INDEPENDENT COUNSEL AFTER *DAVALOS*

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I. INTRODUCTION

Over the last twenty years, perhaps no area of insurance law has generated more controversy than the issue of independent counsel. As used in this paper, the term "independent counsel" means those situations in which an insured is entitled to select his counsel and control the defense because of the existence of a specific type of a conflict of interest with the insurer. While this concept has been lurking in the depths of legal waters since 1941,[1] it did not emerge from those waters until the mid-eighties with the decision by the California Court of Appeals in *San Diego Navy Federal Credit Union v. Cumis Ins. Society, Inc.*[2]

Following *Cumis*, there was tremendous uncertainty regarding the application operation of the doctrine. To this extent, at least three states have adopted statutes regulating this situation.[3] In the 2001 Texas Legislative Session, a proposed independent counsel statute was submitted, but was left pending in committee.[4]

In Texas, the use of independent counsel has not had the impact that it had in California. Prior to the *Morgan County Mutual Ins. Co. v. Davalos*,[5] there was scant authority in Texas on this topic. However, following the *Davalos* opinion, there has been tremendous disagreement regarding the breadth of the opinion and what circumstances do trigger the right of an insured to independent counsel. This paper will examine the development of the right to independent counsel in Texas and what issues have been resolved by the

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[1] *Boyse Motor Co. v. St. Paul Mercury Indemn. Co.*, 112 P.2d 1011 (Idaho 1941).

[2] 28 Cal.Rptr. 494 (Cal.Ct.App. 1984).

[3] ALASKA STAT. § 21.89.100 (adopted 1995, amended 1997); CAL. CIV. CODE § 2860 (adopted 1987, amended 1988); FLA. STAT. ANN. § 627.426 (West 2002).

[4] SECTION 1. Subchapter E, Chapter 21, Insurance Code, is 1-6 amended by adding Article 21.56B to read as follows: 1-7 Art. 21.56B. INDEPENDENCE OF COUNSEL. (a) The commissioner, 1-8 in consultation with the State Bar of Texas, shall adopt rules 1-9 under this article to ensure the independence of counsel provided 1-10 to an insured under a casualty insurance policy. The rules must: 1-11 (1) require notice to the insured of the insured's 1-12 right to independent counsel to represent the insured's interests; 1-13 and 1-14 (2) specify circumstances in which, because of 1-15 conflict of interest or other relevant issues, an insurer may not 1-16 offer or provide to the insured the services of an attorney in the 1-17 employ of or under contract to the insurer. 1-18 (b) An insurer that, under a policy of casualty insurance, 1-19 is obligated to defend an insured in a suit may not offer or 1-20 provide to the insured the services of an attorney in the employ 1-21 of or under contract to the insurer unless the insurer complies 1-22 with rules adopted by the commissioner under this article. 1-23 (c) This article applies to any insurer that issues a policy 1-24 of casualty insurance that is delivered, issued for delivery, or 2-1 renewed in this state, including a policy written by a Lloyd's plan 2-2 insurer, reciprocal or interinsurance exchange, county mutual 2-3 insurance company, farm mutual insurance company, or surplus lines 2-4 insurer. 2-5 SECTION 2. (a) The commissioner of insurance shall adopt 2-6 the rules required by Article 21.56B, Insurance Code, as added by 2-7 this Act, not later than December 15, 2001. 2-8 (b) Article 21.56B, Insurance Code, as added by this Act, 2-9 applies only to an attorney's services offered or provided to an 2-10 insured under a casualty insurance policy that is delivered, issued 2-11 for delivery, or renewed on or after January 1, 2002. An 2-12 attorney's services offered or provided to an insured under a 2-13 casualty policy that is delivered, issued for delivery, or renewed 2-14 before January 1, 2002, is governed by the law as it existed 2-15 immediately before the effective date of this Act, and that law is 2-16 continued in effect for that purpose. 2-17 SECTION 3. This Act takes effect September 1, 2001.

[5] 140 S.W.3d 685 (Tex. 2004).

Davalos opinion and what issues still remain.

A. EXISTENCE OF DUTY TO DEFEND

1. Background and Basis of the Duty to Defend

The purchase of a liability policy involves the purchase of two distinct features. These two features are the duty to defend as well as the duty to indemnify. In many cases, the focus is on the duty of the insurance company to indemnify, that is, to pay a judgment or settlement taken against the insurer.

However, equally important is the duty to defend. Often, the defense costs may far exceed any indemnity paid by the insurer. In other cases, there may be no indemnity payment made. Nevertheless, the cost to defeat the liability claims may be staggering. In many instances, the insured would be unable to finance the cost of a defense out of his own pocket, leaving both the insured and the insurer open to greater damage exposure.

The duty to defend is contractual in nature.[6] Because the duty to defend is contractual, in most cases the scope and determination of the duty to defend will be determined by the language of the contract. It should be noted that many liability policies, such as directors and officers liability policies, may not contain a duty to defend at all, but rather may provide for reimbursement of defense costs. Other liability policies, such as excess or umbrella policies, may provide for a defense at the option of the insurer. Therefore, when addressing the duty to defend, first and foremost consideration should be given to the language of the contract itself.

2. Scope of the Duty to Defend

As set forth above, the duty to defend is a contractual obligation. An insurer is required to defend the insured only against claims that are potentially within the coverage of the insurance policy. The general rule in Texas is that, if the insurer has a duty to defend with regard to any aspect of a lawsuit, it has a duty to defend with regard to every aspect of the lawsuit.[7] Therefore, if a duty exists, it extends to covered and non-covered claims as well as alternatively-pled claims. The duty to defend is not unlimited, however. Where the insured has claims of its own that it wants to affirmatively assert, then the insurer has no obligation to pay for the prosecution of these claims. Likewise, the attorney hired by the insurer is only retained with respect to the defense of the claims brought by the plaintiff against the insured.

II. RESPONSE TO A REQUEST FOR A DEFENSE

When presented with a request for a defense, an insurer has at least three options which it may employ. The first option is to deny the request for a defense. Although there are certain limitations that result from an insurer's denial of a defense, the issue of selection and control of counsel is no longer an issue. The insurer has given up that right by virtue of its denial of the defense.

> The unequivocal denial of all liability to pay loss under its insurance policy, in the absence of a special contract with the insured, this qualifies the insurance company for defending a suit against the assured for the recovery of

[6] *Houston Petroleum v. Highlands Ins.*, 830 S.W.2d 153, 155 (Tex. App.--Houston [1st Dist.] 1990, writ denied); *Whatley v. City of Dallas*, 758 S.W.2d 301, 304 (Tex. App.--Dallas 1988, writ denied).

[7] *Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 119 (5th Cir. 1983) (Texas law); *Steel Erection Co. v. Travelers Indemn. Co.*, 392 S.W.2d 713, 716 (Tex.Civ.App.--San Antonio 1965, writ ref'd n.r.e.).

> damages which the insurance company says is not covered by its policy. The insurance company and the assured may enter into a special contract relating to the defense of a claim asserted against the assured by a third party, based upon the premise that the liability of the insurance company is doubtful or not admitted, but after an absolute and continuous assertion of nonliability the assured is not required to accept such a contract.[8]

The second option is to provide an unqualified defense. When insurer provides an unqualified defense, it does so without a reservation-of-rights letter or a nonwaiver agreement. Essentially, the insurer is agreeing to pay for any judgment which may arise as a result of the lawsuit, up to the policy limits. Under Texas law, where an unqualified defense has been tendered, the issue of selection of counsel and control of counsel is generally not an issue. This is because the insured has, through the terms of the insurance contract, contracted away the right to select counsel and control the defense.

