

THE RIGHT TO INDEPENDENT COUNSEL IN TEXAS AND CALIFORNIA

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RESPONSE TO A REQUEST FOR A DEFENSE

- Insurer has three options:
 - Deny the request for a defense;
 - Provide an unqualified defense;
 - Provide a qualified defense pursuant to a reservation-of-rights letter.
- Can Also file a Declaratory Judgment Action

NATURE OF CONFLICT BETWEEN INSURER AND INSURED

Subject to the terms of the insurance policy, if the insurer has a duty to defend with respect to any aspect of the lawsuit, it has the duty to defend with regard to every aspect of the lawsuit.

Heyden Newport Chem. Ins. Co. v. Southern Gen'l Ins. Co., 387 S.W.2d 22, 26 (Tex. 1965)

What are Insured's Options

- Accept the Defense (silence is implied consent); or
- Reject the Defense.

What circumstances give rise to the right to reject (Independent Counsel)?

Types of Conflicts Justifying Rejection

- When the defense tendered “is not a complete defense under circumstances in which it should have been.”
- When the “attorney hired by the carrier acts unethically and, at the insurer’s direction, advances the insurer’s interest at the expense of the insured’s.”
- When “the defense would not, under the governing law, satisfy the insured’s duty to defend;” and
- When though the defense is otherwise proper, “the insurer attempts to obtain some type of concession from the insured before it will defend.”

Northern County Mut. Ins. Co. v. Davalos

- Holdings of the Supreme Court:
 - The Supreme Court held that the right to conduct the defense by the insurer is a matter of contract.
 - The insurer has the right to make defense decisions as if it were the client "*where no conflict of interest exists.*" *State Farm Mutual Automobile Ins. Co. v. Traver.*
 - A disagreement about how the defense should be conducted is not a conflict of interest under *Traver.*
 - Where there is a question regarding the existence of scope of coverage and the duty to indemnify the insured, there may be exist a right for disqualifying conflict. A disqualifying conflict exists when the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends.

When is Independent Counsel Required

- **Claim Against Multiple Insureds – Separate attorneys where insureds' interests are adverse;**
- **Insured Suit Against Other Insureds - No;**
- **Suit for money in excess of policy limits – No;**
- **Punitive Damages - No;**
- **Policy Period - No;**
- **Person insured – Usually No;**
- **Property insured - No;**
- **Covered verses non-covered damages - Mixed;**
- **Covered verses non-covered claims - Yes.**

Housing Authority of Dallas, Tex. V. Northland Ins. Co., 333 F.Supp.2d 595 (N.D. Tex. 2004)

Reservation of rights issued on “willful violation of statute” exclusion created disqualifying conflict in the face of allegations that the insured willfully violated U.S.C.S., Title VII.

Downhole Navigator, LLC v. Nautilus Ins. Co. (5th Cir. 2012)

- Nautilus insured Downhole under a CGL policy;
- Downhole was sued by Sedona for damage to oil well sustained while Downhole was engaged to redirect the well (deviation);
- Sedona sued for loss profits, damage to the well, loss of business opportunity, loss of value in lease, loss of minerals, costs of delay, exemplary damages and attorney's fees.

*Downhole Navigator, LLC v.
Nautilus Ins. Co. (5th Cir. 2012)*

- Nautilus Argued: Conflict only arises when coverage facts will be actually adjudicated in lawsuit.
- Downhill Argued: Conflict arises where facts affecting coverage will be part of discovery in lawsuit.

Downhole Navigator, LLC v. Nautilus Ins. Co. (5th Cir. 2012)

■ Court Held:

- Conflict only arises where coverage facts will be actually adjudicated.
- Rejects Downhill's position – Lawyer's ethical obligation will prevent.
- Jury would be asked if downhill was negligent. Jury would not decide if conduct was intentional, whether conduct constituted "testing" or whether Downhill occupied well.

Graper v. Mid-Continent Cas. Co.,
756 F.3d 388 (5th Cir. 2014).

- Copyright infringement case where Mid-Continent agreed to defend, subject to reservation of rights
- Mid-Continent reserved rights based on possibility that alleged injury occurred outside of policy period
- Also reserved rights as to intentional or willful conduct of insured
- Insured asserted it had right to independent counsel due to conflict of interest

Graper v. Mid-Continent Cas. Co., 756 F.3d 388 (5th Cir. 2014).

- Insured alleged a statute of limitations defense in Underlying Action
- Insured argued that timing relating to coverage and timing relating to accrual of the claims for statute of limitations run on same factual track, so conflict of interest existed.
- Court rejected the argument, noting distinction between adjudicating when a claim accrued (for SOL purposes) and when acts of infringement occurred (for coverage purposes).
- Occurrence determines date of actual injury
- Accrual determines the date of the discovery of injury

Graper v. Mid-Continent Cas. Co., 756 F.3d 388 (5th Cir. 2014).

- Insured argued that issue of “willingness of insured’s conduct” created a conflict of interest because statutory damages for copyright infringement under 17 U.S.C. Sec. 504(c) can be increased if the infringement was willful.
- Court rejected, noting that policy requires a knowing violation of another.
- Statute requires infringement to be committed willfully, but does not require proof of knowing conduct (as the policy does).
- Jury could find willful copyright infringement, without a finding of knowing infringement.

