions:

1) *irrational recalcitrance* on the part of the insurer to pay what is due to the insured;
2) *reprehensible conduct* designed to redirect small amounts from all property damage claims;
3) *evil mindedness* of the adjuster, which results in a refusal to pay a claim;
4) "*malicious intent*" of the adjuster in investigating the claim; and
5) "*conscious wrong doing*" and "*spite*" towards the insured.

These descriptive words have been used to characterize the insurer's actions within the context of both first-party and third-party claims. It should be noted, however, that this article is not intended to provide a complete analysis of the legal standards applied within the first- and third-party context.[1]

One of the dominant goals of the education process is to prevent the insurer from entering the "Bad Faith Insurer Hall of Shame," promoting its entry instead into the "Good Faith Insurer Hall of Fame," as published by Fight Bad Faith Insurance Companies ("FBIC") (a non-profit advocacy organization) at *www.badfaithinsurance.org*. Although reading such publications can be highly inflammatory from the insurance industry perspective, these publications serve to identify the existing climate under which the claims professional and defense counsel must operate. Recognizing where the problems and potential exposure lie, and taking proactive steps to prevent the bad faith claim, constitute more realistic goals for the insurance industry to pursue. These goals can be achieved by educating the industry about acceptable claims handling procedures and analyzing how the industry's actions or inactions will impact the insureds and be judged by the courts.[2]

B. *Who Set the Trap*?

1. The Right to be Wrong

While the claims professional should be ever vigilant to the bad faith setup or trap, the industry should also recognize that the insurance company does have the right to be wrong; an insurer is not compelled to pay a claim or settle a case just because a claim is made or a settlement demand issues from the claimant. Unfounded claims and exorbitant demands within the policy limits need not be paid and should not be paid.[3] Regardless of the specific standard applied in either the first- or third-party context, most courts agree that a "reasonableness" or "fairly debatable standard" should be applied. Not only does an insurer have the right to be wrong, some jurisdictions even recognize an insurer's duty to verify that the claimant (*i.e.*, either a third party or its own insured) did not cause the loss so as not to pay suspicious or collusive claims. Such a duty protects the insurer's innocent premium-paying insureds. In *Time Insurance Co., Inc. v. Harvey Burger*,[4] the Florida

Supreme Court noted: "Insurers have a right and a duty to other policyholders to contest illegitimate claims. This statute should not be given a construction, which destroys that right or frustrates that duty. Payment of illegitimate claims raises the cost of insurance for all policyholders."[5]

The claims professional, who often consults with counsel when determining its position with respect to a particular claim, will sometimes aver that he or she relied on the *advice of counsel*. Courts traditionally have held that an insurer's failure to follow the advice of counsel is evidence of bad faith. More recently, the courts have held that reliance on the advice of counsel is but one factor in determining whether the insurer acted in bad faith, rather than an absolute defense to the claim.[6] It should be noted, however, that reliance on the advice of counsel must be reasonable, resulting from something more than wishful thinking on the part of the claims professional.[7] But what if the advice given by counsel is erroneous?

In *Gordon v. Nationwide Mutual Insurance Co.*,[8] an insurer relied on counsel's advice that a policy could be validly canceled. The New York Court of Appeals responded that reliance on advice of counsel is an absolute defense, noting: "It would be an extraordinary result to hold a client guilty of breach of good faith, with large punitive damages, because it acts on advice of counsel—even mistaken advice . . . ."[9] In contrast, the Court of Appeals for the Fifth Circuit determined in *Blakely v. American Employers Insurance Co.*[10] that the advice of counsel was irrelevant: "We do not hold to the view that an insurer can relieve itself of its duty to investigate, negotiate, settle or defend a claim by showing advices from its investigators, adjusters or legal counsel."[11] There appears to be no consistency among the various jurisdictions; therefore, it is incumbent upon claims professionals and practitioners to review the law in the controlling jurisdiction.[12]

2. Claims Professional's Conduct

Did the claims professional set his or her own trap within the context of the relevant action or inaction? Traditionally, in the claims adjustment process, the claims professional exercised nearly unfettered discretion in adjusting both the first-party and third-party claims. Within this context, bad faith claims focused on the actions or inactions of individual adjusters, asking whether those actions or inactions violated the bad faith standard as applied in a given jurisdiction. Within the first-party context, claimants generally allege that the insurer committed bad faith because:

1) it *arbitrarily* and capriciously denied a claim;
2) it *unscrupulously* denied a claim, placing its own interests over those of the insured;
3) it denied a claim that was reasonable or fairly debatable;
4) it denied a claim where there was no bona fide dispute; or
5) it denied a claim without adequate investigation.

In the third-party context, claimants generally allege that the insurer:

1) failed to provide a defense for a third-party claim in good faith;
2) failed *t*o properly settle the claim of a third party within the policy limits; or
3) failed to provide an adequate defense.

The gravamen of these allegations deals with the reasonable conduct of the insured or its counsel. Therefore, the conduct must be judged by the individual claims professional and his or her supervisor within the confines of the applicable bad faith standard. If claims professionals are not keenly aware of which claims adjustment activities and attitudes can be problematic, they are setting themselves up for a fall.

There are, however, certain claims handling *do's* and *don'ts* that can help keep the claims professional out of trouble or out of the trap. One of the clearest cautions prevents the claims professional from becoming a B.U.M.; that is:

1) *B*iased
2) *U*nfair
3) *M*ean

This acronym was developed by Lee Craig, a partner with the law firm of Butler, Burnette & Pappas in Tampa, Florida.[13]

Evidence of a claims professional's attitude and demeanor typically derives from oral comments or admissions made by the claims professional to the claimant. Such evidence can be found in the claims file, whether stored in hard or electronic copy, which generally is discoverable in most jurisdictions.[14]

Furthermore, any notation in the activity log is potentially discoverable and could make its appearance as a trial exhibit. The following are reported "lapses in judgment" as taken from the activity log notes of actual files:

- "The house is filthy and unsafe for habitation. I told the insured that before I would inspect the damage, she had to clean the place up and call an exterminator."
- "I met with the tenant at the insured location. I told the tenant that the damage was caused by surface water and therefore, not covered. The tenant will explain to insured."
- "I denied coverage for the extensive damage to the floor as the cause of loss is unknown. The insured requested an expert identify the source of water. I told her that I am the expert and the damage is not covered."
- "The insured is stupid and does not speak English very well. I mailed him a denial letter in hopes he can read better than he speaks."
- "The insured submitted notarized lightning affidavits for the damaged contents. I disagree with her expert and am therefore denying coverage for the loss."
- "The insured is submitting a claim for water damage in dining room. I remember this house from a claim last year. The dining room is in the front of the house. There is no source of water near the dining room, so this must be caused by surface water, which is not covered. No inspection needed. I will send insured surface water denial letter."
- "Attempted to contact the insured. I do not speak Spanish. I will close file at this time until the insured can get a translator for me to communicate with."
- "It appears the damage is caused by foundation movement. The insured has hired an engineer who concluded the foundation damage is caused by a plumbing leak in the bathroom. The bathroom is about 40 feet away from the worst damage. A leak in the bathroom could not be causing this damage. No coverage extended."
- "The insured became very upset with my explanation. I definitely do not want to cover this loss after the way she acted."
- "After reviewing the insured's inventory form, it is obvious she is lying. No one living in a house like hers could ever afford contents she is claiming. The insured stated she inherited most of her belongings from her mother who died last year. I don't believe this. If the insured can't produce purchase receipts, I will deny claim."
- "My inspection of the roof indicated extensive damage. I do not know what caused the damage, so I won't cover this loss."
- "The insured will not call me back while I am at the office. He keeps leaving messages on my voice mail after hours while I am not here. I will close the file until he calls me back while I am in the office."[15]

These "lapses" can be utilized by plaintiff's counsel to establish a traditional bad faith claim, where the claims handler has no lawful basis on which to preclude the claim, and a non-traditional case, where there is an intentional or reckless failure to investigate whether a lawful basis exists on which to refuse payment.[16]

The attitude of the claims adjuster is important to the overall process because authorities have recognized that "[b]ad faith is a very contentious issue for both the policyholders and insurance companies. . . . Such claims elicit strong emotions from the parties and often intensify the adversarial nature of a law suit."[17] To the extent that the insurer's representatives add fuel to the fire by way of adverse attitudes and lapses, they subject themselves up to *emotional distress* damages. While there appears to be no consistency among the various jurisdictions regarding whether emotional distress damages will be allowed in bad faith litigation, a number of issues can be determinative. These include whether the claim at issue is a third-party or first-party claim; whether the distress is severe, or differences between tort and contract law. In California, for example, emotional distress damages are recoverable only where the insured or third party has suffered some financial loss.[18]

Claims professionals should consider the following recommendations to defuse the bad- faith time bomb that potentially awaits the unwary claims professional. Each of the items mentioned in the checklists below should be assessed on a case-by-case basis, although no single recommendation presents a "cure" for bad faith litigation.

3. Checklist: First-Party Claims

With regard to first-party claims, the claims professional should observe the following recommendations:

a. Accurately record the analysis of the insured's proof of loss; do not editorialize any adverse or personal impressions.
b. Conduct a site investigation as soon as possible and record all facts, damages, and other information that impacts coverage.
c. Review all obligations of the insurer to the insured and comply.
d. Obtain timely coverage analysis where coverage issues are presented and advise insured of denial in a timely manner.
e. Pay any portion of the claim that may be owing.[19]

4. Checklist: Third-Party Claims

With respect to third-party claims, the recommendations are similar.

a. *Failure to Settle*
1. Investigate all liability aspects of the underlying claim.
2. Promptly evaluate both the liability and damage aspects of the case.
3. Keep the insured informed as to the liability assessment and value of the case.
4. Keep the insured informed of all settlement negotiations, any excess exposure, and the right to contribute.

b. *Failure to Defend*
1. Advise the insured of the insurance company's coverage position, consistent with any obligation imposed by statute or case law (*i.e.*, reservations of rights or denial of coverage).
2. Institute a declaratory judgment and attempt to resolve coverage issues in advance of the underlying liability claim.[20]

Superimposed across each of the foregoing obligations is the recommendation that the claims professional communicate in a direct, diplomatic, and professional fashion, articulating its position in a manner that can be easily understood by the claimant, the insured, and their counsel.[21] At least one court has observed that "[t]he portion of the claims file which explains how the company processed and considered Brown's [the insured's] claim and why it rejected the claim are certainly relevant to these issues."[22] In the matter of *Brown v. Superior Court*, that court further noted: "The claims file is a unique, contemporaneously prepared history of the company's handling of the claim; in an action such as this the need for the information on the file is not only substantial, but overwhelming."[23] Other courts have indulged similar observations: "It seems evident to us that in a case of alleged bad faith refusal to settle, the circumstances and content of the various negotiations and communications between the involved individuals are clearly relevant . . . ."[24]

In light of these comments and because the documentation regarding negotiations and communications will become exhibits in any subsequent litigation, the claims handler must be sensitive to the tenor and manner in which these are recorded. Such awareness can forestall any trap, but equally important, it will prevent the trap from being sprung during the litigation.[25]

5. Insurer's Corporate Policy

As noted earlier, the action or inaction of the claims handler traditionally forms the basis of a bad faith assault. According to some, however, the focus has changed:

> Plaintiffs are broadening their assault against insurer's corporate policies and procedures on two fronts: class action litigation and single or small multi-party plaintiff cases. What characterizes both forms of attack is that plaintiff all but ignores the adjuster's claim specific decision. The trial bar's assault is against the company at the management level because the issue in the case is the allegedly improper guidelines and procedures, promulgated by management, that have been consistently followed by its adjusters, which reap unfair profits from the insurer's policyholders. The adjuster is portrayed almost as an ignorant pawn of corporate management.[26]

The comments of Attorney Arnold D'Angelo raise the specter of institutional bad faith. Succinctly defined, it occurs "[w]hen corporate structure or policies encourage bad faith claims handling."[27] These comments were made eleven years after Leo Jordan, Associate General Counsel for State Farm Insurance, offered the following advice to members of the American Bar Association in 1979:

> The most important advice I can leave you with, is that the time has come for the insurance industry to do its own laundry. If there are practices and procedures, which are tinged with questionable motivation or proprieties, they must be eliminated. If changes are needed in the way we do business, let the industry and its well-trained lawyers lead the way in the reform. We cannot allow the trial bar and courts to establish our practices for us. We will be far better off to cleanse our own procedures and openly present them for public scrutiny. Just as Louis Brandeis said it well: Sunshine is the most powerful disinfectant.[28]

Over the past several years, insurers have adopted new claims handling guidelines in certain circumstances to address many of the issues raised by the challenge that claims adjusters had failed to properly investigate or process claims. Beyond these, changes in claims-handling guidelines were often dictated by economic factors affecting the insurance industry. However, it must be recognized that such procedures, practices and policies cannot be enacted in a vacuum; they should only be enacted "when the procedures have been adopted after a due diligence review which concludes that the practice fulfills the insurers' contractual obligations and is otherwise in conformance with state law."[29] It is evident, therefore, that the individual(s) charged with the drafting of claims-handling policies, practices and procedures must be educated to the manner by which courts interpret existing policy language; they must clearly understand the impact of current and proposed statutory law. Furthermore, the insurer should be vigilant about proposed legislation and the sentiment expressed by the various state legislatures. After considering the impact of these variables, the insurer can determine whether to redraft its practices, policies and procedures and, in the right case, whether to redraft policy language. If an insurer does not develop its claims-handling and billing guidelines in this fashion, it is setting its own trap.

Representatives at the management level should also be aware that they might be joined as individual defendants in any litigation. If not specifically joined, they may be noticed for deposition.[30] In an institutional bad faith claim, the industry representative will be subject as well to an extensive request for production of documents.[31]

The obvious purpose of such discovery is to establish a "pattern and practice" of activity at upper management levels in order to bolster the punitive damage aspects of the bad faith claim.[32] In addition to using traditional discovery devices, counsel for bad faith plaintiffs have developed other proof of pattern and practice. In one case, an insured school district sent letters and questionnaires to other policyholders in order to determine whether its insurers had engaged in a pattern and practice of denying similar claims.[33] Defense counsel undoubtedly will challenge such evidence on grounds that it is prejudicial, confusing, and a waste of judicial time. However, it might be best to address and avoid bad faith claims by engaging a more realistic assessment of an insurer's patterns and practices outside of the litigation process.

With respect to pattern and practice claims, commentator Arnold D'Angelo suggests several solutions for avoiding institutional bad faith claims:

> Suits are always being brought attacking insurance practices and, when successful, should form the basis of an internal dialogue within the insurance company. If the practice under attack is critical to an insurer's strategy, the insurer should determine whether the policyholder assault is meritorious. If so, the policy should be modified or sacrificed. On the other hand, if the practice is critical to the success of the business, the company may be able to preserve the practice by changing the policy language. By doing so, any policyholder's suit which is brought will only be able to attack the insurer's past practices, and liability will be thereby limited.[34]

6. Claimant's Setup

It is generally recognized that an actual offer within the policy limits is prerequisite to a bad faith claim. However, there are situations where a settlement demand is made by the claimant's counsel in order to set a trap for the claims professional.[35] Thus, the claims professional should be wary when:

1. Settlement demand is patently unreasonable, yet within the policy limits.
2. Settlement demand is made with the specific intent not to settle the case.
3. Terms and conditions (*i.e.*, length of time the demand remains open) are so unreasonable that they cannot be met.