The third option is to provide a qualified defense pursuant to a reservation-of-rights letter or a nonwaiver agreement. Because of the tender of a qualified defense, a potential conflict arises between the insured and the insurer. As a result of this conflict, the insured's rights under its insurance policy are altered.

One such right that is altered is the enforcement of the voluntary assumption of liability in no-action clauses. If the insured rejects a defense pursuant to a reservation-of-rights letter, an insurer is also barred from enforcing voluntary assumption of liability in no-action clauses.[9]

A. *Steel Erection Company v. Travelers Indemnity Company*

The first case to address this issue in Texas was *Steel Erection Company v. Travelers Indemnity Company.*[10] The controversy in this case arose out of a crane rented by H. H. Higdon ("Higdon") and Steel Erection Company ("Steel Erection") from Thomas P. Sullivan d/b/a D. J. Sullivan Erection Company ("Sullivan") to be used in the LaSalle High School project. While the crane was being operated under the supervision of Judson H. Phelps ("Phelps") and Higdon, the crane was damaged. Higdon and Steel Erection were served with a lawsuit and requested Travelers to defend them. Travelers refused to defend the lawsuit on the grounds that Exclusion L under the policy excluded damage to property which is under the possession and control of Higdon and Steel. The allegations in the plaintiff's petition show that the crane was damaged when it was under the exclusive control of Higdon and Steel.

Higdon and Steel employed their own attorney to defend them in the lawsuit. After maneuvering in court, Sullivan filed an amended petition in which he dropped Higdon and Steel as defendants. Higdon and Steel were thereafter joined by Employers, the insurance carrier of Sullivan. Employers filed a third-party action against Higdon and Steel seeking subrogation on the theory that at the time the crane was damaged, it was being operated by Sullivan and his employees as an independent contractor. After the

[8] *Great American Indemn. Co. v. City of Corpus Christi*, 192 S.W.2d 917 (Tex.Civ.App.--San Antonio 1945, writ ref'd n.r.e.).

[9] *Travelers Indemn. Co. v. Equipment Rental Co.*, 345 S.W.2d 831, 835 (Tex.Civ.App.--Houston 1961, writ ref'd n.r.e.).

[10] 392 S.W.2d 713 (Tex.Civ.App.—San Antonio 1965, writ ref'd, n.r.e.).

amendment to the pleading, Travelers informed Higdon and Steel that due to the allegation of independent contractor on the part of Sullivan, it was Traveler's opinion that there would probably be coverage under its policy of insurance and it offered to defend the suit. Higdon and Steel meanwhile had filed a third-party action to bring Travelers in the lawsuit. Higdon and Steel offered to permit Travelers to defend the lawsuit provided Travelers would extend to them full coverage under the policy. Travelers refused to do so. Eventually, the lawsuit between Higdon and Steel and Travelers was severed from the underlying case. The underlying suit went to trial with Higdon and Steel's personal attorney defending them. The jury found that the crane was not under the possession and control of Higdon and Steel at the time it was damaged and that the damage was not caused by the neglect of Higdon and Steel. Based upon these findings, judgment was rendered in favor of Higdon and Steel.

Higdon and Steel then sought recovery of their attorney's fees in the amount of $3,285 against Travelers. This sum amounted to the amount of attorneys fees that had been required to expend in the defense of the Sullivan suit. The parties, by stipulation, divided the attorney's fees into three categories. First, the sum of $630 expended by Higdon and Steel in defense of the Sullivan suit prior to April 15, 1964, at which time Travelers first offered to defend the suit. Second, the sum of $1,710 expended by Higdon and Steel in defense of the Sullivan suit, subsequent to April 15, 1964. Third, the sum of $945 incurred by Higdon and Steel in the prosecution of their cross-action and third-party action against Travelers.

Higdon and Steel contended that Travelers breached its insurance policy by refusing to defend the Sullivan suit. Travelers, on the other hand, contended that Higdon and Steel breached the provisions of the insurance policy by refusing to permit it to defend the suit after April 15, 1964. The trial court entered judgment permitting Higdon and Steel to recover the $630 for attorney's fees in the first category, but refused them any recovery of attorney's fees stipulated in the second and third categories.

On appeal, while Higdon and Steel complained of the failure to award the attorneys fees in the second and third categories, Travelers also, by cross-assignment, complained of the award of the $630 stipulated in the first category.

The first issue addressed by the court of appeals was the liability of Travelers for the $630 incurred prior to April 15, 1964. Prior to this time period, the allegations in the petition were that the crane was under the exclusive control and possession of Higdon and Steel. The court of appeals concluded that:

> The pleadings in the Sullivan suit clearly alleged that the crane was in the exclusive possession and under the control and management of Higdon and Steel at the time it was damaged, and such damage was clearly excluded from coverage by the insurance policy under paragraph (L). Travelers had a right to rely upon the facts alleged by Sullivan in his petition and the provisions of its insurance policy in determining its duty, *vel non*, of defending the lawsuit. As long as these pleadings remained unchanged, Travelers owed no duty to Higdon and Steel to defend them in this lawsuit.[11]

[11] *Steel Erection Co.*, 392 S.W.2d at 715.

The situation with the post-April 15, 1964 attorney's fees was different. Category Two represented the amount of attorney's fees expended by Higdon and Steel in defense of the Sullivan suit subsequent to April 15, 1964, on which date the pleadings had been amended and contained an allegation that the crane was being operated by Sullivan as an independent contractor under which circumstances Travelers would be required to defend Higdon and Steel. Travelers offered to do so, but this was refused by Higdon and Steel because of the conflict of interest between them and Travelers. The court of appeals noted that:

> Where the insurer is denying coverage, but at the same time demanding the right to defend the lawsuit on behalf of the insured, and where coverage, *vel non,* will depend upon the finding of the trier of facts as to certain issues in the main case, which here is the question of whether the crane at the time it was damaged was being operated by Sullivan as an independent contractor, or by Higdon and Steel under a bailment agreement, the insurer is not in a position to defend the insured. Travelers was confronted with the situation that it must acknowledge coverage and thus eliminate the controversy between it and Higdon and Steel, or stand upon its contention that there was no coverage. By its action in denying full coverage, Travelers brought itself in a position where it could not properly represent Higdon and Steel. Travelers chose not to admit full coverage, and thus Higdon and Steel had a right to be defended by Earle Cobb, Jr., an attorney of their own selection. Travelers not being in a position to defend the lawsuit, due to its conflict with Higdon and Steel, is liable for the $1,710.00 expended for attorney's fees, as stipulated in the second category.[12]

The court of appeals held that Higdon and Steel were not entitled to the third category of money representing attorney's fees expended in the suit against Travelers.[13] (This would not be the result under Chapter 38 of the Civil Practices and Remedies Code, which allows an insured to recover attorney's fees for suit brought upon an insurance contract.)[14]

In summary, the *Steel Erection* case held that in circumstances where coverage will depend upon the finding of the trier of fact as to certain issues, the conflict exists between the insured and the insurer. Because of this conflict, the insured has the right to select its own counsel.

