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Defending insurance claims: an ethical Bermuda Triangle

Conflicts of interest often arise in insurance defense when attorneys must balance the competing priorities of insurers and policyholders, creating an ethical Bermuda Triangle that demands careful navigation.

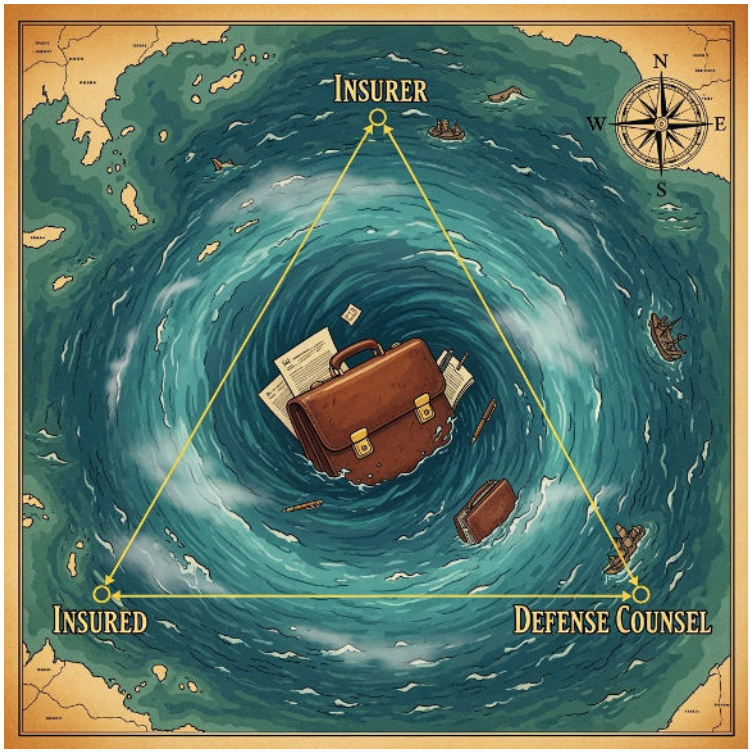
By Hon. Eddie C. Sturgeon (Ret.)

Imagine a personal injury case involving a defective product. The plaintiffs want damages for pain and suffering, medical expenses and other losses. The manufacturer tenders the claim to its liability carrier, and the carrier lines up defense counsel.

The insurer will be paying the bill, but the insured's name is on the complaint. As long as both of them see eye-to-eye, there's no reason why the same attorney can't represent both parties. But what are the odds that insured and insurer will agree on how the case should be handled?

Given the common - one might even say almost inevitable - conflicts of interest that can arise between insurers and their policyholders, how does a defense attorney meet his ethical obligation to protect both of their interests?

Tripartite relationships can be the ethics Bermuda Triangle of insurance claims, but with appropriate care and strategy, they can be successfully navigated.



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Our hypothetical

The plaintiffs in our product liability case are now alleging oppressive, fraudulent or malicious conduct on the manufacturer's part. They want punitive damages - generally not insurable under California law (See PPG Industries, Inc. v Transamerica Ins. Co., 20 Cal. 4th 310, 319, 975 P.2d 652, 658 (1999)). If they get their way, both the carrier and the insured will end up writing big checks.

The insurer cares primarily about limiting its costs. Unless liability is sufficiently clear and egregious, the carrier will push to settle the claim below the policy limit. Such a result will be a good outcome for its bottom line, but a huge problem for its policyholder. With a smaller damages recovery, the plaintiffs may still want their pound of flesh in the form of punitive damages - out of the insured's pocket.

If the defense attorney only focuses on the carrier's interests, the manufacturer may be left holding the punitive damages bag. If he focuses on the policyholder's interest, the carrier may end up paying damages as high as the policy limit. Whose interests should be prioritized?

The tripartite dilemma

Which client must be prioritized is ultimately a matter of state law. Some states, such as Texas, require defense counsel to place the policyholder's interests first, even though the insurer is paying the legal bill. In California, unsurprisingly, defense attorneys have a dual allegiance; they owe the same duty of representation to both the insurer and the insured. When those two can agree on how to handle a claim, everything is fine. But what happens when they don't agree?

Liability policies require insurers to defend policyholders and to indemnify them for losses covered by their policies. The insurer must defend a claim whenever there is even a remote possibility of coverage, even if such coverage ultimately turns out to be unavailable (*See Montrose Chem. Corp. v. Superior Court*, 6 Cal.4th 287, 299-300, 861 P.2d 1153, 1160 (1993)).

