

When Your Insurance Carrier Must Provide You A Second Attorney:

Appointing No. 2 To Look Out For No. 1

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(First of a two-part series)

Your company bought a liability insurance policy to pay for an attorney to represent it should someone file suit against the company or its employees. Someone then files suit against your company or your employees, and you tender the suit to your carrier for defense. Your carrier says it will appoint an attorney to defend the suit, but under a “reservation of rights.” What exactly does that mean? Might you lose your coverage?

If you do not know the answer to these questions, you are not alone. Many policyholders – and the attorneys who regularly represent them – do not know the implications of an insurer’s “reservation of rights,” and are content to think that their interests are being protected because, at least in the short term, the carrier has appointed them an attorney. Sometimes, their interests will be protected by insurer-appointed defense counsel. But sometimes they won’t.

Knowing what to look for when your insurer agrees to undertake your company’s defense under a reservation of rights will be key to understanding whether its interests are indeed protected. When these interests are not sufficiently safeguarded, many states allow you to insist that your insurer pay for a second, independent attorney to fully defend your company’s interests.

A RESERVATION OF WHAT?

A liability carrier confronted with a potentially covered lawsuit filed against its insured will agree to defend the insured in one of two ways: it will defend under a reservation of rights, or without a reservation of rights. When the insurer defends without a reservation, it



is agreeing to pay all legal fees necessary to defend the policyholder in the action, subject only to the insured’s payment of any deductible or self-insured retention and the policy limits. The carrier concedes that it has no reason to warn you that it might someday deny coverage if the suit turns out in a particular way. As a result, there is no conflict between your company’s interests and those of the insurer: no matter what happens, a settlement or judgment will be covered (in excess of a deductible or retention, up to the policy limits). Because the policy has what is called a “duty to defend,” the insurer must select an attorney to defend your company in the action. Because the goals and desires of the insurer and the insured are fully aligned, the defense lawyer need not worry whether the way the lawyer handles the case might push it toward or away from a non-covered result. This assures your company an unbiased defense.

On the other hand, when your insurer agrees to defend your company, but reserves the right to withdraw the defense and refuse paying any settlement or judgment if events unfold in a certain way, there may be trouble on the horizon. A carrier that defends under a reservation of rights is not fully protecting its insured. Rather than stand behind the policyholder come what may, the insurer stands off to one side, ready to bolt as soon as it finds the evidence it needs to deny coverage. The insurer-selected defense attorney is the gatekeeper of the evidence, the one responsible for developing and presenting it, and the one most likely to be able to influence whether the

case has a covered or non-covered outcome. Even if this lawyer is entirely well-meaning, the conflict with which the lawyer is saddled means that, even if you think your company is being fully and zealously protected by counsel loyal only to you, the reality may be radically different.

THE FOLLOWING SCENARIOS ILLUSTRATE THIS PROBLEM

Scenario 1:

One of your truck drivers is involved in an accident, having been charged with driving under the influence of alcohol. The victim files suit against your driver and your company, alleging negligence and intentional acts. Most likely, your policy would provide a defense against the negligence claims, but not against the intentional tort. (Indeed, most states prohibit insurers from insuring against intentional torts on grounds that it would further bad public policy to allow intentional tortfeasors to obtain coverage for inherently wrongful conduct.) In that case, your carrier likely would agree to defend the suit against the accident victim, but would reserve its right to deny coverage (and potentially seek reimbursement from you for defense costs it paid) if your driver is found to have acted intentionally.

Scenario 2:

Your construction company is sued for various building defects on a project. Some of the alleged defects are for matters plainly covered under your insurance policy – for example, poor workmanship causing property damage to the work of others (like a bad weld that causes a pipe to burst, resulting in water damage elsewhere on the property). Some of the alleged building defects are for matters plainly not covered under your policy – for example, shoddy workmanship that does not cause property damage (like painting a wall the wrong color, or installing a prefabricated staircase backwards). Your insurer agrees to defend against the suit, but reserves its right to deny coverage for a settlement or judgment entered against you that is attributable to any of the non-covered claims (and potentially, to recoup defense costs).