B. *Rhodes v. Chicago Ins. Co.*

The second case applying Texas law to address the issue of independent counsel is *Rhodes v. Chicago Insurance Company.*[15] In *Rhodes*, the plaintiff, Rhodes, applied for a modeling position and was interviewed by John Shirley, a personnel and guidance counselor. Rhodes alleged that, during the counseling process, Shirley engaged in sexual misconduct with her and that he hypnotized her without informing her of the risks involved. Chicago Insurance Company was the malpractice carrier for Shirley under a group policy. Chicago refused to defend Shirley under the original complaint and did not respond to

[12] 392 S.W.2d at 716.

[13] 392 S.W.2d at 716.

[14] *See Grapevine Excavation, Inc. v. Maryland Lloyds*, 35 S.W.3d 1 (Tex. 2000).

[15] 719 F.2d 116 (5th Cir. 1983).

a request for a defense under the first amended original complaint. Chicago tendered a defense to Shirley under the second amended complaint under a reservation-of-rights letter. Chicago contended that the *Rhodes* complaint alleged conduct by Shirley which would constitute sexual misconduct which was specifically excluded from the policy. Shirley refused the tender of defense and pursued his own defense. The suit was settled for $200,000, the policy limits. Plaintiff then filed suit against Chicago seeking payment of the assessed damages. Summary Judgment was granted to Chicago by the District Court.

On appeal, the court of appeals noted that:

> [T]he duty to defend is determined by examining the latest, and only the latest, amended pleadings. A complaint which does not initially state a cause of action under the policy, and so does not create a duty to defend, may be amended so as to give rise to such a duty. Likewise, a complaint which does allege a cause of action under the policy so as to create a duty to defend may be amended so as to terminate the duty. In the first instance, the insurer may properly refuse to defend before the amended complaint is filed, and in the second, the insurer may properly withdraw after the amendment is made. A complaint which contains a claim which does not allege a cause of action under the policy as well as a claim which does allege a cause of action under the policy does not negate the duty to defend. Whether a complaint pleads in the alternative or alleges more than one cause of action, the insurer is obligated to defend, as long as the complaint alleges at least one cause of action within the coverage of the policy.[16]

The court thereafter addressed the options available to the insured and to the insurer where the complaint alleges some claims that would fall within the policy and some that would fall without. The court stated that:

> If, however, the duty to defend arose under the second amended original complaint, the question becomes more complex. The insurer offered to defend, but only with a reservation of rights. A reservation of rights is a proper action if the insurer believes, in good faith, that the complaint alleges conduct which may not be covered by the policy. In such a situation, reservation of rights will not be a breach of the duty to defend, but notice of intent to reserve rights must be sufficient to inform the insured of the insurer's position and must be timely. When a reservation of rights is made, however, the insured may properly refuse the tender of defense and pursue his own defense. The insurer remains liable for attorneys' fees incurred by the insured and may not insist on conducting the defense. Refusal of the tender of defense is particularly appropriate where, as here, the insurer's interests conflicts with those of the insured. "When the insurer is denying coverage, . . . and where coverage, *vel non,* will depend upon the finding of the

[16] 719 F.2d at 119.

> trier of facts as to certain issues in the main case, . . . the insurer is not in a position to defend the insured." *Steel Erection Co. v. Travelers Indemnity Co.*, 392 S.W.2d 713, 716 (Tex.Civ.App.–San Antonio 1965, writ ref'd n.r.e.).[17]

C. *State Farm Mut. Auto. Ins. Co. v. Traver*

The first and only case out of the Texas Supreme Court even remotely addressing the independent counsel issue prior to *Davalos* was *State Farm Mut. Auto. Ins. Co. v. Traver*.[18] In that case, the insured, Ronald Traver, argued that the attorney provided by State Farm committed malpractice in defending a personal injury claim against the estate of which he was the executor, resulting in a judgment in excess of the policy limits. Suit was brought against State Farm by the executor asserting negligence, breach of a duty to defend, breach of the *Stowers* duty, breach of the duty of good faith and fair dealing, as well as violations of the DTPA and Insurance Code.[19] In addressing the liability of the insurer for the conduct of defense counsel, the court focused on the rights granted to the insurer under a liability policy to defend the case. The court stated that:

> We have recognized that a liability policy may grant the insurer the right to take "complete and exclusive control" of the insured's defense. *G.A. Stowers Furniture Co. v. American Indemn. Co.,* 15 S.W.2d 544, 547 (Tex. Comm'n App. 1929, holding approved).

The court noted however that the lack of control of the defense was not absolute. The court held that:

> The insurer's control of the insured's defense under this policy thus includes authority to accept or reject settlements and, where no conflict of interest exists, to make other decisions that would normally be vested in the client, here the insured.[20]

Therefore, in *Traver*, the supreme court mentioned the limitation but did not explain it.

III. *NORTHERN COUNTY MUT. INS. CO. V. DAVALOS*

The supreme court finally squarely addressed the issue of independent counsel for the first time in *Northern County Mutual Ins. Co. v. Davalos*.[21] While the opinion only directly addressed the issue squarely before it, Chief Justice Phillips did provide insight as to how generally the Independent Counsel Rule should be applied. Since the issuance of the opinion, there has been much confusion regarding the scope and breadth of this holding. A careful analysis of the facts and arguments is necessary in order to achieve an appropriate understanding of the case.

1. Facts

Timoteo Davalos was an insured of Northern County and a resident of Matagorda County. While in Dallas County, he was injured in an automobile accident. Davalos sued the driver of the other vehicle in Matagorda County. The other driver and his wife sued Davalos and another person who was involved in the accident in Dallas County. Davalos sent

[17] 719 F.2d at 120-21.

[18] 980 S.W.2d 625 (Tex. 1998).

[19] *Id.* at 627.

[20] *Id.* at 627.

[21] 140 S.W.3d 685 (Tex. 2004).

the Dallas petition in which he was named as a defendant to the attorneys who were representing him in as a plaintiff in the Matagorda action. These attorneys moved to transfer the case to Matagorda County. After filing such a motion, they then notified Northern of the Dallas litigation and tendered the petition to Northern.

Northern responded to the tender in writing and told Davalos they did not wish to engage the attorneys he had selected to defend the action and had chosen a different law firm to represent him in the Dallas action. They also indicated that they were opposed to transferring the case to Matagorda County. The letter also set forth the cooperation clause and indicated that if the motion to withdraw was not withdrawn, the coverage could be jeopardized. Northern stated in their letter that if Davalos' personal attorneys:

> . . . continue to defend you in the Dallas County lawsuit and continue to pursue the motion to transfer venue, we will take the position that there is no liability protection under the [policy], and the outcome of the Dallas County case will be your personal responsibility.

Northern requested that Davalos have his attorneys withdraw from the Dallas County case and allow the attorneys suggested by Northern replace them. Northern did indicate to Davalos that he was free to obtain his own attorney at his own expense and that Northern would cooperate with that lawyer to the extent that he did not jeopardize the defense of the case.

The attorneys representing Davalos did not withdraw from the case. By a second letter dated March 14, 1997, Northern once again advised Davalos of its desire to defend the case through attorneys of its selection. The letter further advised Davalos that Northern believed venue to be proper in Dallas County because the accident had occurred there.

A week after March 14th, Davalos' attorneys wrote to reject the defense tendered by Northern and suggested that Northern had only offered a qualified defense which was insufficient to satisfy the obligations owed under the policy. The attorneys advised Northern that it could not select defense counsel because of the conflict with Davalos over the venue motion, and that they expected Northern to pay their fees in defending Davalos.