This bad faith setup has been described as follows:

> Creative plaintiffs' attorneys often seek to expand the insurer's policy limits by staging facts that would give rise to bad faith liability. Sometimes these attorneys play "dirty pool" in their attempts to set insurers up for bad faith claims, using such techniques as making policy limits offers with unreasonable time limits, making offers before there has been adequate time for investigation or discovery and backing out of settlement agreements under pretexts they blame on the insurer.[36]

When confronted by such situations, the claims professional should document all negotiations and maintain a log of all critical dates, noting what transpired on each date (*i.e.*, noting the date and who said what regarding settlement). This documentation will assist defense counsel in alleging and proving the "setup defense."[37] A review of existing case law clearly indicates that when faced with such settlement demands, the claims professional should develop a time line of critical dates. As noted in *DeLaune v. Liberty Mutual Insurance Co.,* an offer to settle made less than two months after the accident and ten months before trial, which was open only for ten days, "made it virtually impossible to make an intelligent acceptance."[38] Not only should the claims professional be prepared to document these critical dates, he or she must also document what was being done from a claims-handling standpoint during this time frame. This documentation will establish that the settlement demand could not be reasonably and realistically assessed, and that the claims handler's reaction was reasonable.

7. Other Warning Signs

The claims professional should be aware of other warning signs that identify potential claims handling problems and occur on a daily basis. The National Insurance Crime Bureau has developed and published indicators that alert the insurance industry to potentially fraudulent claims. It has also published methods for assessing these claims. These types of claims often lend themselves to bad faith allegations. The following checklist may prove helpful when assessing whether a first-party claim carries the potential for bad faith:

a) Claim is a large one.
b) Claim is excessive in relation to the type of harm suffered or evidence submitted to support the claim.
c) Insured has made frequent claims against this and other policies.
d) Insured has retained an attorney to deal with the insurer immediately after the loss.
e) Additional limits were placed on the insured item before the loss.
f) Insured had been refused coverage by other carriers and is keenly aware of the claims process.
g) Insured exhibits a cavalier attitude towards the loss and merely wants to be paid.
h) Insured's financial condition changed immediately before the loss.
i) Insured makes inconsistent statements and is uncooperative.
j) With respect to a fire policy, insured has absented itself from the property prior to the loss.

While factors of this nature do not conclusively identify all suspicious/fraudulent claims or predict that a bad faith claim will develop, they should put the claims handler on notice that his or her best practices should be followed. Such practices will also provide a strategy (substantiated by documentation) by which to proactively challenge the setup.

When dealing with a third-party claim, the claims handler should be sensitive to the possibility of collusion between the insured and the injured party when settlement has been effectuated without involving the insurer. It has been noted that a settlement:

> [B]ecomes collusive when the purpose is to injure the interests of an absent or nonparticipating party, such as an insurer or non-settling defendant. Among the indicators of bad faith and collusion are unreasonableness, misrepresentations, concealment, secretiveness, lack of serious negotiations on damages, attempts to affect the insurance coverage, profit to the insured, and attempts to harm the interest of the insurer. They have in common unfairness to the insurer, which is probably the bottom line in cases in which collusion is found.[39]

When faced with such indicators, the claims professional should document critical elements without reacting negatively, which might jeopardize the defense of any subsequent bad faith claim.

C. *Proactive Claims Handling*

The threat of a potential bad faith claim does not mean that the claims professional cannot or should not do what is expected in the position. The following are claims-handling pointers, some of which may seem obvious. However, the failure to follow many of these often results in bad faith claims.

1) Keep in mind that the ultimate goal is to commit no act (nor fail to perform some act) that can be utilized by plaintiff's counsel as evidence of bad faith.
2) Be sensitive to the allegations made by the insured, the claimant or counsel in correspondence, and identify strategies.
3) Document responses to any correspondence, communication, or allegations made by plaintiffs. Do not ignore phone calls or written communications.
4) Treat the plaintiff and/or insured with the utmost courtesy, even if the insurer believes the insured is attempting fraud.
5) Be aware of all applicable claims-handling practices and procedures; document how these have been followed or explain why they have not.
6) When the insured or plaintiff's counsel presents evidence of the claim, be receptive and careful in responding. Follow all leads.
7) When evaluating liability and damages, and responding to the insured or plaintiff's counsel, do not act in an arbitrary manner or abruptly supply comment.
8) Follow all leads both for and against the plaintiff's or the insured's claim. Do not focus exclusively on denying the claim.
9) With respect to the claims file:
    a) Avoid any verbiage that provides an appearance of unreasonableness.
    b) Where a decision has been made, include supporting documentation in the file.
    c) Make sure he file is thorough and well organized, containing only information that pertains to the claim in question.
    d) Avoid verbiage pertaining to racial, sexual or religious orientation.
10) Conduct all investigations in a timely and reasonable fashion, documenting the reasons for any delay.
11) Make sure all communications and documentation evidence an open mind in assessing the claim.
12) Do not react adversely to the aggression, rudeness or adverse and negative comments made by the insured or plaintiff's counsel. Do not be lulled into making statements that can be utilized as admissions of bad faith.
13) Move the file through the claims process in a proactive and orderly fashion.
14) Seek advice from co-employees, supervisors, and counsel where necessary; do not handle the claims file in a vacuum.
15) Be aware of all applicable legal standards by which your activities will be judged.
16) Attend continuing legal education programs to remain abreast of current obligations and dangers.
17) Do not conduct a pretextual investigation.
18) Never be perceived as placing company interests above the insured's.
19) Retain experts who will provide an independent assessment of the claims.
20) Do not utilize computerized evaluation programs in a rigid manner; be flexible and realistic in assessing liability and damage potential.
21) Assume that all statements, documents, letters, e-mails, and claims files will be exhibits in any bad faith case and prepare accordingly.
22) Retain defense counsel who is familiar with the company's claims-handling process. Consistency between good claims handling and defense strategies is important.
23) Keep the insured informed.

Observing the foregoing recommendations will educate claims handlers and provide evidence to counter unwarranted bad faith allegations or the contention that the claims handler is a B.U.M.

Education is awareness, information, and communication coupled with an attitude of reciprocity, e.g., "do unto others as you would like them to do onto you." The educated insurance representative will enable defense counsel to properly evaluate and successfully litigate bad faith cases. While the insurance company controls the claims and litigation process contractually through policy language, that ability should not create the perception that company interests predominate over those of the insured. At all levels of the process, the representatives of the insurance industry and defense counsel must be aware of the atmosphere surrounding litigation of bad faith claims. They must clearly understand judicial standards and legislative intent as well. Absent a clearly defined and proactive educational program, the trap will be set and sprung before the bad faith letter leaves the insured's hands. A properly educated claims staff can assist defense counsel in assessing the case and handling the claim.

III.

"PROACTIVE" OR "REACTIVE:" WHAT MESSAGE SHOULD BE GIVEN TO INSURERS IN TODAY'S BAD FAITH CLIMATE?

A. *The Problem*

Without specific dictionary definition, *proactive* is the term that generally describes an affirmative approach to a situation. *Reactive* is defined as tending to be responsive to a situation.[40]

In today's insurance climate,[41] an insurer who faces either a troublesome first-party or third-party claim that holds potential for developing into a bad faith claim should immediately assess its options and determine whether to be *proactive* or *reactive*.[42] It is generally recommended that the insurance industry develop an internal program that prescribes proper claims-handling and litigation techniques. However, a program to identify such claims early in the process is equally important. Similarly, once a bad faith claim is threatened, it is critically important to immediately define the defense strategy. This should include utilizing traditional breach of contract defenses and a creative approach to other defenses that may be available but untested in the particular jurisdiction. This section analyzes not only the traditional defenses available to insurers in a bad faith situation, but also assesses the current status of the comparative bad faith and reverse bad faith defenses. It also discusses recent decisions where the insurer has confronted and successfully recovered damages from the insured (*i.e.*, return of benefits paid, sanctions and fees, and costs). Finally, this section explores claims made by insurers against defense counsel.

Practitioners who litigate in the bad faith arena and claims professionals who are faced with potential bad faith or extra-contractual exposure must not be "gun shy." While the potential for bad faith exposure can be significant and often affects the insurer's public image through adverse publicity,[43] the message of good faith must be projected to the public at large, as well as to judges and juries. Specifically, the duty of good faith and fair dealing implied in every insurance contract "is a two-way street, running from the insured to his insurer and vice-versa."[44] Recognizing that the implied covenant of good faith and fair dealing is a "two-way street," one court noted that "the fact finder, in its search for the truth, should be able to look at the whole forest and not just a few of the trees. This should include a view of the insurer's conduct as well as the insured's."[45] Whether relying on traditional defenses or attempting to stem the tide that favors insureds by invoking the defenses of comparative bad faith and reverse bad faith, the practitioner and claims professional must be prepared to argue that the duty of good faith is a "two-way street." If successful, the following headlines will attain a greater level of prominence:

- "Insured Who Inflated Loss Must Return $1.5 Million to General Accident"[46]
- "Jury Awards Allstate $3 Million in Damages for Inflated Invoices"[47]
- "Insurance Company Wins $800,000 in Punitives Against Fraudulent Policyholder"[48]

Furthermore, any *proactive* or *reactive* approach to an insured's misconduct must underscore the concept that the insurance industry and the state insurance agencies are committed to eliminating insurance fraud. Such misconduct affects society as a whole; it undermines the insurer's obligation to its other policyholders—to pay legitimate claims that should be paid and deny the false and fraudulent claims that should not. Only this approach will guarantee that the insurer can meet its obligations to all insureds.[49] To that end, the analysis below identifies components of the basic dilemma.

B. *Insured versus Insurer, or Insurer versus Insured?*

1. Basic Elements of Bad Faith

For many reasons, the elements of bad faith are extremely difficult to assess. This difficulty is due perhaps to the changing nature of the claims, the inability of courts to agree on the standard of conduct to be used as a benchmark, the fact that some jurisdictions provide a statutory cause of action, or whether the cause of action is viewed as tort or contract within the jurisdiction. While a complete survey of the various states is beyond the scope of this article, each jurisdiction recognizes that a claim of bad faith emanates from the relationship between an insurance company (insurer) and its policyholder (insured).[50] Based on that relationship, the courts recognize that an implied covenant of good faith and fair dealing exists in every insurance contract. A bad faith cause of action generally arises when an insurer fails to provide an insured with a recognized right provided by the policy and the insurer's failure violates the standard of conduct imposed by case law or statute. The standard of conduct differs from jurisdiction to jurisdiction. For example, an unreasonable standard or wrongful denial standard is used in California.[51] However, a gross disregard or egregious conduct standard is used in New York.[52] Other jurisdictions, such as Arizona, require an intentional denial without a reasonable basis.[53] These differences illustrate the difficulty in assessing the particular elements of a bad faith claim and the need for the claims professional and practitioner to become familiar with the standard applied in the particular jurisdiction.[54] Once the standard is determined, the strategy for defense of the case can be designed and implemented based upon that standard.

2. Contract versus Tort

Critical to any analysis of bad faith litigation is the question whether a particular jurisdiction bases the cause of action on breach of contract or tort theory. The particular theory adopted by the courts of a given jurisdiction can impact the nature and extent of damages, the length of the statute of limitations, and the types of defenses available. A majority of jurisdictions that have considered this issue have determined that the cause of action for breach by the insurer of the implied covenant of good faith and fair dealing sounds in tort.[55] In *Kransco v. American Empire Surplus Lines Insurance Co.*,[56] the California Supreme Court considered the matter but issued a decision that involved a majority opinion, a concurring opinion by one judge, a concurring and dissenting opinion by one judge, and a dissenting opinion by another judge. The majority opinion noted the following:

> Because the covenant is a contract term, in most cases compensation for its breach is limited to contract rather than tort remedies. But "an exception to this general rule has developed in the context of insurance contracts where, for a variety of policy reasons, courts have held that [an insurer's] breach of the implied covenant will provide the basis for an action in tort." The availability of tort remedies in the limited context of an *insurer's* breach of the covenant advances the social policy of safeguarding an insured in an inferior bargaining position who contracts for calamity protection, not commercial advantage.[57]

The two dissenting judges also agreed that an action by an insured for an insurer's breach of the implied covenant sounds in tort.[58] As noted below, the *Kransco* decision went beyond this issue to consider an insurer's bad faith claim against an insured.

As a result of the determination that the insured's right to sue the insurer sounds in tort, the insurer who breaches an implied duty of good faith and fair dealing is liable for extra-contractual damages (*i.e.,* the full amount of any judgment against the insured in excess of its policy limits).[59] The rationale for extra-contractual damages has been described as follows: "The policy limits restrict the amount the insurer may have to pay in the performance of the contract, not the damages that are recoverable for its breach."[60] The insurer's liability in the third-party context is triggered when there is an excess verdict in the underlying action.[61]

Within the first-party context, a majority of courts have similarly determined that because an insured's cause of action against an insurer sounds in tort, the insured is entitled to tort damages. These can include punitive damages as well, provided the insurer's action or inaction warrants the imposition of extra-contractual damages.[62] In this regard, courts have utilized the following standards to justify the imposition of punitive damages:

- insurer's conduct was intentional or made without a reasonable basis;
- insurer's conduct is egregious in nature; or
- insurer's actions were wanton and willful.[63]

The insured must allege and prove that the insurer's conduct met one of these standards and that the insurer knew or should have known that it was acting unreasonably.[64]

3. Insurer Defenses and Causes of Actions

When faced with first- or third-party complaints that allege bad faith in violation of the applicable standard, seeking to establish extra-contractual damages, the practitioner representing the insurer must immediately assess all available defenses and potential affirmative claims. Many of the defenses are fact-driven. Thus, the ultimate goal should seek to review all action or inaction of both the insurer and the insured in order to strategize dismissal of the complaint or reduction in compensatory (contract) and extra-contractual (tort) damages. To this end, it is important to investigate any defenses available in the particular jurisdiction whose laws will control the litigation. Before discussing any available contractual defenses, the defenses of comparative bad faith and reverse bad faith should be considered in light of recent case law and other commentary.

a. *Comparative Bad Faith*

Simply stated, comparative bad faith is an affirmative defense based upon the standards of comparative fault; it is designed to apportion damages between the insurer's and the insured's bad faith conduct.[65] However, this defense was rejected recently by the California Supreme Court in *Kransco*, despite earlier legal speculation that "California courts would reduce punitive damages awards when the insurer submits a proper special issue calling for an allocation of the percentages of fault based on the insured's and the insurer's malicious, oppressive or fraudulent behavior."[66] Prior to the *Kransco* decision, many legal commentators had endorsed this affirmative defense.[67] These discussions are still instructive in those jurisdictions, which have not yet addressed the issue. Thus, practitioners who represent insurers should be familiar with the arguments supporting this defense.

When rejecting comparative bad faith, the *Kransco* majority left no room for doubt that such a defense is not viable within the third-party context:

> We agree with the Court of Appeals below that the jury should not have been instructed at all within principles of comparative bad faith. . . .
>
> We observe that rejection of comparative bad faith in this context does not leave the insurer without remedies for an insured's breach of the covenant of good faith and fair dealing.[68]

As noted, however, the court clarified that its determination would not diminish the insurer's ability to defend these bad faith cases, specifically noting that the insurer's remedy would lie with the following contract defenses:[69]

- Insured's conduct may be used to disprove allegations that the insurer's conduct meets the applicable bad faith standard.[70]
- A breach of the cooperation clause of the policy may result in a dismissal of the complaint.[71]
- A material misrepresentation by the insured voids coverage altogether.[72]
- Fraudulent misconduct provides a separate, distinct defense and is separately actionable.[73]

Each of these defenses is separate and distinct, requiring a specific factual analysis unique to the particular defense.