Advising Insured of Right to Independent Counsel

- *J.E.M. v. Fidelity and Casualty Co. of New York*, 928 S.W.2d 668 (Tex.App.—Houston [1st Dist.] 1996, no writ):

This case does not present a *Tilley* problem because there is no allegation that Fidelity used the same attorneys to defend the defendants that it used to determine coverage issues. Furthermore, the reservation of rights letter in this case detailed specific coverage problems that the defendants might face, and informed them they had a right to seek outside counsel.

Splitting the File

- “Splitting the File” - one adjuster oversees the liability case, and another adjuster oversees the coverage dispute.
- A prudent insurer will split the file to avoid a potential conflict of interest
- If defense counsel has a conflict of interest, your adjuster does, too.
- Splitting the file may be prudent even where independent counsel is not required.

Practical Considerations for Splitting the File

- The liability adjuster and coverage adjuster do not share information or documents: Chinese Wall
- It may be prudent to have both attend mediation and trial
- Advise your insured in writing

WHAT ABOUT CALIFORNIA?

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California **IS NOT** Texas

What is the Legal Basis?

- The “Cumis” Case:

San Diego Navy Fed Credit Union v. Cumis Ins. Society (1984) 162 Cal.App.3d 358

- The Statute: California Civil Code §2860 (1987)

- 772 cases: interpreting §2860

What Conflict?

1. The Conflict defined by §2860(b):
defense counsel can control the outcome of
the coverage issue

- Requires Actual Not Theoretical Conflict

Dynamic Concepts, Inc. v. Truck Ins.
Exchange (1998) Cal.App.4th 999

What Conflict?

1. The Conflict defined by §2860(b): defense counsel can control the outcome of the coverage issue (continued)

- Similar to, but not the same as, Davalos Standard
 - Davalos – Resolution of facts litigated in liability case will determine outcome of coverage question
 - §2860 – Whether defense counsel can control outcome of coverage question.
 - Downhill's unsuccessful argument in Downhole Navigation [facts affecting coverage will be part of discovery]

What Conflict?

2. Not Every ROR Creates a Conflict

- Damages outside policy period
§2860(b); Federal Ins. Co. v. MBL, Inc. (2013) 219 Cal.App.4th 29
- Punitive Damages
§2860(b); Foremost Ins. Co. v. Wilks (1988) 206 Cal.App.3d 25
- Some Damages Not Covered
Blanchard v. State Farm Fire & Cas. Co. (1991) 2 Cal.App.4th 345

What Conflict?

2. Not Every ROR Creates a Conflict (continued)

- Right to Seek Reimbursement for Defending Non-Covered Claims

James 3 Corp v. Truck Ins. Exchange (2001) 91 Cal.App.4th 1093

- Sub-contractor's insurer covering developer as AI

Centex Homes v. St. Paul Fire and Marine Ins. Co. (2015) 237 Cal.App.4th 23

Can the Insured Waive Independent Counsel?

Yes. By written waiver:

- In form provided in §2860(e).
- Practical consideration – defense counsel developing early relationship.

How much must I pay?

1. Fee Rate

- What insurer pays in defending similar actions where claim arose or is being defended (§2860(c))
 - Insured will assert means “highest paid”
 - So, avoid making an “exception”

How much must I pay?

2. Fee Dispute

- Arbitration (§2860(c)).
- Dispute over independent counsel *rights and obligations* – Declaratory Relief
United States Fidelity & Guaranty Co. v. Superior Court (1988) 204 Cal.App.3d 1513
 - Declaratory relief must precede arbitration
Housing Group v. PMA Capital Ins. Co. (2011) 193 Cal.App4th 1150
 - Problem – Stay of declaratory relief while liability action pending
Montrose Chemical Corp. v. Superior Court (1993) 6 Cal.4th 287, 301-302
- Rate limitation not retroactive to fees before insurer began paying for defense
City Art, Inc. v. Superior Court 2014 unpub. Lexis 8741 (CA.Ct.Appeal 2014)

Who controls what?

1. Settlement

- Insurer controls

Even though §2860(f) allows counsel to “participate in all aspects of the litigation”

Western Polymer Technology, Inc. v. Reliance Ins. Co. (1995) 32 C.A.4th 14

Who controls what?

2. Handling of Defense Strategy

- Insured controls

Bogard v. Employers Casualty Co. (1985) 164 Cal.App.3d 602

- *But* both independent counsel and insurer retained counsel shall be allowed to participate in all aspects of the litigation. §2860(f)
- *But* independent counsel obligated to:
 1. Report non-privileged information concerning the action, and
 2. Cooperate with insurer retained counsel
§2860(f)

Who controls what?

2. Handling of Defense Strategy (continued)

- “Outside counsel guidelines”
 - No case has addressed
 - But indication would not apply, to the extent it would “impede the attorney’s own professional judgment about how to best competently represent the insureds”.

Dynamic Concepts, Inc. v. Truck Ins. Exchange (1998) 61 Cal.App.4th 999.

Do I Split the File?

No. Separate adjusters for the liability and coverage issues not required.

State Farm Fire & Cas. Co. v. Superior Court (1989)
216 Cal.App.3d 1222

Employers Ins. Of Wausau v. Albert D. Seeno Constr. Co.
(9th Cir. 1991) 945 F.2d 284