In this tripartite relationship, the attorney may find himself between the proverbial rock and hard place: unable to serve the interests of both clients. Under California case law, both are his clients only as long as there is no conflict. He must adhere to all rules of ethics in representing both. When a conflict arises, joint representation may no longer be an option; the insured must be advised of its rights to retain independent counsel

Strategy

Because the insurer generally controls defense of the claim, the insured is required to surrender control over the choice of defense strategy. Defense counsel should carefully review that strategy to identify potential conflicts of interest at the earliest opportunity. The sooner such conflicts are noted, the better the parties will be positioned to protect their respective interests.

Conflicts can show up in many ways. If pursuing the insurer's strategy will be harmful to the insured's interests, there is a conflict. If pursuing an alternative strategy will hurt the insurer, there is a conflict. A lowball settlement offer by the insurer could leave the insured ex-

posed to damages not covered by insurance. A policy-limit offer might better protect the insured but could expose the insurer to a greater financial burden.

A decision by the insurer to litigate the case, rather than negotiate an early settlement, could create a conflict of interest if it results in a verdict at trial that is beyond the policy limits. However, a lawsuit seeking damages in excess of policy limits does not, by itself, create a conflict of interest. (*See Gafcon, Inc. v. Ponsor & Assoc.*, 98 Cal.App.4th 1388, 1421 (2002).)

Reservation of rights

A reservation of rights arises when an insurer sees a chance that a matter might be excluded from coverage. The insurer must notify the policyholder that it is reserving the right to deny coverage. This doesn't mean that there is necessarily a conflict of interest, but it should alert defense counsel to the potential for such a conflict.

If an insurer defends a case under a reservation of rights, the defense attorney might be motivated to develop the case in such a way that it favors the insurer on coverage issues, to the detriment of the insured. This would then create a conflict of interest between the parties. Whenever such a conflict arises, California Civil Code Section 2860 requires that the insurer pay for independent, "Cumis" counsel for the insured.

The term "Cumis counsel" comes from the landmark case of *San Diego Navy Federal Credit Union v. Cumis Ins. Socy, Inc.* 162 Cal.App.3d 358, 375 (1984), in which the Court of Appeals held that "[w]here 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."

Communications

Conflicts may also arise when communications take place between defense counsel and parties. It is the duty of all attorneys, pursuant to Business and Professions Code Section 6068(e)(1), to maintain the confidences of clients and to preserve their secrets. But what happens when counsel learns of matters that change the defense picture?

Imagine, for example, that the manufacturer in our initial hypothetical shares with counsel - in confidence - that the part that failed was not properly inspected because the supervisor was too busy playing video games on his phone. This information, unknown by the insurer, could drive the plaintiffs' demand through the roof. It could also cause the insurer to deny coverage.

Because defense counsel's primary duty of loyalty and confidentiality should be with the insured, any information detrimental to the insured's interests should generally not be disclosed to the insurer. Where the insured has disclosed matters to counsel in confidence, with the clear intent that they not be shared with the insurer, defense counsel must honor that intent.

Conclusion

Under the Rules of Professional Conduct, attorneys must always act in the best interests of their clients. But when their clients have competing interests, this may not be possible.

Can defense counsel, in order to protect the insured, ethically push for a settlement greater than the assessed actual damages but within policy limits, even if that settlement is not necessarily in the best interest of the insurer? Should counsel, in order to comply with confidentiality obligations, withhold information about potential harmful activity?

When confronted with a potential conflict of interest, defense counsel's obligation should be to advise the clients of the conflict and the insured's right to retain independent counsel. When, however, defense counsel is faced with an ethically untenable choice, the obligation might be to step entirely away from the case.

The tripartite, dual-client relationship is an ethical minefield, and defense counsel must always be alert for conflicts and potential conflicts.

Hon. Eddie C. Sturgeon (Ret.) *is a neutral with Signature Resolution who served on the Municipal and Superior Courts in San Diego County. He presided over landmark cases involving mass tort litigation and high-profile disputes including the Apple wage and hour case, the Johnson & Johnson pelvic mesh lawsuit, and The People of the State of California vs. Ashford University. With a diverse background, Judge Sturgeon is dedicated to helping parties resolve cases in all areas of law.*