In both scenarios, the carrier agrees to defend the suit, while reserving the right to deny any duty to pay future defense costs or a settlement or judgment should the facts turn out a certain way, that is, if the evidence shows that your driver committed uninsurable intentional conduct (as in Scenario 1) or that plaintiff's losses are from pure construction defects only, and not from damage to property (as in Scenario 2). If the insurer defends your company under a reservation of the right to withdraw coverage in the event of these results, your company is on a slippery slope. It can do nothing but hope that the insurer-selected attorney defends the non-covered claims, shifting any liability exposure to covered theories of action. Or your company can insist that the insurer pay an independent defense lawyer to protect your company's interests by trying to steer any liability exposure (consistent always with good faith) to a covered result. Why would you choose this second option?

INDEPENDENT ATTORNEY OWES NOTHING TO THE INSURER

In both scenarios the insurer-selected attorney is representing your interests. But in both scenarios, your attorney could also be representing your insurer's interests.

What if, under Scenario 1, the insurer-appointed defense lawyer reflexively steers the facts, discovery and argument away from the covered negligence theory and, indirectly, toward the non-covered intentional tort theory? If this happens, your company would be on the hook for the intentional tort and your insurer would minimize its expenditures. That strategy would benefit your insurer and harm you.

What if, under Scenario 2, your attorney argues that the owner's damages are due to construction deficiencies, not property damage? In that case your company would be on the hook for the claim; your insurer would not. Again, your insurer benefits; you lose.

Remember, your insurer is agreeing to pay the attorney to represent you. When it comes to a settlement or judgment in your case, your carrier has every incentive to pay as little as possible on your behalf. At the same time, the attorney appointed to defend you is likely getting repeat business from your insurer. Insurers typically refer cases to a group of attorneys listed on a “panel” from which the insurer draws in selecting defense counsel for suits filed against insureds. These lawyers are, for that reason, referred to as “panel counsel.” Such attorneys have primary relationships with the carriers who feed them. You, on the other hand, are unlikely to see the defense lawyer again once the case is over. Panel counsel, therefore, has natural incentives to please a carrier who sends them case after case.

In many states, a “tripartite” relationship is said to exist between the insurer, the panel defense counsel, and the insured, in which panel defense counsel is deemed to represent both the insurer and the insured. Where the carrier defends under a reservation of rights and the panel counsel has the theoretical ability to push the case toward a non-covered outcome, there is now a conflict of interest between the interests of insurer and insured, and the interests of the lawyer’s two clients now do not align. The defense attorney’s ethical duties expressed in rules of professional responsibility and common law prohibit the lawyer from representing one client over another – even if the lawyer gets substantial repeat business from one client (the carrier) and none from the other (the policyholder).

To cure this conflict, the carrier must appoint at its expense independent counsel to defend the insured in a manner protective of its right to coverage. The rationale for this rule lies in the ethical prohibition against the attorney’s dual representation of clients with conflicting interests. Where this conflict potentially cripples a defense attorney’s ability to provide the insured an unbiased defense, the insurer must pay for a new defense lawyer aloof from that conflict. Indeed, some states are willing to find that such a conflict exists solely from a carrier’s undertaking of defense obligations under a reservation of rights.

THE ATTORNEYS APPOINTED BY YOUR CARRIER HAVE NATURAL INCENTIVES TO PLEASE THE CARRIER THAT FEEDS THEM

Other conditions and kinds of conflicts may also justify the appointment of independent counsel, such as when an insurer is covering multiple policyholders with adverse interests in the same litigation. Even when a particular state requires the insurer to pay an independent attorney to protect the insured, carriers are often only required to pay independent counsel at hourly rates comparable to those of the insurer’s regular panel defense counsel – whose rates may well be tied to the volume of business they receive from the insurer. It pays to know what your state allows when an insurer defends your company under a reservation of rights, so you can request independent counsel if your company is so entitled.

CONCLUSION

None of this is to suggest that the attorney appointed by the insurer to defend the insured is sinister or malevolent. Very likely the attorney is not. Nevertheless, the law in many states recognizes the bona fide conflict of interest that can exist when an attorney appointed by an insurer has every incentive to minimize defense expenses and avoid payment for non-covered claims, while a policyholder has every incentive to maximize benefits under the policy.

For this reason, you should take care to scrutinize not only your insurer’s particular reservation of rights, but the particular claims made against your company. The difference could mean allowing your insurer to shift the entire burden of the suit to you.

(Part II will appear in the next issue: State-By-State Analysis.)