Despite Davalos' rejection of the defense, Northern settled the claims against Davalos approximately a year after the suit was filed, obtaining a full and final release with no payment being made by Davalos.

In response to the rejection of the request that Northern pay attorneys selected by Davalos, Davalos sued Northern County Mutual in Matagorda County asserting breach of the duty to defend, bad faith, as well as violations of the insurance code.

B. Trial Court's Holding

The trial court denied Northern's motion for summary judgment and granted the motion that had been filed by Davalos. A final judgment was rendered in Davalos' favor for breach of contract and violation of article 21.55 of the insurance code.

1. Court of Appeals' Holding

The case was appealed by Northern to the Corpus Christi Court of Appeals.[22] The court of appeals noted that:

[22] *Northern County Mut. Ins. Co. v. Davalos*, 84 S.W.3d 314 (Tex.App.–Corpus Christi 2002).

> When an insurer is faced with the dilemma of whether to defend or refuse to defend a proffered claim, it has four options: (1) completely decline to assume the insured's defendants; (2) seek a declaratory judgment as to its obligations and rights; (3) defend under a reservation of rights or a non-waiver agreement; or (4) assume the insured's unqualified defense.[23]

The court of appeals went on to note that Northern County did not decline to assume Davalos' defense, nor did it seek a declaratory judgment as to its obligations and rights, nor did it defend under a reservation-of-rights letter.[24]

The court of appeals then addressed whether Northern County was entitled to assume complete control of the defense. The court held that:

> In determining an Insurer's responsibilities under the standard form Texas personal auto policy, the Texas Supreme Court held that: "The insurer's control of the insured's defense under this policy thus includes authority to accept or reject settlement offers and, **where no conflict of interest exists**, to make other decisions that would normally be vested in the client, here the insured." *State Farm Mutual Ins. Co. v. Traver*, 980 S.W.2d 625, 627 (Tex. 1998).[25]

Based upon the statement in *Traver*, the court concluded that if a conflict of interest exists, the insurer was not entitled to appoint counsel. The court concluded that the choice of venue was "an obvious conflict of interest." And that, under *Traver*, Northern County forfeited it's control of the defense and choice to settle.[26]

C. Northern County's Position in the Supreme Court

In the supreme court, Northern County took the position that the right of Northern County to control defense was determined by the terms of the contract.

> Since 1929, Texas Courts have held insuring agreements and "settle or defend" clauses give the insurer "the right to take complete and exclusive control of the suit." *G.A. Stowers Furniture Co. v. Am. Indem. Co.*, 15 S.W.2d 544, 544-547 (Tex. Comm'n App. 1929, holding approved). These provisions give the insurer "absolute and complete control of the litigation, as a matter of law." *G. A. Stowers Furniture Co.*, 15 S.W.2d at 544-547. The contractual obligations in an insuring clause give the insurer "control over the insured's defense." *Am. Physicians Ins. Exchange v. Garcia*, 876 S.W.2d 842, 846 (Tex. 1994). An insured must cooperate with his insurer and turn the defense over to the insurer when the insurer tenders an unconditional defense. *See Rodriguez v. Texas Farmers Ins. Co.*, 903 S.W.2d 499, 509 (Tex. App.– Amarillo 1995, writ denied).

[23] *Id.* at 317-18.

[24] *Id.* at 318.

[25] *Id.* at 318.

[26] *Id.* at 318.

> The insured's actions must not deprive the insurer of any valid defense. *Rodriguez*, 903 S.W.2d at 509.[27]

Northern went on to argue that the court of appeals erred in holding that a conflict of interest existed between the interest of Northern County and Davalos in the case at hand:

> The controlling mistake in the intermediate court's holding is that a conflict of interest existed between Northern County (who wished to defend in Dallas County) and Mr. Davalos (who wished to defend and sue) in Matagorda County. *See Davalos*, 84 S.W.3d at 318. This does not constitute a conflict in the sense of insurance coverage. Rather, a conflict exists when an insurer questions whether an event is covered by an insurance policy. *See Farmers Texas County Mut. Ins. Co. v. Wilkinson*, 601 S.W.2d 520, 522 (Tex.Civ.App.–Austin 1980, writ ref'd n.r.e.) (Rule is based on the apparent conflict of interest that might arise when the insurer represents the insured in a lawsuit against the insured and simultaneously formulates its defense against the insured for noncoverage). Northern County has never disputed that the automobile collision between Mr. Davalos and the Weinbergs was covered under the policy.[28]

Northern County argued that the change of venue was not a decision involving conflict of interest, but rather one involving tactics with respect to the litigation. They argued that such decision was one that Davalos had yielded to his insurer when he purchased the insurance policy.

> The choice of venue is a tactical litigation decision. As Justice Quinn has stated:
>
> [I]t cannot be sincerely disputed that motions to transfer venue or dismiss via special appearances are defensive tactics available to an insurer. They have potential to influence the course of the proceeding.

Rodriguez v. Texas Farmers Ins. Co., 903 S.W.2d 499, 512 (Tex.App.–Amarillo 1995, writ denied) (Quinn, J., concurring) (emphasis added). In this case, Mr. Davalos's desire to transfer venue from Dallas County to Matagorda County was a litigation decision, which he yielded to his insurer under the insurance policy. C.R. Vol. I, p. 24, 31 (policy).[29]

Finally, Northern County argued that the court of appeals had misapplied *Traver* and if upheld, would render the insurer's right to control the defense illusory.

> The panel majority misapplies this Court's decision in *Traver* when it cites *Traver* for support. *Davalos*, 84 S.W.3d at 318 (citing *State Farm Mutual Ins. Co. v. Traver*, 980 S.W.2d 625, 627 (Tex. 1998)). The *Davalos* majority quotes

[27]Petitioner's Brief on the Merits, *Northern County Mutual Ins. Co. v. Davalos*.

[28]Petitioner's Brief on the Merits, *Northern County Mutual Ins. Co. v. Davalos*.

[29]Petitioner's Brief on the Merits, *Northern County Mutual Ins. Co. v. Davalos*.

the following language from *Traver.*

> The insurer's control of the insured's defense under this policy thus includes authority to accept or reject settlement offers and, *where no conflict exists*, to make other decisions that would normally be vested in the client, here the insured.
>
> *Davalos*, 84 S.W.3d at 318 (citing *State Farm Mutual Ins. Co. v. Traver*, 980 S.W.2d 625, 627 (Tex. 1998) (emphasis in original)). Under the majority's reading of *Traver*, a conflict occurs anytime the insured disagrees with the insurer's tactical defense decisions.[30]

D. *Davalos'* Position in the Supreme Court

In the supreme court, Davalos argued that Northern County refused to provide any defense to him unless and until he waives his venue challenge in the Dallas lawsuit.

> Consistent with its repeated refusal to consider the undisputed facts, Northern County wants to argue theory and the world of "what ifs," not the actual facts in this case. First, an actual material conflict did exist between Davalos and Northern County on how the defense should be conducted. "The first thing that an insurer with a duty to defend must determine . . . is whether there is a conflict of interest between it and the insured *with regard to how the lawsuit should be defended."* Windt, *Insurance Claims and Disputes* § 4.20, p. 218 (1995). *Emphasis added.* Davalos sued his insurer as a result of the same accident that the Dallas lawsuit involved. Davalos sued Weinberg and his insurer first in Matagorda County. Later, Weinberg sued Davalos in Dallas County and Davalos wanted that suit moved where he first filed his lawsuit or the Dallas suit abated. Clearly, a conflict exists between an insured and his insurer where the insured has sued his insurer over the same claim and where the insured seeks a defense from the same insurer involved in that claim. Obviously, a conflict did exist on how the Dallas lawsuit would be defended.[31]

Davalos argued a second conflict existed because Northern County allegedly sought coverage advice from the lawyer it selected to defend Davalos.