The *Kransco* case is not the only recent decision to consider accepting or rejecting the defense of comparative bad faith. The United States District Court for the Virgin Islands, Division of St. Croix, recently considered the application of this defense as well. In the matter of *In re Tutu Water Wells Contamination Litigation*,[74] that Virgin Islands district court made a similar determination:

> Although there is existing case law, which supports the adoption of comparative bad faith, the clear weight of authority holds to the contrary. . . . Thus the Court concludes, consistent with the mandates of Virgin Islands Code, that the common law as understood throughout the United States does not recognize the affirmative defense of comparative bad faith.[75]

In reaching its decision, the court refused to align itself with those jurisdictions that allow the defense.[76]

The Virgin Islands district court also declined to follow *Eastman Kodak Co. v. Traveler's Indemnity Co.*[77] In that case, the Superior Court of New Jersey allowed the defendant insurers to amend their answers and counterclaims to include common law fraud and a breach of the duty of good faith and fair dealing by the insured (a violation of the New Jersey Insurance Fraud Protection Act). The basis for the claims in the *Eastman* case was the insured's failure to provide critical information to the insurer regarding its coverage position.[78]

There is little doubt that *Kransco* will have significant impact on the defense of comparative bad faith. As one commentator speculated prior to the decision,

> The decision that will be issued by the California Supreme Court in *Kransco* is likely to have a great deal of influence on courts across the country with respect to their willingness to accept comparative bad faith defenses by insurance carriers. It may also affect the New York courts, which have not yet addressed the comparative bad faith doctrine.[79]

Another commentator also surmised that recognition of the defense was the next logical step: "[T]he mere fact that Texas has consistently followed California in the area of insurance bad faith law supports adoption of the defense."[80] However, his surmisal predated *Kransco*.

It should be noted that the *Kransco* decision is not without criticism. Notwithstanding *Kransco*, some case law and legal commentaries continue to support the defense:

> Ultimately, some will explain *Kransco* as a case of bad facts making bad law, at least for insurers. . . . Unfortunately, rather than affirm the Court of Appeal's decision on the facts of the case, the majority eliminated the defense of "comparative bad faith" as a matter of law.[81]

In fact, one court has even suggested that bad faith law would be improved by a comparative bad faith defense.[82]

The concurring opinion authored by Judge George in *Kransco* argued that the majority should not have rejected the comparative fault doctrine, noting that "the court should rest its decision in this case solely upon the narrower, and fully dispositive ground that the insured's conduct here at issue negligently providing an incorrect answer to a discovery request does not constitute the type of misconduct that properly may reduce an insured's liability or damage resulting from its failure to accept a reasonable settlement."[83] Notwithstanding his rationale, a majority of the court overturned the state's prior law, which had determined that an insurer could raise as a defense the tort concept of comparative fault (*i.e.*, comparative bad faith) in a bad faith action.

While the concurring and minority opinions indicate the fallacy of entirely rejecting the comparative bad faith defense, the majority appears to have reasoned from a faulty premise. Specifically, the majority rejected the principle that the obligations of insurer and insured are comparable and mutual in the insurance relationship. To the contrary, the court observed that "[a] fundamental *disparity* exists between the insured, which performs its basic duty paying the policy premium at the outset, and the insurer, which, depending on a number of factors, may or may not have to perform its basic duties of defense and indemnification under the policy."[84] The court went on to conclude that since the insurer and the insured held different financial interests, "[a]n insured is . . . not on equal footing with its insurer—the relationship between the insured and insurer is inherently unequal, the inequality resting on contractual asymmetry."[85] Historically, of course, various commentators have noted that well-established public policy considerations are contradicted by the comparative bad faith concept. Specifically, one commentator has observed:

> A major public policy consideration in insurance litigation is the concept of fairness between the insurer and insured "that is equalization of the contenders' strategic advantages." The superior advantage an insurance carrier has over its individual insured in all aspects of the insurer-insured relationship is most prevalent when it comes time for the insurers to "pay up" under the contract. Due to their advantageous position over the insureds, this idea of fairness and equalization impliedly leads the courts to treat insurance policies as adhesion contracts.[86]

Although the implied duty of good faith and fair dealing traditionally protected against this superior bargaining position,[87] several commentators have questioned whether this "superiority" continues within the current climate, or whether insureds have increased their bargaining positions.[88] In fact, it has been suggested that one size does not fit all and that all insureds are not created equal—at least with respect to commercial insureds.[89] These insureds have greater sophistication, often have self-retained limits, employ risk managers, and have access to legal counsel and other professional advisors. Following this analysis, some have noted:

> The implied duty of good faith and fair dealing originally served to protect against the unequal bargaining power held by the insured. Many insureds now enjoy greater bargaining power. The large disparity in bargaining power is a thing of the past. This has led to the development of comparative bad faith as an affirmative defense to offset the damages caused by an insured's own bad faith conduct.[90]

Other justifications by which to apply the comparative bad faith defense have surfaced as well:[91]

- The defense of comparative bad faith is connected with the comparative responsibility system enacted in the jurisdictions.[92]
- The defense is compatible with contractual liability theories within the jurisdiction.[93]
- The concept of fundamental fairness is promoted by the defense by shifting the responsibility back to the insureds for their misconduct.[94]

The defense of comparative bad faith clearly suffered a blow from the California precedent. At least in that state, the defense of a bad faith claim can be an all or nothing proposition. In defending both third- and first-party claims, a California insurer can avoid bad faith in two ways. By pleading and proving that the insurer acted appropriately under the circumstances without violating the good-faith standard, the insurer's counsel can utilize the insured's conduct to establish the overriding atmosphere and demonstrate how the insured's actions or inactions affected the insurer's ability to act. In the alternative, if the insured's conduct amounts to a breach of contract, misrepresentation, fraud, the failure to mitigate damages or the failure to cooperate, these defenses should be raised separately.

In other jurisdictions that either allow a comparative bad faith defense or have not yet ruled on the issue, the practitioner should plead the defense with specificity. These pleadings should aver generally that the defense of comparative bad faith is sought and request a reduction in the damages assessed, if any, in the insured's underlying bad faith claim against the insurer. Similarly, the practitioner in these jurisdictions should allege any applicable contract defenses. In addition, the practitioner should be aware that if the defense is not raised affirmatively in the answer, it could be waived.[95]

b. *Reverse Bad Faith*

The issue presented by this defense is whether an insurer has the affirmative right to proactively sue an insured for breach of the good faith covenant of fair dealing. As one commentator has observed, "If the duty of good faith and fair dealing truly is a 'two-way street,' the answer to the question should be yes."[96] One court has held that the doctrine of reverse bad faith "creates an independent tort that allows an insurer to seek affirmative relief for an insured's breach of good faith and fair dealing."[97] If recognized as a tort, it appears that extra-contractual damages would be allowed, whereas only compensatory damages would lie if the court recognizes that the cause of action is viable only in contract.[98]

While many courts and commentators interchange the concepts of comparative bad faith and reverse bad faith, they are distinct.[99] Comparative bad faith, as noted above, allows the court to apportion damages and reduce the bad faith compensatory and punitive damages awarded against the insurer in an appropriate case. Reverse bad faith involves an affirmative action against the insured, either as a direct cause of action in a complaint or a counterclaim, allows an affirmative dollar recovery in favor of the insurer against the insured,[100] and places the action or inaction of the insured before the judge or jury.

The elements of a reverse bad faith claim have been identified as follows:

- The insured owes the insurer a duty to meet a specific standard of conduct with respect to the claim-handling and litigation process (*i.e.*, duty of good faith and fair dealing);
- The insured breached that duty, and that breach interfered with the claim-handling and litigation process; and
- The insurer's ability to adjust or defend the case was affected, causing damage or prejudice to the insurer.[101]

Given these elements, the practitioner representing the insurer should peruse the claim-handling and litigation processes to determine whether the insured's conduct during the "adjustment, investigation, negotiation phases of the first-party or third-party claims"[102] violated the covenant of good faith and fair dealing.

Whether a reverse bad faith claim constitutes a viable alternative to insurers is still an open question in many jurisdictions. The availability of reverse bad faith was recently considered in the case of *In re Tutu Water Wells Contamination Litigation.*[103] The court there reviewed existing common law throughout the United States. At issue in *Tutu Water Wells* was the insurer's contention that "its investigatory efforts, coupled with the plaintiff's [insured's] failure to provide the insurer with the relevant policy terms and conditions prior to Cigna's denial of coverage"[104] constituted reverse bad faith. In order to determine the law of the Virgin Islands, absent guidance from the Restatement of Torts, the district court examined the common law throughout the United States. The court concluded its analysis as follows: "Since an examination of the current state of the law reveals that 'reverse bad faith' has not been recognized by any jurisdiction in the United States, the Court must dismiss Cigna's counterclaim for reverse bad faith."[105] The court specifically had reviewed the following authority:

- *Tokles & Son, Inc. v. Midwestern Indemnity Co.,*[106] where the court rejected the defense, recognizing that an insurer has other avenues by which to pursue an insured for a fraudulent claim, and noting that the insurer holds the purse strings.
- *First Bank of Turley v. Fidelity & Deposit Insurance Co.*,[107] where the court refused to acknowledge that an insured's nonperformance of a contractual duty amounted to a freestanding breach of contract or a tort.
- *Johnson v. Farm Bureau Mutual Insurance Co.,*[108] where the insurer claimed that the insured failed to closely examine the policy before alleging bad faith, and that this constituted reverse bad faith; the court rejected the defense since there were other remedies available.

To be candid, the court's analysis appears to be incomplete; however, under the laws of the Virgin Islands, it was required to search for existing common law. The insurer had argued that "the refusal to recognize reverse bad faith would permit tortuous conduct to result in damages for which the victim of the tortuous conduct—the insurer—has no other remedy,"[109] and the court recognized that this was a good argument. However, because the insurer did not cite a single jurisdiction that recognized reverse bad faith, the court declined to recognize the defense. The court thus felt compelled to ignore the insurer's good argument, but it conducted no independent analysis of case law indicating that a reverse bad faith defense could exist.[110] Thus, it ignored the following significant implications:

- *First Bank of Turley v. Fidelity & Deposit Insurance Co.*,[111] where the court considered the nonfeasance of the insured, but did not rule that a reverse bad faith action should be precluded where malfeasance existed.
- *Parker v. D'Avolio*,[112] where the court noted that "indeed, case law suggests, in the context of insurance claims, that courts be vigilant to ensure that plaintiffs not engage in 'reverse bad faith' conduct."[113]
- *Snap-on Tools Corp. v. First State Insurance Co.,*[114] where the court refused to consider a reverse bad faith cause of action on procedural grounds, but affirmed an award of compensatory and punitive damages against an insured.
- *Garvey v. National Grange Mutual Insurance Co.,*[115] where the court allowed the bad faith claim against the insured to go to the jury based upon the insured's misconduct.
- *Gendreau v. Foremost Insurance Co.,*[116] where the court found that the insured knew the claim was false and, based upon a jury finding that the insured acted in violation of a state statute, affirmed the award to the insurer against the insured.

In addition, Tennessee statutorily provides a remedy against an insured and in favor of an insurer, which becomes part of the insurer's action.[117]

In its search of the applicable common law, the district court in *Tutu Water Wells* also ignored various unreported decisions, which offer compelling reason to recognize a cause of action for reverse bad faith.[118] Further, because the decision was premised on established common law, the court could not resort to the opinions or rationale of those commentators who favor the adoption of reverse bad faith.[119] This factor alone should reduce the precedential value of the case.

Those courts which have rejected the application of reverse bad faith have relied on such reasons as the disparity of the bargaining power between the insurer and insured, the fact that it is the insurer who drafts the contract of insurance, the claim that the insured will not have the same incentive to sue the insurer for bad faith, and the fact that the insurer has other remedies available to redress any wrong. These reasons are not without challenge, however. As noted above, the disparity in bargaining position and financial ability is now subject to question in light of the existing insurance climate. Further, as noted by one commentator, "bad faith has nothing to do with business acumen and financial recourse; it has everything to do with malice and wrongful conduct."[120] Also, while judicial perception regarding the disparity "may be true with respect to individual insureds or small businesses, it is not universally applicable. Commercial insureds with substantial assets and ready access to legal advice are on relatively equal footing with their insurers. Such equality of bargaining power and sophistication removes the need for preferential judicial treatment."[121]

It has also been argued generally that a cause of action in reverse bad faith within the first-party context (i.e., arson or fraud) should be allowed. One commentator has listed ten arguments favoring such a cause of action:[122]

- An insured suffers alleged financial straits because of its own actions (arson or fraud).
- The claim for fraud and/or arson are "factually and legally irrelevant and immaterial to the essence of relative bargaining strengths."[123]
- Exclusions for wrongful acts are meant to prevent an insured from profiting from its own acts.
- A reverse bad faith claim, because it is based on good faith action, is implied in law; it should not be precluded because the insurance contract is perceived to be an adhesion contract.
- Other available remedies do not allow an insurer the opportunity to seek affirmative relief for compensatory and extra-contractual damages.
- An insurer should not be precluded from asserting a compulsory counterclaim remedy because it engages in the business of insurance.
- An insurer should be allowed to pursue its claim within the context of the same action and should not be prevented from doing so in the interest of judicial economy.
- Other remedies such as sanctions are generally assessed against counsel and rarely sufficient to cover all damages.
- The availability of a reverse bad faith cause of action will check unjustified and baseless bad faith claims by an insured.
- Mindful of the economic bottom line, insurers will not institute frivolous or malicious claims.

Because courts have tended to favor insureds over insurers and have not often assessed the internal operations of the insurance industry, it should be argued that "judicial consistence"[124] favors the recognition of reverse bad faith. A practitioner who represents the insurance industry should, in the right case, utilize the foregoing arguments to inform the court that the traditional reasons for disallowing a reverse bad faith cause of action are no longer viable.

c. *Abuse of Process/Sanctions*

In today's insurance climate, the number of bad faith claims attached to first-party contract claims has increased significantly. From a practical standpoint, counsel for the insured attempts to gain some leverage in the bargaining and settlement process by routinely attaching a bad faith claim to a claim that is purely contractual in nature. In recent years defendants have clamored for recognition of a "new tort," i.e., malicious prosecution. However, plaintiffs continue to debate the need for such a cause of action.[125]

Historically, courts have been reluctant to find abuse of process.[126] The decision in *Johnson v. Farm Bureau Mutual Inurance Co.*[127] helps to clarify the limitations of this defense within the context of bad faith litigation. In that case the insurer alleged that the insured had abused the litigation process by filing a frivolous bad faith claim. Reasoning that such a claim would not lie under the circumstances, the court first defined abuse of process as "the use of legal process, whether criminal or civil, against another primarily to accomplish a purpose for which it was not designed."[128] Further, the court recognized two essential elements for such a claim: (1) use of the legal process; (2) in an improper and unauthorized manner.[129] At first blush, it appeared that the insurer's claim might fall within this definition; however, the court went on to note that the second element posed some difficulty because it required an "impermissible purpose or illegal motive."[130] Since settlement leverage was germane to the litigation process, the court rejected the insurer's abuse of process claims: "Farm Bureau's assertion that the bad faith claim was added to gain leverage for a settlement in the breach of contract claim does not advance its claim for abuse of process. Settlement is included in the goals of proper process, even though the suit is frivolous."[131] Consequently, the Iowa standard has been difficult to meet.