> Second, this conflict persisted because Northern County sought coverage advice from the very lawyer it selected to defend Davalos. C.R. 183-185. Specifically, Steven W. Drinnon, Northern County's choice of counsel, provided advice on coverage solicited by Northern County.[32] *Id.* at

[30]Petitioner's Brief on the Merits, *Northern County Mutual Ins. Co. v. Davalos*.

[31]Respondent's Brief on the Merits, *Northern County Mutual Ins. Co. v. Davalos*.

[32]Any claim that Davalos' summary judgment evidence on this point is somehow inadmissible and not probative has not been preserved by Northern County. Northern County was required to secure a ruling of Davalos' summary judgment evidence to preserve same for appeal. Northern County's failure to do so waives any complaint on admissibility. *See Utilities Pipeline Co. v.*

> 184-185. Specifically, Askins revealed that Drinnon opined that Northern County could withhold a defense until Davalos waived venue. *Id.* This sort of dual representation violates conflict of interest rules. *Employers Casualty Co. v. Tilley*, 496 S.W.2d 552, 557-559 (Tex. 1973). This conflict entitled Davalos to his own counsel at the expense of Northern County. *Britt v. Cambridge Mutual Fire Ins. Co.*, 717 S.W.2d 476, 481 (Tex.App.–San Antonio 1986, writ ref'd n.r.e.); *Steel Erection Co. v. Travelers Indemnity Co.*, 392 S.W.2d 713, 716 (Tex.Civ.App.–San Antonio 1965, writ ref'd n.r.e.).[33]

Third, Davalos argued that the tender of the defense was not an unconditional tender. Davalos argued that the tender of the defense was conditioned upon venue being maintained in Dallas County and, therefore, such was not an unconditional tender.

> Third, there was no conditional tender to Northern County by Davalos of Davalos' defense. C.R. 71-73. Davalos ceded control of the defense to Northern County with his request that venue be maintained in Matagorda County since Davalos' lawsuit against Weinberg and his insurer were filed there first and that was the county of Davalos' residence. Issues of collateral estoppel and res judicata were clearly an issue. Absent a joinder of the two lawsuits or abatement, it would simply be a race to trial with loser facing collateral estoppel and res judicata, especially with regard to determinations of liability. Instead of assuming the defense, Northern County demanded Davalos waive venue (no discussion of abatement) and that Northern County would not defend Davalos until he did so. C.R. 162 and 165-166.[34]

Finally, Davalos argued that a conflict existed by virtue of the affirmative claims that were being asserted by Davalos. Davalos argued that an insurer such as Northern County was not entitled to compromise an insured's affirmative claims in the handling of the coverage claims against the insured.

> Fourth, an insurer is not entitled, by virtue of its insurance policy with its insured, to compromise an insured's affirmative claims against a third party including a claim against the insurer. *See Hurley v. McMillan*, 268 S.W.2d 229, 234 (Tex.Civ.App.–Galveston 1954, _____). Northern County's demands seeks to do just that.[35]

As a result, it was argued by Davalos that because of these four conflicts, Northern County forfeited its right to control the defense and Davalos was authorized to engage the services of some

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American Petrofina Marketing, 760 S.W.2d 719, 723 (Tex.App.–Dallas 1988, no writ).

[33]Respondent's Brief on the Merits, *Northern County Mutual Ins. Co. v. Davalos*.

[34]Respondent's Brief on the Merits, *Northern County Mutual Ins. Co. v. Davalos*.

[35]Respondent's Brief on the Merits, *Northern County Mutual Ins. Co. v. Davalos*.

attorney at the expense of Northern County.

> Northern County forfeited its right to control the defense not only by attempting to impose a condition not mandated by its policy with Davalos, but by acting directly contrary to ethical considerations and duties to its insured. "It is well settled that once an insurer has breached its duty to defend, the insured is free to proceed as he sees fit; he may engage his own counsel and either settle or litigation, at his option." *Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 120 (5th Cir. 1983) citing *Great American Indemnity Co. v. Corpus Christi*, 192 S.W.2d 917, 919 (Tex.Civ.App.–San Antonio 1946, writ ref'd n.r.e.).[36]

E. Holdings of the Supreme Court

The supreme court made five holdings regarding the conduct of the defense. First, the supreme court held that the right to conduct the defense by the insurer is a matter of contract. Under most policies, the right to conduct the defense includes the authority to select the attorney who will defend the claim and make other decisions that would normally be vested in the insured as the named party in the case.[37]

Second, the supreme court held that this right to conduct the defense is not without its limits. Specifically, the court referred to its earlier opinion in *State Farm Mutual Automobile Ins. Co. v. Traver*,[38] where the court generally held that insurer has the right to make defense decisions as if it were the client "where no conflict of interest exists." The court then addressed what situations would and would not give rise to the right of the insured to control its own defense.

Third, the supreme court held that generally disagreement about how the defense should be conducted would not amount to a conflict of interest within *Travers* meaning.[39]

Fourth, the supreme court held that where there is a question regarding the existence of scope of coverage, 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.[40]

Finally, the court referenced other types of conflicts which may also justify an insured's refusal to a defense which are outside the scope of coverage. These are as follows:

> (1) When the defense tendered "is not a complete defense under circumstances in which it should have been."
> (2) 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."
> (3) When "the defense would not come under the governing law, satisfy the insurer's duty to defend"; and
> (4) When, though the defense is nevertheless proper, "the insurer intends to obtain some type of concession from the insured before it will defend."[41]

[36]Respondent's Brief on the Merits, *Northern County Mutual Ins. Co. v. Davalos*.

[37]140 S.W.3d at 688.

[38]980 S.W.2d 625, 627 (Tex. 1998).

[39]140 S.W.3d 685 at 689.

[40]140 S.W.3d 685 at 689.

[41]1 ALLAN D. WINDT, INSURANCE CLAIMS AND DISPUTES §

F. What Coverage Disputes Give Rise To Independent Counsel?

One of the primary questions resulting from the *Davalos* opinion is what coverage questions will give rise to independent counsel? Several lawyers, courts and commentators have erroneously advocated that any time a reservation-of-rights letter is issued by an insurer, that a conflict of interest exists that will give rise to the right to independent counsel. This position not only is inconsistent with prior Texas law, it is also inconsistent with the actual holding by the supreme court in the *Davalos* decision. The mere fact that a reservation-of-rights letter has been issued will not in and of itself give rise to independent counsel. Rather, the critical factor will be the nature of the coverage dispute.

In order to obtain a proper perspective of this issue, it is necessary to examine prior Texas authority as well as closely examine the language in the *Davalos* opinion.

1. Test Employed by Prior Texas Cases for Independent Counsel

A Texas test for independent counsel was set out by the San Antonio Court of Appeals in *Steel Erection Co. v. Travelers Indemnity Company*[42] and *Rhodes v. Chicago Insurance Company*[43] The operative holding in *Steel Erection* is as follows:

> Where the insurer is denying coverage, but at the same time demanding the right to defend the lawsuit on behalf of the insured, and where coverage, *vel non,* will depend upon the finding of the trier of facts as to certain issues in the main case, . . . the insurer is not in a position to defend the insured.[44]

Therefore, under the Texas rule, there are two requirements that must be satisfied for the insured to be entitled to independent counsel. The first requirement is that the insurer is denying coverage while at the same time exercising the right to defend the lawsuit. Stated in other words, the insurer is offering a defense pursuant to a reservation-of-rights letter. A reservation-of-rights letter is a unilateral written communication to a policy holder setting forth the company's assumption of the defense subject to coverage reservations.[45]

The same result can be accomplished by a nonwaiver agreement. A nonwaiver agreement is a bilateral agreement between the insurer and the insured that the insurer's defense of the action against the insured will not result in a waiver of any rights by the insurer to later assert some defense coverage. In contrast to a reservation-of-rights letter, the bilateral nature of the nonwaiver agreement requires the signature of the insured in order to be effective. With respect to the defense of insureds, nonwaiver agreements are rarely used today except in those circumstances where an insurer wishes to preserve the ability to allocate defense costs for indemnity payments.[46] It should be emphasized at this point that while the issuance of the reservation-of-rights letter may, under certain circumstances, trigger the right to

4.25 at 393 (4th ed.2001), 140 S.W.3d 685 at 689.

[42]392 S.W.2d 713 at 716.

[43]719 F.2d 116 at 121.

[44]392 S.W.2d at 716.

[45]*Western Casualty & Surety Co. v. Newell Manufacturing Co.*, 556 S.W.2d 74 (Tex. Civ. App.--San Antonio 1978, writ ref'd n.r.e.).

[46]*See Texas Ass'n of Counties County Gov't Risk Mgmt. Pool v. Matagorda County*, 52 S.W.3d 128 (Tex. 2000).

independent counsel, it does not in and of itself create such a right on behalf of the insured.

The second requirement under Texas law for an insured to be entitled to independent counsel is that "coverage, *vel non,* will depend upon the finding of the trier of fact as to certain issues in the main case."[47] In other words, if the findings in the main case would not be dispositive of coverage, there is no conflict and no right to independent counsel. The reason for this rule is based upon the potential conflict between the insurer and the insured. If the findings in the underlying case could be determined to support coverage, then obviously it would be to the insured's interest to have those findings made, and it would be in the best interest of the insurer to have those findings made in such a manner that would not support coverage. However, where the findings in the underlying case will not in any form or fashion affect coverage, there is no conflict between the insured and the insurer.

G. Test Announced in *Davalos*

In *Davalos*, the court provided the following holding:

> Ordinarily, the existence or scope of coverage is the basis for a disqualifying conflict. In the typical coverage dispute, an insurer will issue a reservation of rights letter, which creates a potential conflict of interest. *See* 1 ALLAN D. WINDT, INSURANCE CLAIMS AND DISPUTES § 4.20 at 369 (4th ed.2001).[48]

Many judges and commentators terminate their analysis of the *Davalos* opinion at this point in time. They then arrive at the erroneous conclusion that just because a reservation-of-rights letter has been issued, there is a question about the existence or scope of coverage and, therefore, the basis for a disqualifying conflict. However, the analysis ignores the remainder of the paragraph, as well as the analysis by Windt in his treatise on insurance claims and disputes. The remainder of the paragraph goes on to state:

> And when the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends, the conflict of interest will prevent the insurer from conducting the defense. *See Id.* at 370-71. On the other hand, when the disagreement concerns coverage but "the insurer defends unconditionally, there is, because of the application of estoppel principles, no potential for a conflict of interest between the insured and the insurer." *Id.* at 369.[49]

The supreme court has held that a reservation-of-rights letter will not necessarily create a disqualifying conflict. Only where the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends will the conflict be one that is disqualifying. This is consistent with the prior Texas authority on the subject announced the Fifth Circuit in *Rhodes v. Chicago Insurance Co.*,[50] and the San Antonio Court of Appeals in *Steel Erection Co. v. Travelers Indemn. Co.*[51] Moreover, this is consistent with the conclusions of Allan D. Windt on pages 370 and 371 of his treatise which was

[47] 392 S.W.2d at 716.

[48] 140 S.W.3d 685 at 689.

[49] 140 S.W.3d 685 at 689.

[50] 719 F.2d 116 (5th Cir. 1983).

[51] 392 S.W.2d 713 (Tex.Civ.App.--San Antonio 1965, writ ref'd n.r.e.).

cited with approval by the supreme court. Specifically, Windt states that:

> In short, the existence of a reservation of rights does not automatically give rise to a conflict of interest between the insurer and the insured with regard to the conduct of the insured's defense. The only conflict of interest that necessarily arises when the insurer reserves its right later to deny coverage is a conflict of interest between the insurer and the insured with regard to the existence of a duty to indemnify.
>
> The correct rule, therefore, is (1) that an insurer can lose its right to select the insured's defense counsel only if a conflict of interest exists between the insurer and the insured as to the defense, (2) that such a conflict of interest does not exist simply because the insurer has issued a reservation of rights letter, and (3) that a conflict of interest exists only if the facts that will be adjudicated in the lawsuit against the insured are the same facts upon which the existence of coverage depends.
>
> Not every reservation of rights creates a conflict of interest requiring appointment of independent counsel. It depends upon the nature of the coverage issue, as it related to the issues in the underlying case. If the issue on which coverage turns is independent of the issues in the underlying case, *Cumis* counsel (counsel selected by the insured) is not required. [Citations omitted.] A conflict of interest does not arise unless the outcome of the coverage issue can be controlled by counsel first retained by the insurer for the defense of the underlying claim.[52]

It in its holding, the supreme court held that where there is a disagreement over coverage and the insured defends unconditionally, there is no potential for conflict of interest because of the application of estoppel principles. The Texas Courts have recognized that the doctrines of waiver and estoppel cannot be used to create insurance coverage where none exist under the terms of the policy period.[53] However, there is authority supporting an exception to the rule. If an insurer assumes an insured's defense without declaring a reservation of rights or obtaining a non-waiver agreement, and with knowledge of facts indicating noncoverage, all policy defenses, including those of noncoverage, are waived, or the insured may be estopped from raising them.[54] The court in *State Farm v. Williams*, [55] noted that some jurisdictions hold that when an insurer assumes exclusive control of an insured's defense without reserving its rights and with knowledge of coverage, prejudice is conclusively foreseen. However, Texas does not follow that rule and requires that there be "clear and unmistakable" harm

[52] 1 WINDT § 4.20 at 370-371 (4th ed.2001).

[53] *Texas Farmers Insurance Co. v. McGuire*, 744 S.W.2d 601, 602 -03 (Tex.1988); *see Republic Insurance Co. v. Silverton Elevators, Inc.,* 493 S.W. 748, 751 (Tex. 1973).

[54] *Farmers Texas County Mutual Insurance Co. v. Wilkerson*, 601 S.W.2d 520, 522 (Tex.Civ. App. -- Austin 1980, writ ref'd n.r.e.); *Pacific Indemnity Co. v. Acel Delivery Service, Inc.*, 45 F.2d 1169, 1173 (5th Cir. 1973).