In other jurisdictions, the standards have proved equally difficult. For example, in the state of Florida, the tort of malicious prosecution requires an element of malice.[132] Consequently, these standards may be insurmountable within the context of insurance litigation. However, the standard suggested by the court in *Aranson v. Schroeder*[133] may be more plausible in this context. The court in *Aranson* determined that there is a viable defense to litigation initiated, continued or procured "primarily for a purpose other than that of securing the proper adjudication of the claim and defense thereto, such as to harass, annoy or injure, or to cause unnecessary delay or needless increase in the cost of litigation."[134] The case of *Old Republic Insurance Co. v. FSR Brokerage*[135] likewise offers a more lenient standard:

> [W]e discern in malicious prosecution a better procedure for resolving whether Old Republic's fraud claim was meritless and improperly motivated than that adopted here to resolve FSR's bad faith claim. To establish a cause of action for malicious prosecution, a plaintiff must demonstrate . . . that the underlying action "was brought without probable cause."[136]

Although such standards ease the insurer's burden, they do not imply that abuse of process occupies a viable niche in modern insurance litigation.[137] That issue typically asks whether other mechanisms are available to deter frivolous bad faith claims. For example, the court in *Johnson* noted that: "[a] motion for rule 80(a) sanctions . . . does not require a wrongful motive to remedy the filing of a frivolous claim. We believe sanctions under Iowa Rule of Civil Procedure 80(a) provide an adequate remedy to insurance companies when an insured files a frivolous bad faith claim."[138]

Many jurisdictions award sanctions in one form or another against an attorney or party who prosecutes frivolous litigation.[139] However, it is generally considered that very few courts award sanctions for the full amount of a party's damages; therefore, the insurer requires other, alternate remedies in order to be made whole.[140] Of course, the practitioner need not rely on state statutes or common law; the practitioner representing the insurer may wish to seek removal of the case to federal court in order to avail itself of the larger federal sanctions. In that regard, Rule 11 of the Federal Rules of Civil Procedure and 28 U.S.C. § 1927 are typically invoked.

Rule 11 provides in part that sanctions can be imposed against the party and/or the attorney for filing papers and arguing baseless positions. Further, § 1927 imposes sanctions when there is bad faith. Recently, in *Syracuse Exploration Co. v. Northbrook Property & Casualty Insurance Co.*,[141] the district court issued sanctions against the insured's attorney for making an unreasonable motion for a new trial following the defense verdict in a bad faith claim.[142] These included attorney's fees and costs. Chief Magistrate Judge Linnea R. Johnson also recommended reasonable attorney's fees in the sum of $579,644.30 and taxable costs of $46,564.50 in *Dictiomatic, Inc. v. United States Fidelity & Guaranty Co*.[143] These remedies effectively inhibit frivolous bad faith claims.

C. *Insurer versus Defense Counsel*

Most legal analysts recognize that "[t]en to 15 years ago malpractice suits by insurance carriers against their retained counsel were virtually unheard of, but today these suits appear to be on the rise."[144] Two recent cases conceptualize the relevant issues when an insurer seeks to recover its damages from defense counsel. In *Paradigm Insurance Co. v. The Langerman Law Offices*,[145] the Arizona Court of Appeals considered a malpractice counterclaim brought by the insurer against its retained counsel who had defended a physician insured in a medical malpractice case. The claim was based on allegedly incorrect advice given by counsel to the insurer regarding coverage issues. Initially, the Arizona court decided whether the insurer had standing to sue the defense counsel (*i.e.*, whether an attorney-client relationship existed between the insurer and defense counsel). Having grappled with this issue for years,[146] that court recognized that such a relationship exists absent a conflict of interest between the insurer and insured. Therefore, the insurer could institute an action against defense counsel. Specifically, the court noted: "[b]ecause there is no evidence of any conflict between Paradigm and its insured, a dual attorney-client relationship existed, and Paradigm is entitled to bring a malpractice action against Langerman. The trial court therefore erred in finding that Paradigm could not maintain a malpractice action against Langerman."[147]

The issue was similarly treated in *Gulf Insurance Co. v. Berger, Kahn, Shafton*,[148] a malpractice action commenced against defense counsel who were hired by the insured from the insurer's approved counsel list. (It should be noted that this was not a *CUMIS* situation). In deciding that an attorney-client relationship existed sufficient to provide the insurer with standing to institute an action against defense counsel, the court recognized a tripartite relationship under the circumstances. Citing *Bogard v. Employers Casualty Co.*,[149] the court noted that "[t]he attorney hired by the insurance company to defend in an action against the insured owes fiduciary duties to two clients: the insurer and the insured."[150] However, not all jurisdictions recognize the insurer's right to institute a direct action against defense counsel.[151] For example, in *Safeway Managing General Agency v. Clark & Gamble*,[152] the Texas Court of Appeals held that the insurance company must establish an appropriate relationship before a direct action can be instituted. However, in light of the decision by the Texas Supreme Court in *State Farm Mutual Automobile Insurance Co. v. Traver*,[153] which adopted the one-client rule (insured) and specifically held that no attorney-client relationship exists between the insurer and defense counsel, a direct action is not permitted in the state of Texas.

If the jurisdiction does not recognize a two-client rule (insured and insurer), an insurer seeking to recover its damages against defense counsel should contemplate testing the following legal theories:[154]

- *Equitable subrogation*—allows the injured or damaged party to stand in the place of the client and institute an action against the client's counsel. This remedy is only available to excess insurers, but in some jurisdictions the primary insurer holds the same right.[155]
- *Assignment by insured to insurer*— in such situations an insured assigns its cause of action against defense counsel to the primary insurer or excess insurer. Upon consideration, however, most courts have rejected this issue on public policy grounds.[156]
- *Third-party beneficiary*—under this theory the insurer contends that it is the third-party beneficiary of the relationship established between the insured and defense counsel. This theory, too, has been generally rejected.[157]

A review of the relevant cases covering the impact of the right of the insurer's right to sue defense counsel clearly indicates that the law is in flux. Unfortunately, the impact of these decisions holds significant ramification for the tripartite relationship since it affects the duty to defend and the use of case management and liability guidelines. Both the insurer and defense counsel should tread lightly in this area—especially where the law will be decided within the malpractice context. The best defense against these types of actions is still good lawyering, and the insurer must select qualified and effective defense counsel.

D. *Other Theories of Reimbursement and Recoupment*[158]

An insurer may confront situations in which recovery of payments made to third parties is appropriate.[159] These situations generally occupy the following distinct areas:

- Recovery from the insured directly where the insurer and insured had previously agreed that the insured would reimburse the insurer, should the insured receive payment from a third party.[160]

- At the time of making payment, the insurer understood that payment was required by the coverage terms of the policy; however, as a result of a change in circumstances, the insurer was not obligated to make payments under the policy (e.g., the cost of defense was paid until coverage issues were resolved).[161]
- Recovery of expenditures that were made, knowing they were not required by the policy, because the payments that were required and those that were not required were intertwined.[162]
- Recovery of payments that were made as a mistake by the insurer; the insurer never intended payment, paid the wrong entity, or paid the wrong amount (over payment).[163]
- Payments were made because of misrepresentation or fraud by or on behalf of the insured.[164]

Many of the concepts that establish this right of recoupment are likewise in a state of flux. In order to define the parameters of these recovery actions, the practitioner must begin by understanding the concepts themselves.

Any time an insurer can obtain recover proceeds wrongly paid to the insured or third parties, total claims costs are reduced. The recovery of these proceeds, however, may not be cost-effective in all situations, and the insurer should assess whether the cost of instituting such actions outweighs the foreseeable benefits.[165]

The ultimate goal of reimbursement and recoupment actions is to reduce the premiums charged for liability insurance. As one commentator has observed, "[t]o the extent it is cost effective to pursue reimbursement and thereby reduce total claims costs, the insurer should be able to offer less expensive liability insurance to policyholders."[166]

Despite the potential for saving costs, an insurer may be hesitant to seek reimbursement if it is threatened with a potential bad faith claim for being proactive and suing the insured directly. In *Old Republic Insurance Co. v. FSR Brokerage, Inc.*,[167] the insurer sought reimbursement for defense costs it had expended with respect to claims it contended were partially outside the policy, citing *Buss v. Superior Court*.[168] The insurer also alleged causes of action for fraud, breach of contract, and bad faith against the insured. With respect to the reimbursement issue, the court ruled that there were questions of fact about whether the insurer had waived its right of reimbursement. Ultimately, the insured pursued only a single claim for bad faith against the insurer, "based on the theory that the fraud claim in Old Republic's [the insurer] second amended complaint was an act of bad faith."[169] In response, the insurer alleged that the claim constituted an improper claim of malicious prosecution and was barred by the absolute privilege provided by California Civil Code section 47. The jury was later instructed as follows:

> Before an insurance company sues its insured for fraud, the insurance company owes a duty of good faith and fair dealing to the insured to reasonably and carefully investigate both the facts and law to determine that it has proper grounds, reasonable cause, to charge the insured with fraud.[170]

The court ultimately dismissed the insured's bad faith claim because it did not allege that the insurer acted *unreasonably* in investigating or paying the underlying insurance claim; the mere allegation that the insurer's lawsuit constituted bad faith was insufficient. The court further held that the insurer's action was protected by California Civil Code section 47. Interestingly, the court also noted that the insured is "nonetheless protected from abusive litigation by cost of litigation against the insurer (sic), and by the availability of an action for malicious prosecution and other remedies consistent with the absolute privilege under Civil Code Section 47."[171] Consequently, as long as the insurer reasonably and carefully investigates the potential action against the insured and has reasonable cause to institute the action, an insurer should not hesitate to sue its insured directly or raise the appropriate counterclaim.

E. *Conclusion*

The dangers of a bad faith claim are ever present if an insurer does not implement a proactive plan to prevent such claims from the outset. Significant exposure is likewise threatened if the insurer has not designed a proactive approach to challenge the trial tactics of the insured, including the insurance expert. However, the time frame between the initial claim and the trial of the claim is equally important. When faced with a potential claim, the claims professional should immediately seek the input of a practitioner familiar with bad faith litigation; together they will comprise the strategic defense team. That team will explore the viability of all contract defenses and determine as well the availability of comparative bad faith and/or reverse bad faith defenses. The team will also discern whether any action or inaction by the insured adversely affected or influenced the insurer's position. No stone should remain unturned in the effort to convince the court and the jury that the implied covenant of good faith and fair dealing is a "two-way street" on which the insured is "responsible" for its own actions. Further, when it is cost effective, the insurer should follow the flow of dollars from its pocket to the insured or other third parties, seeking reimbursement for dollars initially expended in the appropriate case. To forestall designing an approach to bad faith litigation will not only allow the insured to dictate the processes initially, it could also foreclose affirmative relief allowed to the insurer by the courts and statutes. At the very least, the team should consider whether it is beneficial to be *proactive* or *reactive*. As part of its plan, the team must determine whether to retain its own expert and how to challenge any expert retained by the opposing party.

ENDNOTES

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1 From an educational standpoint, the claims professional and attorney practicing in the extra-contractual/bad faith arena must, on a periodic basis, assess the standards applied in the given jurisdiction and constantly develop benchmarks to gauge the performance of the individual claims office and the company as a whole. The jurisdictions of California, Florida, New York and Texas, because of the diverse standards applied by courts in those states, should be reviewed. Equally important is the responsibility of the claims professional and the practitioner to remain abreast of new legislation and proposed legislative changes. Again, the legislative history behind any enacted or proposed legislation can assist the insurance industry in formulating claims handling procedures and guidelines. For example, the recent legislative and voter experience in the state of California and proposed legislation in the state of New York highlight the need to be educated; they should alert the industry and its counsel to the ever-changing bad faith atmosphere. (*See* Appendix A.)

2 For an excellent overall discussion of education and prevention, see DENNIS J. WALL, LITIGATION AND PREVENTION OF INSURER BAD FAITH (2d ed. Supp. 1994 & 1995).

3 For a general discussion of this issue within the first-party context, see D.G. Houser, *Good Faith: The Insurance Company's Right To Be Wrong*, INT'L INS. MONITOR, May/June, 1994.

4 712 So. 2d 389 (Fla. 1998).

5 *Id.* at 393. For an excellent discussion of the insurer's rights in this area, see J.M. White, *Suspicious Claims*, presented at the DRI First-Party Property Seminar, Tampa, Florida, Feb. 2000; *see generally*, Gulf Atl. Life Ins. Co. v. Barnes, 405 So. 2d 916 (Ala. 1981); Noble v. Nat'l Amer. Life Ins. Co., 624 P.2d 866 (Ariz. 1981); Dolan v. Aid Ins., 431 N.W.2d 790 (Iowa 1988); Bibeault v. Hanover Ins. Co., 417 A.2d 313 (R.I. 1980); Wright v. League Gen. Ins. Co., 421 N.W.2d 647 (Mich. 1988) and Gibson v. Group Ins. Co., 369 N.W.2d 484 (Mich. 1985).

6 *See* St. Paul Surplus Lines Ins. Co. v. Dal-Worth Tank Co., 917 S.W.2d 29 (Tex. Ct. App. 1995).

7 *See* Allen v. Allstate Ins. Co., 656 F.2d 487 (9th Cir. 1981).

8 285 N.E.2d 849 (N.Y. 1972).

9 *Id.* at 852.

10 424 F.2d 728 (5th Cir. 1970).

11 *Id.* at 734. For an excellent discussion of the advice of defense counsel, see WILLIAM H. SHERNOFF ET AL., INSURANCE BAD FAITH LITIGATION § 30.04 (1999) and Stephen S. ASHLEY, BAD FAITH ACTIONS—LIABILITY & DAMAGES § 7:13 (1997); *see also* Annotation, *Reliance On, or Rejection of, Advice of Counsel as Factor Affecting Liability in Action Against Liability Insurer for Wrongful Refusal to Settle Claim*, 63 A.L.R.3d 725 (1975).

12 *See* Kevin M. Christensen, *Take My Advice: How Listening to Your Lawyer Might Limit Your Liability*, MEALEY'S LITIG. REP.: INS. BAD FAITH, Nov. 7, 2000, at 22.

13 *See also* Lee Craig, *Ten Stupid Things Insurance Companies Do To Mess Up Their Files*, MEALEY'S LITIG. REP.: INS. BAD FAITH, Nov. 21, 2000, at 31.

14 *See generally* Thomas E. Workman, *Plaintiff's Right to the Claim File, Other Claim Files and Related Information: The Ticket to the Gold Mine*, 24 TORTS & INS. L.J. 137, 155 (1988); John J. Pappas, *Institutional Bad Faith Claims*, presented at the DRI Extra Contractual Liability Seminar, Atlanta, Georgia, Sept. 1998; P.M. Kaplan, *Discoverability of Claim Files in Bad Faith Litigation*, FOR THE DEFENSE, ___, Feb., 1999.

15 The foregoing lapses in judgment were enumerated by Atty. Brad Crawford of Crawford, Hyde & Associates, Dallas, Texas. They were provided during his presentation at the 1999 Annual Seminar of the International Association of Special Investigative Units, Dallas, Texas, September, 1999; *see also* Dennis J. Wall, *Avoiding "Bad Faith" in Settlement: What are the Developments?*, 63 DEF. COUN. J. 249 (1996).

16 *See* Employees' Benefit Ass'n v. Grissett, 732 So. 2d 968 (Ala. 1998); State Farm Fire & Cas. Co. v. Slade, 747 So. 2d 293 (Ala. 1999); Alfa Mut. Fire Ins. Co. v. Thomas, 738 So. 2d 815 (Ala. 1999).