[55] 791 S.W.2d 542 at 553 (Tex.App.--Dallas 1990).

demonstrated.[56] In *Davalos*, the supreme court did not address the situation of where an insured defends without a reservation-of-rights letter, but no "clear and unmistakable" harm has been demonstrated by the insured.

IV. POST *DAVALOS* CASES

A. *Rx.Com, Inc V Hartford Fire Insurance Co.*[57]

1. Facts

Rx.com was sued by its founder and certain officers, directors and investors alleging that the defendants had forced Rosson, the founder, out of the company.

2. Policy

Hartford issued Rx.com a general liability policy which under Coverage B, provided, among other things, coverage for statements that libeled or slandered a person or his goods or services as well as for violation of a person's privacy rights.

3. Underlying Litigation

Rx.com tendered the lawsuit to Hartford but Hartford initially refused to defend. However, after the petition in the underlying suit was amended to include allegations for defamation and privacy rights violations Hartford tendered a defense pursuant to a reservation of rights. Hartford's defense was rejected because Rx.com claimed there was a conflict of interest. At the end of the litigation, counsel selected by Hartford entered an appearance. Eventually the underlying case settled with no payment by Rx.com.

4. Coverage Litigation

Rx.com sued Hartford for defense expenses it incurred after it made a demand for a defense. Hartford claimed that under the allegations in the amended petition, there was no right to independent counsel.

5. Holding

Following Davalos the court noted that "Not every reservation of rights creates a conflict of interest allowing an insured to select independent counsel. Rather, the existence of a conflict depends on the nature of the coverage issue as it relates to the underlying case. If the insurance policy (like the policy in this case) gives the insurer the right to control the defense of a case the insurer is defending on the insured's behalf, the insured cannot choose independent counsel and require the insurer to reimburse the expenses unless 'the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends.'"

The court held that in the case at hand "Rx.com has not shown that, as a matter of law, the facts to be decided in the underlying lawsuit are the same facts that would defeat coverage by triggering a policy exclusion. Hartford's reservation of rights letter did not invoke a coverage exclusion that would be established by proof of the same facts to be decided in the underlying lawsuit."

B. *Downhole Navigator, L.L.C. v. Nautilus Insurance Company*[58]

1. Facts

Downhole provides services to the oil drilling industry. In December of 2008 it was hired to redirect a well towards a better location within the desired production zone. It was alleged that Downhole damaged the well in the process. Suit was filed by its customer to recover the economic damages sustained as a result of the alleged damage to the well.

2. Policy

Nautilus issued a general liability policy covering the operations of Dowhole. Three exclusions were raised by Nautilus. The first was an exclusion

[56] *Id.* at 553.

[57] 426 F.Supp.2d 546 (S.D.TEX. 2006)

[58] 2011 WL 4889125 (S.D. Tex. 2011)

entitled "Exclusion-Testing or Consulting Errors and Omissions" ("Testing Exclusion") The second was an exclusion entitled "Exclusion-Engineers, Architects or Surveyors Professional Liability" ("Professional Liability Exclusion") The third was an exclusion entitled "Professional Liability Exclusion-Electronic Data Processing Services and Computer Consulting or Programming Services" ("Data Processing Exclusion")

3. State Court Litigation

The client filed suit in March of 2009 against Dowhole alleging that Downhole caused damage to the well and seeking direct and consequential damages resulting from the damages. Downhole submitted the petition to Nautilus who tendered a defense subject to a reservation of rights letter citing the exclusions as well as whether there was an "occurrence" or "property damage".

On April 27,2009, Downhole rejected the defense tendered by Nautilus asserting a right to independent counsel. Nautilus disagreed, asserting that Downhole was not entitled to independent counsel.

4. Coverage Litigation

Downhole sued Nautilus in federal court in the Southern District of Texas asking for a declaration of its right to independent counsel and seeking recovery of its defense costs. Nautilus asserted that Downhole was not entitled to independent counsel and that Downhole had breached the policy by rejecting its defense and that it owed no duty to defend or indemnify.

5. Holding

Both sides filed motions for summary judgment. The trial court noted that in Davalos the Texas Supreme Court had ruled that "under certain circumstances, however, an insurer may not insist upon its contractual right to control the defense." The trial court then went on to address what conflicts would prevent an insurer from controlling the defense. The court held that "in *North (sic) County Mut. Ins. Co. v Davalos*, the Texas Supreme Court considered those conflicts that might entitle an insured to select its own attorneys, stating that, 'ordinarily [a question about] the existence or scope of coverage is the basis for a disqualifying conflict.' 140 S.W. at 688. 'In the typical coverage dispute," the court explained, 'an insurer will issue a reservation of rights letter, which creates a potential conflict of interest.' *Id.* Under Texas law, 'when the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends,' a reservation of rights creates a 'conflict of interests [that] will prevent the insurer from conducting the defense.' In other words, a 'conflict of interest does not arise unless the *outcome* of the coverage issue can be controlled by counsel retained by the insurer for the defense of the underlying claim.'"

The court compared the allegations in the complaint to the reservation of rights letter and conclude that "the facts to be adjudicated' in the *Sedona* suit are not the same facts 'upon which coverage depends.' . . . At issue in the *Sedona* suit is whether Downhole performed its work negligently. But Nautilus did not reserve its right to disclaim coverage based on whether Plaintiff's work was negligent. Unlike *Northland,* Downhole has not shown that an insured-hired lawyer in the *Sedona* suit could control the "outcome" of the coverage issue before the court." . . "On this record, then, Plaintiff has not shown that the 'facts to be adjudicated' in the *Sedona* suit are the 'same facts upon which coverage depends.'"

V. WHEN INDEPENDENT COUNSEL IS REQUIRED

A. Reservation-of-Rights Letter - Some Causes of Action Covered; Some Not

In a situation where an insurer tenders a defense pursuant to a reservation-of-rights letter to an insured, where some of the causes of action are

covered and some are not, the right to independent counsel is triggered. In *Steel Erection Co. v. Travelers Indemnity Co.*,[59] the allegations included that the crane which had been damaged was under the care, custody and control of the insured (which would be excluded), or was being operated by an independent contractor (which would not be excluded). The court of appeals held that in that situation, because coverage could depend upon the outcome of the underlying case, the insured had a right to control its own defense.

Similarly, in *Rhodes v. Chicago Ins. Co.*,[60] the allegations included sexual misconduct (which would be excluded) as well as allegations of professional negligence (which would not be excluded). Again, the court in *Rhodes* found that because the outcome of the underlying case could determine the coverage issue, that the insured would have a right to independent counsel.[61]

Allan D. Windt opines that this situation would likewise create a conflict of interest that would require independent counsel:

> This is not to say, however, that a conflict of interest will not come under certain circumstances, arise with regard to the conduct of the insureds' defense. Specifically, a conflict over the existence of coverage will serve to create a conflict of interest with regard to the insured's defense when the insurers' potential liability could be reduced if the insured were defended in a particular manner. For example, assume that a plaintiff alleges that a defendant-insured is guilty of either negligence or an intentional tort because of his wrong doing, and the insurance policy does not provide coverage for intentional torts. The insurer, under those circumstances, would be benefitted, at the expense of the insured, if the insured's counsel shaped the defense so that, in the event he was unable to prove that the insured was not liable, the insured would be found guilty of an intentional tort. A conflict of interest, therefore, does exist in that situation.[62]

B. Manner of Defense

The supreme court in *Davalos* also lists four other situations which might justify an insured's refusal of an offer of defense. With respect to these four instances, the court held that an insured not might rightfully refuse to accept the insured's defense and appoint counsel of their own choosing at the expense of the insurer. These four situations are as follows:

> (1) When the defense tendered "is not a complete defense under

[59] 392 S.W.2d 713 (Tex.Civ.App.—San Antonio 1965, writ ref'd, n.r.e.).