17 M. Elizabeth Medaglia et al., *Privilege, Work Product, and Discovery Issues in Bad Faith Litigation*, 32 TORT & INS. L.J. 1 (1996).

18 *See* Maxwell v. Fire Ins. Exchange, 70 Cal. Rptr. 2d 866 (Ct. App. 1998) (allowing recovery in both third- and first-party claims). For a general and thorough discussion of the availability of emotional distress

damages, *see* Wall, *supra* note 2, at § 13.08; *see also* David R. Anderson, & John W. Dunfee, *No Harm, No Foul: Why A Bad Faith Claim should Fail When an Insurer Pays the Excess Verdict*, 33 TORT & INS. L.J. 1001, 1006-08 (1998).

[19] *See generally* Dennis. J. Wall, LITIGATION AND PREVENTION OF INSURER BAD FAITH §§ 9.23, 9.24 (2d ed. 1994).

[20] *See generally id.* §§ 3.96, 3.97 and 3.98.

[21] For an extremely practical analysis of the communication issue, see Janet K. Colaneri & Bobbi Reilly, *Bad Faith: What Is It? Is It Catching? How Do I Avoid It*, presented at International Association of Special Investigative Units, Dallas, Tex., September, 1999.

[22] Brown v. Superior Court, 670 P.2d 725, 734 (Ariz. 1983).

[23] *Id.* at 734.

[24] Meritplan Ins. Co. v. Superior Court, 177 Cal. Rptr. 236, 238 (Ct. App. 1981).

[25] *See* Craig, *supra* note 13, at 31.

[26] A_________ _. D'Angelo, Jr., *Modern Trends In First-Party Insurance Litigation*, presented at the DRI First-Party Property Seminar, Tampa, Fla., Feb. 2000; *see also* Pappas, *supra* note 14, which characterizes this type of bad faith litigation as "Institutional Bad Faith."

[27] Pappas, *supra* note 14, at C-8.

[28] Materials taken from speech delivered by Arnold D'Angelo, Jr., at DRI First-Party property Seminar, *supra* note 26.

[29] D'Angelo, *supra* note 26, at 15.

[30] *See*, Janet L. Brown, & Amanda H. Reher, *Personal Liability of Adjusters and Other Claims Professionals*, presented at DRI First-Party Property Seminar, Tampa, Fla., Feb., 2000.

[31] *See* Pappas, *supra* note 14, at C-22-23 (listing twenty-five categories of documents whose production was demanded in a particular case).

[32] *See* Jonathan Gross, *Defending "Pattern and Practice" Evidence in Punitive Damage Cases*, 61 DEF. COUN. J. 403 (1994); D'Angelo, *supra* note 26, at 7.

[33] *See* Roberto Ceniceros, *Making A Case For Coverage: Policyholder Tries to Bolster Bad Faith Charge Against Insurer*, BUSINESS INSURANCE, Oct. 25, 1999 at 2.

[34] D'Angelo, *supra* note 26, at 19. This appears to be a more realistic approach to the business environment and judicial atmosphere presently confronted by the insurance industry.

[35] For an excellent discussion of the bad faith setup, see Stephen R. Schmidt, *The Bad Faith Setup*, 29 TORTS & INS. L. J. 705 (1994). *See also* Robert T. Horst & Robert M. Runyon, III, *How To Diagnose and Avoid the Bad Faith 'Set Up' In the First-Party Property Insurance Context*, 14 MEALEY'S LITIG. REP.: INS. BAD FAITH, Dec. 5, 2000.

[36] Schmidt, *supra* note 35, at 705.

[37] *See* Patrick v. State Farm Mut. Auto. Ins. Co., 919 F.2d 906 (5th Cir. 1990); Baton v. Transamerica Ins. Co., 584 F.2d 907 (9th Cir. 1978); DeLaune v. Liberty Mut. Ins. Co., 314 So. 2d 601 (Fla. Dist. Ct. App. 1975); Pavia v. State Farm Mut. Auto. Ins. Co., 589 N.Y.S.2d 510 (App. Div. 1992), *rev'd*, 626 N.E.2d 24 (N.Y. 1993). *See also* Schmidt, *supra* note 35, at 712.

[38] *DeLaune*, 314 So. 2d at 604.

[39] Schmidt, *supra* note 35, at 728.

[40] AMERICAN HERITAGE DESK DICTIONARY 1030 (1981).

[41] *See* the 1999 Report to the Governor and the Legislature of the State of New York on the operations of the Insurance Frauds Prevention Act (article 4 of Insurance Law), at http://www.ins.state.ny.us/p0002091.htm. The number of criminal convictions in insurance fraud cases almost doubled in 1999 as compared to 1998.

[42] Schmidt, *supra* note 35; Thomas F. Segalla, *Bad Faith Avoidance: Who Sets the Trap*?, presented at the Defense Research Institute Extra-Contractual Seminar, 2000.

[43] Examples of recent headline verdicts (without insurers identified) include:

- Insurer Ordered To Pay $30 Million For Lying About Pollution Exclusion
- Insurer That Denies Long-Term Care Coverage Hit With $2 Million Verdict
- Insurer Hit For Frivolous Liability Defense

[44] Commercial Union Assur. Co. v. Safeway Shoes, Inc., 610 P.2d 1038 (Cal. 1980); *see also* Rawlings v. Apodaca, 726 P.2d 565 (Ariz. 1986); Beck v. Farmers Ins. Exch., 701 P.2d 795 (Utah 1985); Modisette v. Found. Reserve Ins. Co., 427 P.2d 21 (N.M.1967); *see generally* F. Krinick, *Comparative Bad Faith: A New Defense? New York Courts Have Not Yet Been Asked to Accept the Doctrine*, N.Y. LAW J. (1/12/98), available at *http://www.rivkinradler.com/nylj198.html* (last updated 9/28/00).

[45] Texas Farmers Ins. Co. v. Soriano, 844 S.W.2d 808, 832 n.2 (Tex. Ct. App. 1992).

[46] Express Textile v. General Accid., Inc., No. 98-CV-5056 CBM, C.D.Cal., reported in 13(24) MEALEY'S LITIG.REP.: INSURANCE BAD FAITH 10 (4/18/00); L.A. TIMES, Apr. 18, 2000, at B6 (valley ed., metro).

[47] Allstate Ins. Co. v. Booth, No. 98-CV-503 (C.D. Cal. June 10, 1998).

[48] Provident Life v. O'Connor, No. 96- 56015 (9th Cir. Nov. 5, 1997).

[49] *See generally* DENNIS J. WALL, LITIGATION AND PREVENTION OF INSURER BAD FAITH (2d ed. 1994).

[50] Zurich Re (North American) & F.A. Smith, *Bad Faith: A Fifty State Survey*, *at* http://www.sdma.com/images/BadFaithFiftyStateSurvey.html (last updated 9/28/00).

[51] Neal v. Farmers Ins. Exch., 582 P.2d 980 (Cal. 1979). For a general discussion of California law, see BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES §§ 12.02, 12.03(a) (10th ed. 2000).

[52] Pavia v. State Farm Mut. Auto. Ins. Co., 626 N.E.2d 24, 27-28 (N.Y. 1993) (gross disregard standard applied in third-party context); New York Univ. v. Continental Ins. Co., 662 N.E.2d 763, 767 (N.Y. 1995) (applying an egregious conduct standard directed at public in general). For a general discussion of New York law, *see* OSTRAGERG & NEWMAN, *supra* note 51, §§12.04, 12.12(a).

[53] Hawkins v. Allstate Ins. Co., 733 P.2d 1073 (Ariz. 1987), *rev'd on other grounds*, 30 F.3d 1077 (9th Cir. 1994), *cert. denied,* 515 U.S. 1141 (1995).

[54] For a fifty-state survey on bad faith law, *see* Re & Smith, *supra* note 50, which provides an appendix setting forth a state-by-state analysis of first-party and third-party bad faith law; *see also* OSTRAGER & NEWMAN, *supra* note 51, at § 12.12(b), which provides a survey of first-party bad faith cases in various jurisdictions.

[55] STEPHEN S. ASHLEY, BAD FAITH LIABILITY: A STATE BY STATE REVIEW § 4:02 (1987); William S. Anderson, Comment, *Placing A Check On An Insured's Bad Faith Conduct*; *The Defense of "Comparative Bad Faith*," 35 S. TEX. L.REV. 485, 489 (1994); Douglas R. Richmond, *An Overview of Insurance Bad Faith Law and Litigation*, 25 SETON HALL L. REV. 74, 80-81 n.33 (1994).

[56] 2 P.3d 1 (Cal. 2000).

[57] *Id.* at 8 (citations omitted).

[58] *Id.* at 19-26.

[59] *Id.* at 8 (citing Murphy v. Allstate Ins. Co., 553 P.2d 584 (Cal. 1976)).

[60] Lawton v. Great Southwest Fire Ins. Co., 392 A.2d 576, 579 (N.H. 1978).

[61] Strause v. Farmers Ins. Exch., 31 Cal. Rptr. 811, 813-14 (Ct. App. 1994); Med. Mut. Liab. Ins. Soc. v. Evans, 622 A.2d 103, 114 (Md. 1993); Soto v. State Farm Ins. Co., 635 N.E.2d 1222 (N.Y. 1999).

[62] *See generally* OSTRAGER & NEWMAN, *supra* note 51, § 12.12.

[63] *Id*.

[64] For a general discussion of the test applied in first-party cases, *see* Douglas R. Richmond, *The Two-Way Street of Insurance Good Faith: Under Construction, But Not Yet Open*, 28 LOY. U. CHI. L.J. 95 (1996). It should be noted that Justice Kennard cited this article in his dissenting opinion in *Kransco*. *See Kransco*, 2 P.3d at 418.

[65] *See generally* William M. Savino, *Comparative and Reverse Bad Faith: The Covenant is Reciprocal*, 7(1) MEALEY'S LITIG. REP.: INS. (5/6/93); Anderson, *supra* note 55, at 505; J. Lee Boothby, *Comparative Bad Faith: Will the Courts Allow Insurance Carriers To Introduce a Unicorn Into Insurance Bad Faith Litigation*? 18 T. JEFFERSON L. REV. 121 (1996).

[66] Anderson, *supra* note 55, at 507 (citing Fleming v. Safeco Ins. Co. of Am., 206 Cal. Rptr. 313 (Ct. App. 1984) and California Cas. Gen'l Ins. Co. v. Superior Court, 218 Cal. Rptr. 817, 818 (Ct. App. 1985)).

[67] *See generally* Ellen Smith Pryor, *Comparative Fault and Insurance Bad Faith*, 72 TEX. L. REV. 1505 (1994); Douglas G. Houser et al., *Comparative Bad Faith: The Two-Way Street Opens for Travel*, 23 IDAHO L.

REV. 367, 377 (1986-87); Patrick E. Shipstead & Scott S. Thomas, *Comparative and Reverse Bad Faith: Insured's Breach of Implied Covenant of Good Faith and Fair Dealing as Affirmative Defense or Counterclaim*, 23 TORT & INS. L.J. 215, 231 (1987).

68 *Kransco,* 2 P.3d at 13.

69 For a general discussion of contract defenses, *see* Pryor, *supra* note 67, at 1522-25.

70 Blake v. Aetna Life Ins. Co., 160 Cal. Rptr. 528, 538 (Ct. App. 1979); Campbell v. Allstate Ins. Co., 32 Cal. Rptr. 827, 829 (Ct. App. 1963).

71 Dyno-Bite, Inc. v. Travelers Cos., 439 N.Y.S.2d 558, 560 (App. Div. 1981). *See also* OSTRAGER & NEWMAN, *supra* note 51, §§ 2:08(a) and (b).

72 Imperial Cas. & Indemn. Co. v. Sogomonian, 243 Cal. Rptr. 639, 646 (Ct. App. 1988); OSTRAGER & NEWMAN, *supra* note 51, § 3.01.

73 Agricultural Ins. Co. v. Superior Court, 82 Cal. Rptr. 2d 594 (Ct. App. 1999).

74 78 F. Supp. 2d 436 (D.V.I. 1999). The following jurisdictions have rejected the defense of comparative bad faith: Nationwide Prop. & Cas. Ins. Co. v. King, 568 So. 2d 990 (Fla. Dist. Ct. App. 1990); Kelly v. State Farm Mut. Auto Ins. Co., 764 F. Supp. 1337 (S.D. Iowa 1991); Stephen v. Safeco Ins. Co. of Am., 852 P.2d 565 (Mont. 1993); Stumf v. Continental Cas. Co., 794 P.2d 1228 (Or. Ct. App. 1990); Isaac v. State Farm Mut. Auto. Ins. Co., 522 N.W.2d 752 (S.D. 1994); Powers v. United Serv. Auto Ass'n., 962 P. 596 (Nev. 1998).

75 *In re* Tutu Water Wells Contamination Litig., 78 F. Supp. 2d at 455

76 State Farm Fire & Cas. Co. v. Gandy, 880 S.W.2d 129 (Tex. Ct. App. 1994) *rev'd on other grounds*, 925 S.W.2d 691 (Tex. 1996) (trial court should have submitted comparative bad faith to the jury); Dalton v. Educ. Testing Serv., 663 N.E.2d 289 (N.Y. 1995) (obligations are imposed on both insurer and insured); Rawlings v. Apodaca, 726 P.2d 565 (Ariz. 1986); Modisette v. Found. Reserve Ins. Co., 427 P.2d 21 (N.M. 1967); Commercial Union Assur. Co. v. Safeway Stores, Inc., 610 P.2d 1038 (Cal. 1980) (two-way street running from the insured to his insurer and vice versa); Ins. Co. of N. Am. v. Milberg Weiss Bershad Specthrie & Lerach, No. 95 Civ. 3722 (LLS) (S.D.N.Y. 1996) (allowing an affirmative defense of comparative bad faith); Carpenter v. Auto. Club Interins Exch., 58 F.3d 1296, 1303-04 (8th Cir. 1995) (applying Arkansas law, court allowed defenses of contributory negligence and lack of good faith). Specifically, the court rejected the Texas decision in State Farm Fire & Cas. Co. v. Gandy, 880 S.W.2d 129 (Tex. Ct. App. 1994), *rev'd on other grounds*, 925 S.W.2d 691 (Tex. 1996) (court held that comparative bad faith created a jury question).

77 No. L-2322-96 (N.J. Super. Ct., Somerset Co., July 14, 2000).

78 *Id.*; *but see* Willis Corroon Corp. v. Home Ins. Co., 203 F.3d 449, 453 (7th Cir. 2000) (court refused to allow amendment to include claim for reverse bad faith because there was no evidence; court observed that it was highly doubtful such a claim existed).

79 Evan H. Krinick, *Comparative Bad Faith: A New Defense? New York Courts Have Not Yet Been Asked to Accept the Doctrine*, N.Y. L.J. (1/12/98), available at http://www.rivkinradler.com/nylj198.html (last updated 9/28/00).

80 R. Kent Livesay, *Levelling the Playing Field of Insurance Agreements in Texas: Adopting Comparative Bad Faith as an Affirmative Defense Based on the Insured's Misconduct*, 24 TEX. TECH L. REV. 1201, 1213 (1993).

81 Samuel H. Ruby, *The Demise of Comparative Bad Faith: The California Supreme Court Strikes Tort Defenses to Insurers' Tort Liability*, MEALEY'S LITIG. REP.: INS. BAD FAITH, Sept. 5, 2000, at 26.

82 Tex. Farmers Ins. Co. v. Soriano, 844 S.W.2d 808, 832 n.2 (Tex. Ct. App. 1992).

83 Kransco v. American Empire Surplus Lines Ins. Co., 2 P.3d 1, 17 (Cal. 2000).

84 *Id.* at 11 (emphasis added.)

85 *Id.*

86 Boothby, *supra* note 65, at 126-27 (discussing the cases of *Safeco Ins. Co. of Amer. v. Tholen*, 173 Cal. Rptr. 23 (Ct. App. 1981) and *Comunale v. Traders & Gen'l. Ins. Co.*, 328 P.2d 198 (Cal. 1958) (citations omitted)).

87 *See generally* Livesay, *supra* note 80; *see also* Arnold v. Nat'l Mut. Fire Ins. Co., 725 S.W.2d 165, 167 (Tex. 1987).

88 ASHLEY, *supra* note 55, at § 214; Livesay, *supra* note 80, at 1215.

[89] *Id.*; Lawrence P. McLellan, Note, *Insurance Settlements: An Insured's Bad Faith*, 31 DRAKE L. REV. 877, 880 (1981).

[90] Livesay, *supra* note 80, at 1226.

[91] For a general discussion of bad faith law in Texas and outlining reasons for such a defense, *see* Livesay, *supra* note 80.

[92] *See*, *e.g.,* N.Y. C.P.L.R., art. 14 (2000) or TEX. CIV. PRAC. & REM. CODE ANN. § 33.001 (2000).

[93] Livesay, *supra* note 80, at 1212-13.

[94] *Id.* at 1219-20.

[95] For a discussion of how to plead a comparative bad faith defense, *see* Livesay, *supra* note 80, at 1224-25 (reviewing the pleading rules of the State of Texas).

[96] Richmond, *supra* note 55, at 134.

[97] First Bank of Turley v. Fid. & Deposit Ins. Co., 928 P.2d 298, 307 (Okla. 1996).

[98] *In re* Tutu Water Wells Contamination Litig., 78 F. Supp. 2d 436 (D.V.I. 1999); for a general discussion of reverse bad faith, *see* OSTRAGER & NEWMAN, *supra* note 51, § 12.13.

[99] OSTRAGER & NEWMAN, *supra* note 51, § 12.13.

[100] *Id.*

[101] Lori J. Caldwell & David B. Shelton, *Faced With a Bad Faith Suit? A Reverse Bad Faith Claim may be an Alternative*, available at http://www.rumberger.com/art_fraud.htm (last updated 10/17/00).

[102] Richmond, *supra* note 55, at 128.

[103] 78 F. Supp. 2d 436 (D.V.I. 1999).

[104] *Id.* at 441.

[105] *Id.* at 443. Concluding that no common law cause of action for reverse bad faith existed, the court had to disregard its prior ruling in this case in which it had determined that the insured acted in bad faith concerning a settlement agreement. *Id.*

[106] 605 N.E.2d 939, 945 (Ohio 1992).

[107] 928 P.2d 298 (Okla. 1996).

[108] 533 N.W.2d 203 (Iowa 1995).

[109] *In re Tutu Water Wells Contamination Litig.*, 78 F. Supp. 2d at 453 (D.V.I. 1999) (citing the insurer's (Cigna) brief at 23).

[110] For a general discussion of those jurisdictions that have applied the doctrine of reverse bad faith, *see* Cathryn M. Little, *Fighting Fire With Fire: "Reverse Bad Faith" in First-Party Litigation Involving Arson and Insurance Fraud*, 19 CAMPBELL L.REV. 43, 44 (1996).

[111] 928 P.2d 298, 308 (Okla. 1996).

[112] 664 N.E.2d 858 (Mass. App. Ct. 1996).

[113] *Id.*

[114] 502 N.W.2d 282 (Wis. Ct. App. 1993).

[115] No. 95-0019, 1996 U.S. Dist. LEXIS 5782 (E.D. Pa. April 29, 1996).

[116] 423 N.W.2d 712, 714 (Minn. Ct. App. 1988).

[117] TENN. CODE ANN. § 56-7-106 (2000); Adams v. Tenn. Farmers Mut. Ins. Co., 898 S.W.2d 216, 219-20 (Tenn. Ct. App. 1994).

[118] For a discussion of these unreported decisions from the states of Texas and Connecticut and the recommended position in North Carolina, *see* Little, *supra* note 110, at 52-54.

[119] *See* Richmond, *supra* note 55; Anderson, *supra* note 55; Shipstead & Thomas, *supra* note 67; John F. Dobbyn, *Is Good Faith in Insurance Contracts a Two-Way Street?* 62 N.D. L. REV. 355, 370-77 (1986).

[120] Richmond, *supra* note 55, at 136-37.

[121] *Id.* at 139 (citations omitted).

[122] Little, *supra* note 110, at 47-49.

[123] *Id.* at 47.

[124] Richmond, *supra* note 55, at 139.

[125] *See* Lee Craig, *Malicious Defense*, 13 MEALEY'S LITIG.REP. No. 16 at 25 (12/21/99) (concluding that such a tort action is not needed in suits against insurance companies0. *See also* Jonathan K.Van Patten &

Robert E.Willard, *The Limits of Advocacy: A Proposal for the Tort of Malicious Defense in Civil Litigation*, 35 HASTINGS L.J. 891 (July, 1984).

[126] *See* Triplett v. Farmers Ins. Exch., 29 Cal. Rptr. 2d 741 (Ct. App. 1994); *cf.* Aranson v. Schroeder, 671 A.2d 1012 (N.H. 1995).

[127] 533 N.W.2d 203 (Iowa 1995).

[128] *Id.* at 209.

[129] *Id.*

[130] *Id.*

[131] *Id.*

[132] Craig, *supra* note 125, at 26.

[133] 671 A.2d 1023 (N.H. 1995).

[134] *Id.* at 1029.

[135] 95 Cal. Rptr. 2d 583 (Ct. App. 2000).

[136] *Id.* at 688 n.5.

[137] Craig, *supra* note 125, at 20.

[138] 533 N.W.2d 203 (Iowa 1995).

[139] For examples, see the following state statutes: FLA. STAT. Ch. 57.105 (2000); IOWA R. CIV. P. 80(a) (2000); N.Y. C.P.L.R. 8303-a (McKinney 2000); N.C. R. CIV. P. § 1A1, Rule 11 (2000).

[140] Little, *supra* note 110, at 63-64.

[141] No. 1CV 97-1405 (M.D. Pa. 2000) (reported in 14 MEALEY'S LITIG. REP. 8 at G-1).

[142] *Id.*

[143] Case No. 93-CV-2123, consolidated with case no. 94-CV-1692 (4/25/00 #574), S.D. Fla., Civil Docket; *see also* Craig, *supra* note 125, at 28.

[144] Shaun McParland Baldwin & Lisa C. Breen, *Malpractice Claims by Primary and Excess Insurers: Is the Honeymoon Over?*, 62 DEF. COUNS. J. 18, 18 (1995); *see also* Robert D. Allen, *Insurers Suing Defense Counsel*, at 335 (presented at the DRI Insurance Coverage and Practice Seminar, 2000).

[145] 2 P.3d 663 (Ariz. Ct. App. 1999).

[146] Charles Silver & Kent Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 DUKE L. J. 255, 280 (1995).

[147] *Paradigm*, 2 P.3d at 669-70; *see also* Home Indem. Co. v. Lane, Powell, Moss & Miller, 43 F.3d 1322 (9th Cir. 1995) (an attorney-client relationship exists where there is no conflict); Unigard Ins. Group v. O'Flaherty & Belgum, 48 Cal. Rptr. 2d 565 (Ct. App. 1995) (permitting a direct action by an insurer against defense counsel); Smiley v. Manchester Ins. & Indemn. Co., 375 N.E.2d 118 (Ill. 1978) (an insurer can sue defense counsel when liability is firmly established); *see generally* Michael J. Brady, *Defense Counsel's Liability to Insurer for Excess Liability*, 49 FED'N INS. & CORP. COUNS. Q. 55, 59-60 (1998).

[148] 93 Cal. Rptr. 2d 534 (Ct. App. 2000).

[149] 210 Cal. Rptr. 578 (Ct. App. 1985).

[150] *Id.* at 609.

[151] *See* Allen, *supra* note 144, at 341.

[152] 985 S.W.2d 166 (Tex. Ct. App. 1998).

[153] 980 S.W.2d 625 (Tex. 1998).

[154] For an excellent analysis of these alternate theories, *see* Allen, *supra* note 144, at 341-46.

[155] Am. Centennial Ins. Co. v. Canal Ins. Co., 843 S.W.2d 480, 483 (Tex. 1992). *But see* Cont'l Cas. Co. v. Pullman, Conley, 929 F.2d 103 (2d Cir. 1991), *aff'g* 709 F. Supp. 44 (D. Conn. 1989); *see also* Allen, *supra* note 144, at 342-44 for a discussion of the various jurisdictions.

[156] *Pullman, Conley,* 929 F.2d at 103; Zumga v. Groce, Locke & Hebdon, 878 S.W.2d 313, 315 (Tex. Ct. App. 1994). But see the analysis of Texas law in Allen, *supra* note 144, at 346, where he concludes that Texas is "ripe for change."

[157] *Pullman, Conley*, 929 F.2d at 105 (recognizing a "chilling effect of the third-party intrusion"). *See also* Allen, *supra* note 144, at 346.

[158] This paper does not consider the subrogation rights of an insurer against third parties for benefits paid by the insurer to its insured. For a general discussion of subrogation, *see* OSTRAGER & NEWMAN, *supra* note 51, § 5.06[d].

[159] *See generally* LEE R. RUSS & THOMAS F. SEGALLA, COUCH ON INSURANCE 3D § 226 (2000) [hereinafter COUCH ON INSURANCE].

[160] Mahler v. Szucs, 957 P.2d 632 (Wash. 1998) (the term "reimbursement" involves a situation where the insurer can "recoup" its payment from the proceeds paid to the insured by the third-party tortfeasor).

[161] Buss v. Superior Court, 939 P.2d 766 (Cal. 1997) (an insurer may seek reimbursement from the insured for costs of defending the insured in a case where there are covered and noncovered claims based on an apportionment theory; however, reimbursement is only allowed for costs related to claims that are not even potentially covered). For an updated discussion of the reimbursement of defense cost issues, *see* Robert H. Jerry, II, *The Insurer's Right to Reimbursement of Defense Costs*, 42 ARIZ. L. REV. 13 (2000); *see generally* COUCH ON INSURANCE, *supra* note 159, § 226:43.

[162] *Id.,* 939 P.2d 766.

[163] Hartford Acc. & Indemn. Co. v. Chicago Hous. Auth., 12 F.3d 42 (7th Cir. 1993); Cohn v. Anthem Life & Health Ins. Co., 965 F. Supp. 1119 (N.D. Ill. 1997); *see generally* OSTRAGER & NEWMAN, *supra* note 51, § 5.07.

[164] A complete discussion of an insurer's action for fraud is beyond the scope of this article. *See generally*, COUCH ON INSURANCE, *supra* note 159, § 226:89 (citing the general rule that where an insurer pays benefits in justifiable ignorance of the fact that insurance was procured by false representation, it is entitled to a return of the money).

[165] For a discussion of the cost/benefit of reimbursement of defense costs, *see* Jerry, *supra* note 161, at 74-75.

[166] *Id*. at 75.

[167] 95 Cal. Rptr. 2d 583 (Ct. App. 2000).

[168] 939 P.2d 766 (Cal. 1997).

[169] 95 Cal. Rptr. 2d at 595.

[170] *Id. But see* Nationwide Mut. Fire Ins. Co. v. John P. Masseria, NQ. 98-G 2197, Ohio App., 11th Dist. (12/7/00) (where court allowed an insured's bad faith claim because insurer failed to investigate before instituting a declaratory judgment action).

[171] *See id.* at 599 and n.5 for a discussion of the standards applicable to a malicious prosecution claim in California.


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Insurance Issues for the 21st Century

SPEAKERS

Tom Baker
William Maul Measey Professor of Law and Health Sciences
University of Pennsylvania Law School

Tom Baker, a preeminent scholar in insurance law, explores insurance, risk, and responsibility using methods and perspectives drawn from economics, sociology, psychology, and history. His research on health insurance exchanges is informing the development of decision tools to improve consumer choice. His recent article, "Liability Insurer Data as a Window on Lawyers' Professional Liability," finds that the legal malpractice landscape has remained remarkably stable since the 1990s.

He is the Reporter for the American Law Institute's Restatement of the Law, Liability Insurance and the co-director of the Health Insurance Exchange Research Group of Penn's Leonard Davis Institute of Health Economics. In August 2013 he received the Robert B. McKay award, a lifetime scholarly achievement award given by the Tort Trial and Insurance Practice Section of the American Bar Association.

William Barker
Senior Counsel
Dentons

William Barker is a member of Dentons in the Chicago office with a nationwide practice in the area of complex commercial insurance litigation, including coverage, claim practices, sales practices, risk classification and selection, agent relationships and regulatory matters. In addition to handling complex litigation, he counsels clients on insurance issues. He also counsels and litigates on matters of lawyers' professional responsibility.

William was a member of the joint defense briefing team that won *In re Katrina Canal Breaches*, 495 F.3d 191 (5th Cir. 2007), and *Chauvin v. State Farm Fire and Cas. Co.*, 495 F.3d 232 (5th Cir. 2007), the major federal cases on insurance coverage for damage caused by the flooding of New Orleans. He also contributed to the joint defense effort in the parallel cases in the Louisiana Supreme Court, including *Sher v. Lafayette Ins. Co.*, 2008 WL 928486 2008 WL 928486 (La. April 8, 2008) (flood exclusion bars coverage for Hurricane Katrina flooding).

William represents various insurers in defending bad faith claims, especially on appeal. For example, he was brought into *Torres v. Travelers Ins. Co.*, Civ. 01-5056 (D.S.D.), after a verdict exceeding US$12 million. He prepared post-trial motions that obtained a reduction to US$2 million and briefed an appeal that ended in a confidential settlement. He is currently handling or has recently concluded appeals in other eight-figure bad faith cases. He is a noted speaker and commentator on bad faith and claim handling issues.

William is a noted advisor and litigator on the professional responsibilities of insurance defense counsel. He was one of the lawyers for Travelers Indemnity Co. in *Unauthorized Practice of Law Committee v. Amer. Home Assur. Co.*, 2008 WL 821034 (Tex. Mar. 28, 2008), upholding the use of staff counsel to defend insureds).

William has litigated a number of cases regarding the constitutional rights of insurers and others, for example:

- *Goldberg v. Sweet*, 488 U.S. 252 (1989), dealing with the taxation of interstate telephone calls, in which the court adopted one theory urged by the amicus brief and the concurrence adopted another
- *McDonald's Corp. v. Nelson*, 822 F. Supp. 597 (S.D. Iowa 1993)
- *Holiday Inns Franchising, Inc. v. Branstad*, 29 F.3d 383 (8th Cir. 1994)
- *Iowa v. Holiday Inns Franchising, Inc.*, 513 U.S. 1032 (1994), dealing with a franchising statute that unconstitutionally impaired the obligation of franchise contracts
- *Allstate Ins. Co. v. Auto Damage Appraiser Licensing Bd.*, 507 N.E.2d 250 (Mass. 1987), which avoided a First Amendment question by the narrow construction of the statute

William's practice includes a concentration in appellate litigation. He has handled scores of appeals and has prepared many amicus briefs in various state and federal appellate courts. He is a former chair of the Appellate Advocacy Committee of the ABA Tort, Trial and Insurance Practice Section.

William has served as an expert witness in bad faith and legal malpractice cases.

Michael Barnes
Parter
Dentons

Michael Barnes is a coverage advisor and trial lawyer in Dentons' Litigation and Dispute Resolution department, working in the San Francisco office. As a member of the firm's Core Coverage and Claims Practice, Michael counsels insurers on claims-handling and coverage issues, defends bad faith suits, and litigates contribution actions among insurers.

Michael has advised clients on thousands of claims in more than 40 states under policies of general liability, homeowners, commercial and personal automobile, environmental impairment liability, professional liability, directors and officers liability, disability, health and accident, fidelity, long-term care and marine insurance. In addition to advising clients in California and the West, he has acted as national coverage counsel for firm clients, coordinating coverage positions and drafting briefs on significant issues involving their business philosophies. Michael also handles commercial litigation against insurers and other firm clients.

Michael has first-chaired jury and bench trials in both state and federal court, and was trial counsel in Blair v. Allstate, featured in the Daily Journal's Top Defense Verdicts of 2003. In 2008 and 2009, Michael obtained consecutive federal court defense verdicts in three cases, including Schaber v. Allstate and Cecena v. Allstate. He has also been involved in more than fifty appeals and writ proceedings as appellate counsel, co-counsel or amicus counsel, including seminal decisions such as Collin v. American Empire, Delgado v. Auto Club,Swain v. California Casualty and Hartford v. Swift Distribution. As coverage counsel in trial court proceedings, Michael's work has led to numerous published decisions on issues of first impression, such as Allstate v. LaPore, American Empire v. Bay Area Cab, Samson v. Allstate, Lindsey v. Admiral, Great American v. Ace Oil, Moncada v. Allstate and Fireman's Fund v. National Bank of Cooperatives.

Michael also advises firm corporate clients on risk management issues ranging from insurance coverage questions to indemnity agreements, using his litigation expertise to provide real-world insight into corporate protection strategies. Similarly, Michael regularly advises our insurance clients on policy drafting and revisions, again using his courtroom experiences to complement the clients' knowledge of marketing factors and competitive trends.

Michael is a frequent speaker and writer on insurance coverage and litigation topics, including monthly contributions to the Insurance Litigation Reporter, where he sits on the editorial board. He recently co-authored chapters on liability insurance for the New Appleman on Insurance Law Library Edition and New Appleman Insurance Law Practice Guide, and presented the insurer's perspective at the 2009 and 2010 Insurance Year In Review events sponsored by the Bar Association of San Francisco.

John Buchanan
Senior Counsel
Covington & Burling LLP

John Buchanan, senior counsel in Covington's Washington office and the firm's first Insurance Practice Group Coordinator, has represented policyholders in insurance coverage advocacy, dispute resolution and counseling for over three decades. His career has ranged from the early DES and asbestos coverage litigation to claims for some of the largest cyber losses in history. Mr. Buchanan has litigated, arbitrated or negotiated a wide variety of complex property and casualty insurance claims, from railroad derailment claims to satellite-in-orbit claims, and from silver-theft claims to cyber claims. *Chambers USA* ranks him as Band 1 for Insurance Dispute Resolution - Policyholder, both in DC and nationally, and he is listed in *Best of the Best USA* and numerous other attorney rating guides.

Mr. Buchanan became involved with cyber-related coverage issues in the mid-1990s and co-authored one of the earliest treatise chapters on cyber insurance coverage in 2001. Starting with the network intrusion and payment card thefts discovered by TJX in 2006, he has represented policyholders pursuing claims for losses arising from data breaches reported to involve tens of millions of compromised records. Mr. Buchanan also frequently counsels policyholders in drafting their cyber and technology errors and omissions policies, along with the insurance-related provisions of their procurement contracts.

Mr. Buchanan has been active as an invited Adviser to the American Law Institute's Restatement of the Law of Liability Insurance, and he has spoken to audiences of judges and lawyers on issues presented in the draft Restatement. He teaches a graduate-level course on Insurance Litigation at the Insurance Law Center of the University of Connecticut School of Law and has also guest taught at the University of Virginia Law School. Mr. Buchanan speaks regularly on insurance-related topics in a wide variety of academic symposia and CLE seminars, and he is the author or co-author of many papers and articles on topics relating to insurance, litigation and alternative dispute resolution, including recently on the topic of the Internet of Things and insurance for cyber-physical risks.

Among other bar association activities, Mr. Buchanan has served on the ABA Dispute Resolution Section's Task Force on Improving Mediation Quality; was an elected member of the Steering Committee of the Law Practice Management Section of the DC Bar; served on the ABA Task Force for a Manual on Complex Insurance Coverage Litigation; and has served in various leadership roles for the ABA Litigation Section's Insurance Coverage Litigation Committee, including as Website Co-Editor-in-Chief and Co-chair of its annual meeting. As an elected member of the American Law Institute, Mr. Buchanan has served on the Members' Consultative Group for the Restatement (Third) of Torts, in addition to his current role with the Liability Insurance Restatement. He is also an elected Fellow of the American College of Coverage and Extracontractual Counsel.

Mr. Buchanan is a graduate of Harvard Law School, Oxford University, and Princeton University. After clerking on the U.S. Court of Appeals for the Third Circuit, he has spent his entire legal career at Covington.

Timothy W. Burns
Partner
Perkins Coie

Timothy W. Burns is a partner at Perkins Coie LLP. He is the former co-chair of the Insurance Coverage Litigation Committee of the American Bar Association.

Tim is favorably ranked in the 2006 (Illinois), 2007 (recommended in "Insurance" nationally), and 2008 to 2014 (Band 2 - nationally) editions of *Chambers USA: America's Leading Lawyers for Business*. According to the publication, Tim "shines brightly in the sensitive and complex area of D&O insurance," and corporate interviewees for the publication agreed that he "is probably the best counselor in the business for the procurement of this insurance . . . and is a real client magnet in this specialized field." According to one client quoted, "He is smart, diligent, innovative, resourceful and practical." Tim also is listed in *The International Who's Who of Insurance & Reinsurance Lawyers* and as one of the nation's top thirty policyholder-side insurance lawyers in the *Executive Counsel Shortlist.*

Tim has developed a nationally prominent D&O and fiduciary liability insurance practice. He advises clients on all aspects of D&O and fiduciary insurance, including counseling them with respect to the insurance aspects of securities and derivative litigation, fiduciary claims, government investigations, initial public offerings, spin-offs, mergers and acquisitions, and bankruptcies. Tim's practice also includes representing corporate policyholders in their disputes and litigation with their insurance carriers. He has represented major policyholders in insurance coverage litigation since 1992.

Mary Craig Calkins
Partner
Kilpatrick Townsend & Stockton LLP

Mary Craig Calkins is a partner in Kilpatrick Townsend's Los Angeles office, where she leads the West Coast Insurance Practice. She has more than 30 years of insurance coverage experience, recovering hundreds of millions of dollars on behalf of policyholders in complex, high-stakes directors and officers liability, entertainment/intellectual property coverage disputes, cyber and technology risks, first- and third-party claims and broker liability issues.She also advises company management on how to maximize insurance protections.

Mary is President and a member of the Executive Committee of the American College of Coverage and Extracontractual Counsel, an honorary organization of the country's top insurance coverage lawyers. She is also an active leader of the American Bar Association Section of Litigation, where she is former co-chair of the Insurance Coverage Litigation Committee, chaired the national Women of the Section of Litigation Annual Conference in 2014 and 2015, and currently holds several senior leadership positions. Mary has been listed by *Chambers USA* in the area of Insurance: Policyholder (2006-2016), named as a "Top 100 Women Litigator" by the *Los Angeles/San Francisco Daily Journal* (2007-2009, 2014), recognized as one of 50 "Women to Watch" by *Business Insurance Magazine*, and has been listed repeatedly in *International Who's Who of Insurance and Reinsurance Lawyers, Legal 500,* and the prestigious 2013 *Expert Guide to the World's Leading Women in Business Law.* Mary is a frequent author, lecturer and media resource on insurance topics, and serves as a arbitrator.

Martin S. Checov
General Counsel
O'Melveny & Myers LLP

Martin S. Checov is in his second decade as the General Counsel of O'Melveny & Myers LLP, and was a founding partner of the Firm's San Francisco office. Martin is recognized as a leading insurance coverage litigator and consulting and testifying expert for his representation of domestic and foreign insurance carriers and reinsurers in coverage, financial, regulatory and cost-recovery disputes, environmental disputes, and bad faith claims.

In his capacity as General Counsel, Martin is the chair of the Business Intake Committee and Firm-wide chief ethics compliance officer. He serves as counselor to the Firm's attorneys at all levels, providing guidance with regard to a vast range of matters, including client intake, engagement documentation and management, policy development and enforcement, conflicts, proposed pro bono matters, fee disputes, the interpretation, refinement and enforcement of the Firm's partnership agreement, data management and security, document requests to the Firm, lateral intake and integration issues, separation and retirement matters, and the defense of malpractice lawsuits and arbitrations.

Martin also maintains practice visibility by advising clients with regard to insurance-related issues, and plays a central role in the negotiation and management of all aspects of O'Melveny's multi-faceted insurance program. In addition, he organizes and presents risk management training programs for new and lateral partners, as well as other selected groups, throughout the Firm's offices, and has been a leader for many years in the Firm's attorney recruiting efforts.

Andrew B. Downs
Shareholder
Bullivant Houser Bailey PC

Andrew B. Downs is a Shareholder in Bullivant Houser Bailey PC, resident in its San Francisco, California office and is a member of the firm's Board of Directors. Admitted in both California and Nevada, Andy practices throughout both states on behalf of insurers. Andy presently represents insurers regarding commercial property policies, commercial liability policies, professional liability policies, Directors & Officers' policies and marine and inland marine policies.

Andy has been recognized by Chambers USA as one of California's top insurance lawyers from 2010 through 2016. He has also been a Northern California Super Lawyer since 2006. He is a member of the Federation of Defense & Corporate Counsel, where he formerly served on its Board of Directors, was its voice on social media, and was the Program Chair for the Federation's 2015 Annual Meeting. He is also a former chair of ABA/TIPS' Property Insurance Law Committee, a former member of the PLRB's Claims Conference Committee, and a member of the Editorial Board of West's Insurance Litigation Reporter.

Outside the office, Andy is a Nationally Certified Official for USA Swimming at swim meets at the local and national levels as well as serving as a Referee/Starter at High School meets in Northern California.

David Goodwin
Partner
Covington & Burling LLP

Mr. Goodwin is one of the nation's leading insurance coverage practitioners, ranked in the highest tier by *Chambers USA* both nationally and in California. The leading legal directory described him as "one of the strongest players around in contentious insurance cases" and "a world-class litigator and an expert in insurance disputes." He has also been recognized by *Law360* as one of the country's top three "most valuable players" in the insurance practice area.

With more than 30 years of experience representing corporate policyholders in insurance coverage disputes and litigation, his practice runs the gamut of insurance issues, including major property damage and business interruption losses, errors and omissions, cyber risk, fidelity, crime, financial guarantee, and director and officer claims, offshore, and onshore construction insurance disputes, and marine, products liability and environmental insurance matters. Mr. Goodwin has served as a party arbitrator or counsel for a party in insurance arbitrations in the U.S., the UK, Bermuda, and Singapore. He also is a highly experienced appellate advocate who has argued more than 50 appeals.

Mr. Goodwin has served as an adjunct professor at University of California at Berkeley Law School, where he taught courses on insurance law.

Meghan Magruder
Partner
King & Spalding

Meghan Magruder is a Partner in King & Spalding's Atlanta office and a member of the Business Litigation Practice Group. Ms. Magruder represents corporate clients in insurance coverage and complex commercial litigation matters. She is listed in *The Best Lawyers In America, Georgia Super Lawyers,* and *Top Women Attorneys in Georgia*.

Ms. Magruder has more than thirty years of experience handling complex commercial litigation matters with particular emphasis in insurance claims, indemnity disputes, purchaser and supplier disputes, mass tort defense and product liability litigation. She handles multi-party, class action, and multi-jurisdictional litigation and various forms of dispute resolution. She also provides clients with counseling on preventative litigation strategies, and advises policyholders on a wide variety of insurance and risk management matters. She serves as lead trial counsel in jury and non-jury trials, as well as lead counsel in international arbitration disputes. Ms. Magruder was lead counsel in a lengthy international arbitration in London for the largest automotive company based in India and successfully obtained dismissal of over $100 million of claims against her client and an award of attorney's fees in favor of her client. The award was challenged in the English High Court and was upheld on appeal. Ms. Magruder was also lead trial lawyer in a three week federal court jury trial winning a verdict for her client that was second highest in the State in the contract verdict category. The case was appealed and in 2013, the verdict was upheld on appeal.

Ms. Magruder is a fellow in the Litigation Counsel of America, which is an invitation-only trial lawyer honorary society and represents less than one-half of one percent of American lawyers. Fellows are selected based upon excellence and accomplishments in litigation, trial work and superior ethical reputation. Ms. Magruder is also a fellow in the American College of Coverage Counsel for her work representing policyholders in connection with claims in negotiation, litigation and arbitration including international arbitration. She advises clients with respect to all types of insurance policies and all matters of claims, including cyber, commercial liability, all risk, property, directors and officers, crime, employment, environmental errors and omissions and electronics specialty policies. She handles property loss and business interruption claims, and she has been retained by companies to assist with insurance strategies in situations where large numbers of cases and class actions, such as consumer class actions, asbestos and other toxic tort litigations have been filed. Ms. Magruder also counsels clients on review of their insurance programs and adequacy of coverages.

Ms. Magruder also has substantial experience advising clients on corporate governance and risk management issues. She serves as general counsel for the Institute of Nuclear Power Operations, whose members include all U.S. based nuclear power facilities.
Ms. Magruder also represents clients in a variety of mass tort and product liability matters. For example, she has represented a major pharmaceutical company involved in class action consumer fraud cases. She has been national coordinating counsel for international automotive companies involved in benzene exposure litigation. She has also defended companies in multi-jurisdictional asbestos and lead litigation, and she has represented a building products manufacturer in a number of lawsuits alleging defective products.

Michael Manire
Partner
Manire & Galla, LLP

Mike Manire's practice has focused on insurance since 1993. Mr. Manire has represented global D&O, E&O, and professional liability insurers in connection with complex claims on policies issued both in the U.S. and abroad. He has represented insurers in coverage and bad faith litigation, and he has participated in settlements of both coverage and underlying liability issues in hundreds of matters, including securities fraud class actions, shareholder derivative actions, creditors' committee and bankruptcy trustee claims, breach of fiduciary duty claims, consumer class actions, employment liability actions, bankers' and investor advisors' liability claims, media and intellectual property claims, and a variety of other professional and management negligence claims.

Before 1993, Mr. Manire practiced in New York City primarily as a transactional and corporate lawyer. That experience informs his approach to dispute resolution, and he has continued to represent clients on business, regulatory and financial matters.

Leo Martinez
Albert Abramson Professor of Law
University of California Hastings College of the Law

Leo P. Martinez is the Albert Abramson Professor of Law at the University of California, Hastings College of the Law. He served as UC Hastings' Academic Dean for twelve years and he served as the Acting Chancellor and Dean of the College in the 2009-10 academic year.

Professor Martinez is a current member of the Council of the Section on Legal Education and Admissions to the Bar for the American Bar Association (ABA). He is a past president of the Association of American Law Schools (AALS). He has chaired or served on more than two-dozen ABA law school site evaluation visits and he has assisted more than ten law schools in their strategic planning. He is a member of the American Law Institute (ALI), he is one of the academic Advisers on the ALI's Principles of the Law of Liability Insurance project, and he was a member of the ABA Task Force on the Future of Legal Education.

Outside of academia, Professor Martinez has been an active participant in local and national non-profit organizations that seek to improve the world. He has chaired the boards of four different non-profit organizations including KQED, Inc.; Public Advocates, Inc.; the St. Francis Hospital Foundation; and Public Media Company. He is a member of the board of CollegeTrack, a Bay Area-based organization that provides mentoring for high school students living in low-income and under-served areas within the United States and he is a member of the University of Kansas Chancellor's Advisory Board (he is a rabid Jayhawk fan).

Professor Martinez is a co-author of a leading insurance law casebook, a co-editor of a four-volume insurance treatise, and the author of many articles on tax, insurance law, and legal education that have appeared in journals ranging from the Stanford Law Review to the Tulane Law Review to the Yale Law and Policy Review to the China EU Law Journal.

Professor Martinez has been honored with Annual Latino/a Law Professors Award in recognition of "outstanding contributions to the Latino/a community in general and Latino/a law professors in particular," he has been recognized as a Distinguished Alumnus by UC Hastings Law Raza Law Students Association, and he was recognized in 2011 for leadership in the legal arena and in the public interest with the Public Advocates Voices of Conscience Award. In 2010, in recognition for his service to the College the Hastings Board of Directors approved the establishment of the $100,000 endowed Leo P. Martinez student scholarship at Hastings.

Lorelie S. Masters
Partner
Perkins Coie

A 2014 and 2015 Top 10 Super Lawyer and prominent insurance coverage litigator, Lorie Masters handles all aspects of complex, commercial litigation and arbitration. She has recovered millions of dollars of insurance coverage for products, environmental, employment, directors and officers, fiduciary, property damage, cyber, and other liabilities. Lorie also regularly handles various types of first-party property insurance claims, including claims under boiler and machinery, business-interruption, contingent business-interruption, extra expense, and other related coverages. She is the co-author of:

- *Insurance Coverage Litigation* (Wolters Kluwer); and
- *Liability Insurance in International Arbitration: The Bermuda Form* (Bloomsbury Publishing), which the English Court of Appeal called "the standard work on the topic." The book also won the British Insurance Law Association's 2012 Book Prize for outstanding contributions to the literature on insurance law.

Lorie is a partner in the Insurance Recovery practice and a "much-admired practitioner, with an impressive expertise in the London market and Bermuda Form arbitrations" according to comments in *Chambers USA*, which ranks her in the upper echelons of her practice nationwide.

She represents large and small companies, trade associations, and individuals seeking to enforce their insurance coverage. Highlights include her work as lead counsel in a case awarding full policy limits, plus attorney fees and interest, to the policyholder under a contract requiring arbitration in London. In another case, Lorie was lead trial counsel for a major chemical company in a coverage case resulting in a jury verdict named by *The National Law Journal* as one of the most significant of the year. She has served as lead counsel in numerous matters obtaining millions of dollars in recoveries in environmental coverage cases and has succeeded in helping clients find millions of dollars in "lost insurance" policy assets.

Lorie writes and speaks extensively on insurance coverage, technology, and litigation, as well as on diversity and inclusion topics. She has represented many individuals and groups pro bono, including policyholders denied healthcare coverage and victims of human trafficking.

Lorie is one of the founding members of the American College of Coverage and Extracontractual Counsel (ACCEC), and has served on the ABA Commission on Women in the Profession, ABA Gender Equity Task Force, and as an officer in the ABA Section of Litigation. From 2000 - 2003, she served as national Policyholder Chair of the Section's Insurance Coverage Litigation Committee. She led the Women's Bar Association from 2007 - 2008. Her civic leadership includes serving on the boards of directors of D.C. Vote, D.C. Appleseed, D.C. Bar Foundation, Legal Aid Society of D.C., and the Women's Bar Association Foundation. In 2004, she was inducted into the American Law Institute (ALI) and, in 2010, chosen to serve as one of 40 Advisers to ALI's *Restatement of the Law, Liability Insurance.*

Mary McCutcheon
Partner
Farella, Braun + Martel

Mary McCutcheon represents corporate and individual policyholders in a wide variety of insurance coverage disputes.

Her wide-ranging experience includes coverage disputes arising out of: securities investigations, class actions and derivative actions, venture capital and private equity litigation, intellectual property and technology errors and omissions lawsuits and sensitive employment claims.

Ms. McCutcheon has special expertise advising companies and individual directors regarding issues involved in the placement of directors' and officers' liability, management liability and financial services liability insurance and related indemnification issues, as well as handling claims under those policies. She also advises clients on risk transfer and claims under self-insurance and traditional insurance programs.

Chambers USA recognizes Ms. McCutcheon as one of the leading insurance attorneys in California. She has also been recognized in Northern California Super Lawyers, as one of the Top 50 Women Lawyers for the past several years and as one of the Top 100 Northern California Super Lawyers in 2015. She is listed in The Best Lawyers in America in the area of Insurance Law. She is a 2016 recipient of Legal Momentum's Women of Achievement Award.

Ms. McCutcheon is a founding member of the American College of Coverage and Extracontractual Counsel and serves as Secretary-Treasurer.

Carl Metzger
Partner
Goodwin Procter

Carl Metzger is a partner in Goodwin's Financial Industry and Business Litigation practices and Chair of the firm's Risk Management + Insurance practice and the Partnership Committee. His clients include both public and private companies, insurance carriers and brokerages, private equity and venture capital firms and non-profit and educational institutions.

Mr. Metzger is recognized as an expert in advising boards of directors and senior officers on liability and risk management issues, as well as D&O insurance, indemnification and fiduciary duty issues. His experience includes securities litigation defense, financial fraud litigation, governmental and self-regulatory organization investigations, and complex business disputes.

Throughout his career, Mr. Metzger has played leading roles in a variety of professional and civic organizations. He is currently a board member of the Professional Liability Underwriting Society (PLUS), the American Camp Association and the Squam Lakes Conservation Society. He has also served as a board member of the New England Children's Foundation, the Massachusetts Appleseed Center of Law and Justice, the John and Anna Newton Porter Foundation and the First Unitarian Society of Newton. He has previously served as co-chair of the American Bar Association's Subcommittee on Securities and the Internet, and editor of the American Bar Association's journal, *Securities News*.

Prior to joining Goodwin, Mr. Metzger was a partner at Testa, Hurwitz & Thibeault in Boston where he led the firm's risk management and insurance practice area and was the litigation partner liaison to the Private Equity Group.

Mr. Metzger has been elected as a Fellow to The American College of Coverage and Extracontractual Counsel. He has been recognized by *Corporate LiveWire* as a Global Award winner for expertise in the field of insurance and reinsurance, was the exclusive winner of *Lexology's* Client Choice Award for Insurance and Reinsurance in Massachusetts, and is continuously recognized by *Boston Magazine* as both a Massachusetts and New England "Super Lawyer."

Mr. Metzger writes and speaks nationally on litigation-related topics, and he has been quoted in such media outlets as *The New York Times, The Wall Street Journal,* CNN, *The Boston Globe, The Philadelphia Inquirer, Corporate Board Member Magazine, Business Insurance* and *CFO Magazine.* He has made several appearances on *The Directors Letter's* Boardroom Video Series to address board liability and governance issues.

Julia A. Molander
Member
Cozen O'Connor

Julia A. Molander represents the insurance industry in virtually all aspects of their business, including insurance coverage litigation, insurance counseling, extracontractual (bad faith) liability, insurance fraud, underwriting matters, policy drafting, regulatory compliance, brokerage and agency liability, insurance insolvency and legislative issues. She has served as first-chair in more than 20 bench trials, jury trials and arbitrations.

Julia has more than 30 years experience in strategically managing insurance risk, on an enterprise-wide basis (state, regional and national), in areas such as construction defects, class actions, cyber risks, trucking and cumulative trauma. Julia was elected a fellow of the American College of Coverage and Extracontractual Counsel in 2014 and the Insurance Litigation Institute of America, where she currently serves as chair. She is rated AV Pre-eminent by her peers and has been recognized as a "Super Lawyer" since 2005.

Julia has lectured at major professional conferences sponsored by the American Bar Association, Association of Defense Counsel, Defense Research Institute, Association of California Insurance Companies, the California Continuing Education of the Bar, the American Conference Institute, the Property Law Research Bureau, the Insurance Risk Management Institute and the Practising Law Institute. She is a contributing editor the CEB publication California Liability Insurance Practice: Claims and Litigation. She has published numerous articles and scholarly discussions on a variety of insurance topics. Julia earned her Bachelor of Science with distinction from Northwestern University in 1974 and her J.D. from Stanford Law School in 1978.

Morris Ratner
Associate Professor and Associate Dean for Academic and Professional Success
University of California Hastings College of the Law

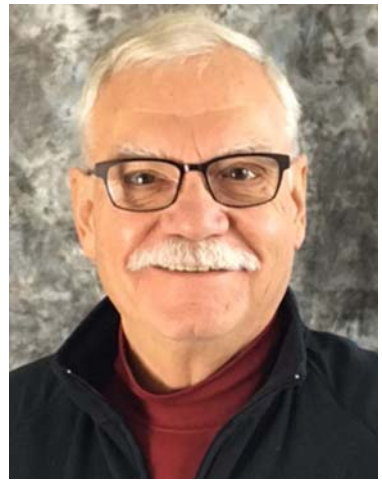
Professor Ratner (BA, Stanford University 1988; JD, Harvard Law School 1991) teaches civil procedure, legal ethics, and the business of law practice, and produces scholarship at the intersection of those fields.

Starting July 1, 2016, in addition to teaching, Professor Ratner will serve as Associate Dean for Academic and Professional Success, in connection with which he will be responsible for supervising academic support and bar passage programs and LWR/Moot Court, and for proposing and implementing pedagogical, curricular and programmatic innovations to help students acquire the skills necessary for success.

Since 2013, Professor Ratner has also managed JD/MBA and JD/Masters in Economics concurrent degree programming at UC Hastings.

Professor Ratner joined the UC Hastings Faculty in 2012, after teaching at Harvard Law School as a visiting lecturer and then as a visiting assistant professor from 2009 to 2011. Professor Ratner was a litigator at the San Francisco-based plaintiffs' firm Lieff, Cabraser, Heimann & Bernstein, LLP, where he was a partner for ten years and where he prosecuted product liability, environmental, mass personal injury, consumer, and human rights actions. Among other high-profile matters, Professor Ratner prosecuted and settled Holocaust-era slave labor, looted asset, dormant bank account and unpaid insurance claims against European companies, producing global settlements in those cases worth more than $7.5 billion

Thomas F. Segalla
Founding Partner
Goldberg Segalla LLP



Thomas F. Segalla is a founding partner of Goldberg Segalla, where he is a Co-Chair of the firm's Global Insurance Services Practice Group and resides in its Buffalo office. An internationally recognized authority on insurance, reinsurance, and bad faith, he has been retained by major insurance carriers and policyholders in more than 40 jurisdictions internationally and has served as an expert witness in more than 100 bad faith, coverage, and extracontractual cases across the country.

Tom is the co-author of the renowned insurance law treatise Couch on Insurance 3dand editor of the Reinsurance Professional's Deskbook published this year by Thomson Reuters and DRI. He was the founding President of the American College of Coverage and Extracontractual Counsel (ACCEC), of which he led the formation in 2012 to improve the quality of the practice of insurance law. He possesses an AV-Preeminent rating, the highest honor available in the Martindale-Hubbell peer-review rating system.

Jodi Short
Professor of Law
University of California Hastings College of the Law

Professor Jodi Short graduated from Duke University, BA cum laude (1992); Georgetown Law, JD magna cum laude (1995); and UC Berkeley, PhD in Sociology (2008). She most recently taught at Georgetown Law and was a Senior Policy Scholar at the Georgetown Center for Business and Public Policy, at the McDonough School of Business. Her research and teaching interests are in the regulation of business, in particular, the intersection of public and private regulatory regimes and the theory and practice of regulatory reform. Her prior work has examined the effects of corporate internal compliance auditing on regulatory performance, theoretical justifications for and critiques of public regulation, and tensions in the U.S. administrative state between cooperation and coercion, expertise and politics, and public and private interests.

Her studies have shown how robust regulatory enforcement encourages corporations to implement effective internal compliance systems. Her current research investigates the effects of private, transnational efforts to enforce labor and environmental standards in global supply chains. The aim of this research is to demonstrate the key role of states in a world of rapidly proliferating private regulatory arrangements.

Sara Thorpe
Founding Partner
Nicolaides Fink Thorpe Michaelides Sullivan LLP

Sara M. Thorpe is a founding partner of Nicolaides Fink Thorpe Michaelides Sullivan LLP. The firm's focus is on representing insurers in coverage disputes. From offices in California (San Francisco, Los Angeles, and San Diego), Chicago, and New York, Sara and her colleagues assist insurers with a wide-range of insurance policies and issues. Sara's experience includes over 25 years litigating complex coverage issues involving asbestos, environmental contamination, general liability, and professional liability, and defending against "bad faith" and unfair business practice claims.

Sara is AV rated by Martindale-Hubbell. Chambers reports that clients and peers describe Sara as a *"bright and tough lawyer"* who is a *"vigorous advocate for her clients," "very thorough"* and *"very passionate."*

Sara received her JD, *cum laude,* from the University of San Francisco, and her BA in Communications Studies from the University of California at Santa Barbara.

Joyce C. Wang
Founding Partner
Carlson, Calladine & Peterson LLP

Joyce C. Wang is a founding partner of Carlson, Calladine & Peterson LLP and a nationally recognized litigator in the area of insurance coverage and bad faith. For over 30 years, she has represented national and international property and casualty insurers and reinsurers, as well as policyholders in complex commercial property and casualty insurance disputes. She is the head of the firm's cyber coverage practice and is admitted in California and Hawaii.

Ms. Wang's experience includes cases arising from catastrophes such as September 11, Hurricane Katrina, and the Honshu Tsunami, as well as large industrial and energy losses, cyber attacks and fraud. She also handles liability insurance disputes and has successfully obtained summary judgment on the grounds the conduct alleged was not an "accident" under a CGL policy. Her effective advocacy and professionalism enable her to successfully resolve many disputes before trial by way of dispositive motions. Through her extensive knowledge of insurance policies, case law, insurance regulations and statutes, she has earned a national reputation in the field.

Ms. Wang was instrumental in the 9th Circuit appeal in *Northrop Grumman Corp. v. Factory Mutual Insurance Co*., resulting in a ruling that the Policy's Flood exclusion clearly and unambiguously applied to hurricane storm surge. She subsequently obtained summary judgment on the bad faith, misrepresentation and fraud causes of action on the grounds that Factory Mutual's position was reasonable as a matter of law.

Ms. Wang is a past chair of the Property Insurance Law Committee (ABA) and an active member of the Federation of Defense and Corporate Counsel and the American College of Coverage and Extracontractual Counsel. She is a frequent panelist on insurance and bad faith law both here and abroad. California Lawyer Magazine voted her one of the 25 most influential lawyers in California after she argued before the California Supreme Court on behalf of a class of children affected by lead poisoning. She has been selected as a Northern California Super Lawyer every year since it began in San Francisco in 2004. Ms. Wang was recognized by San Francisco Magazine in 2012 as a Top Woman Attorney in Northern California, and by Fortune Magazine in 2013 as a Woman Leader in the Law.

Ms. Wang is admitted to all California State Courts, the U.S. District Court (Northern, Central and Eastern Districts of California), the Ninth Circuit Court of Appeals and all courts in the State of Hawaii.