[60] 719 F.2d 116 (5th Cir. 1983).

[61] This rule is consistent with the holdings in other jurisdictions. *See also Allstate Ins. Co. v. Long*, 446 N.Y.S.2d 742 (App.Div. 1981) (alleging both negligence and intentional torts); *Major Builders Corp. v. Commercial Union Ins. Co.*, 546 N.Y.S.2d 866 (App.Div. 1989) (where the complaint alleged negligence claims as well as contract claims (which are not covered)); *Nelson Elec. Contracting Corp. v. Transcontinental Ins. Co.*, 660 N.Y.S.2d 220 (App.Div. 1997) (where the petition asserted contribution and indemnity claims (which were covered) as well as breach of contract claims (which were not covered)).

[62] 1 WINDT § 4.20 at 372 -73.

> the circumstances in which it should of been,"
>
> (2) 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,"
>
> (3) When "the defense would not, under the governing law, satisfy the insured's duty to defend," and
>
> (4) When though the defense is otherwise proper, "the insurer attempts to obtain some type of concession from the insured before it will defend."[63]

The supreme court concluded that the insured may rightfully refuse an inadequate defense and may also refuse any defense conditioned on an unreasonable, extra-contractual demand that threatens the insured's independent legal rights. One example given by the court in *Davalos* was that Northern could not have required Davalos to dismiss his *Matagorda* suit as a condition for defending him. If such a demand had been made by Northern, Davalos would have been justified in rejecting the defense.[64]

VI. *PARTAIN V. MID-CONTINENT*

On January 20, 2012, Judge Ellison in the Southern District of Texas issued his opinion in *Partain v. Mid-Continent Specialty Services, Inc*. This case arises out of a copyright litigation brought in 2009 in a case styled *Kipp Flores Architects, LLC v. Hallmark Design Homes, LP, et al.* The underlying case is still pending to this day in the Southern District of Texas. In November 2009, Hallmark Design Homes, LP filed bankruptcy. However, the Kipp Flores case preceded as to Mr. Partain, who later filed bankruptcy in the case. The Kipp Flores v. Hallmark case was tendered to Mid-Continent who issued a reservation of rights letter and offered to defend the insureds. Mr. Partain, one of the insureds in the case, rejected Mid-Continent's defense and ordered that Mid-Continent provide the legal and factual basis for its position that there was no conflict of interest between the defense counsel appointed by Mid-Continent and Mr. Partain. Ultimately, the case resulted in a lawsuit brought first in Harris County and later removed to the Southern District of Texas.

A. The Coverage Lawsuit:

1. Plaintiffs' Claims:

Plaintiffs brought suit under the Texas Declaratory Judgment Act seeking a declaration there a conflict of interest and, therefore, Plaintiff should get to select its own counsel. Plaintiff also alleged causes of action for breach of contract and violations of the Texas Insurance Code and the Texas Deceptive Trade Practices Act. Both parties eventually filed cross-motions for summary judgment regarding the ability to select counsel. The Court first considered Plaintiff's summary judgment and ruled that, at the outset, Plaintiff was entitled to a defense under the Four Corners Rule. Next, the Court considered the right to select a defense counsel for the underlying matter. Before discussing Plaintiff's burden, the Court reasoned that the facts decided in the underlying case will be the same facts upon which his coverage is determined at a later possible coverage lawsuit.

2. Alleged Conflict and Court's Interpretation:

Plaintiff identified five issues presented in Mid-Continent's reservation of rights letter upon which coverage clearly depends that would be adjudicated in the underlying suit. The Court

[63] 1 WINDT § 4.25 at 393.

[64] 140 S.W.3d 685 at 689.

discussed each of these five issues in detail. The issued discussed are: (1) whether the alleged copyright infringement includes advertising injury which is covered by the policy; (2) whether the alleged infringement occurred within the policy period; (3) whether the alleged infringement was willful, negating coverage; (4) whether a party covered under the policy is responsible for the alleged infringement; and (5) whether Plaintiff's tendered notice of the claim to Mid-Continent was so late as to prejudice Mid-Continent's ability to defend the underlying case. The Court addressed each of these five issues in detail as discussed below.

The Court first considered whether the underlying suit would adjudicate facts regarding personal and advertising injury on which coverage depended under coverage via the policy. Plaintiffs argued that the allocations in the underlying case concerned "infringing advertising activities" by the Plaintiffs and, therefore, whether or not advertising occurred would be adjudicated. The Defendant countered arguing that under *Davalos* the same fact requirement was not met by the underlying case because the classification of the injury as advertising or not advertising would not be adjudicated in the underlying case. The court ultimately agreed with Mid-Continent that the underlying suit would not adjudicate whether or not advertising injury occurred. The court reasoned that under any proposed jury charge, the jury would not be faced with the question as to whether or not the infringement took place in advertising. As such, the court found that no disqualifying conflict of interest arose.

Next, the court considered whether the alleged infringement occurred within the policy period and whether that would be adjudicated in the underlying case. Plaintiff relied on the statement in Mid-Continent's reservation of rights letter that it would only pay for instances of alleged infringement that occurred during the policy period. Plaintiffs further contended that because they had asserted a statute of limitation defense, that the requirement of when the infringement occurred would be adjudicated in the underlying case. The court disagreed with Plaintiff arguing that in the underlying case the only infringement dates that would apply would be when the statute of limitations accrued, not when the infringement was committed. The court ultimately held that no matter how the court looked at the underlying case as to discovery date or accrual, the same facts would not be adjudicated in the copyright litigation, thus not giving arise to disqualifying conflict of interest.

The third area the court explored was whether or not the willfulness would be litigated in the underlying case, thus leaving the Plaintiff without coverage. The court analyzed the fact that the Federal Copyright Act provided an award of statutory damages and an increased amount based on the willfulness found by the court. However, the Court summarily held that the Plaintiffs' request in the underlying case for statutory damages made no mention of willful infringement, thus not leading to adjudication of willfulness in the underlying case.

Fourth, the court analyzed whether the underlying case would determine the responsibility for the alleged infringement. The court pointed out that Mid-Continent referenced in its reservation of rights that there were no defense obligations to parties not named as insureds under the policy. The court analyzed the insureds under the policy and determined that Plaintiffs failed to argue that a finding of joint and several liability would require the jury to make a determination of facts upon which coverage depended. Thus, the court concluded that joint and several liability determination did not give rise to disqualifying conflict of interest.

Finally, the court analyzed whether late notice to Mid-Continent would be

adjudicated in the underlying case. The court quickly concluded that late notice would not be adjudicated in any way in the underlying case and, therefore, no disqualifying conflict of interest existed.

The court went on to discuss the Plaintiff's breach of contact in DTPA claims and left for another day whether or not the Plaintiff violated the cooperation clause in the contract as a result of its failure to allow Mid-Continent to defend with its own counsel. Later, Judge Ellison considered this issue and ruled that Mid-Continent must show prejudice as a result of Plaintiff's refusal to allow Mid-Continent to defend with its own counsel in order to prove that Plaintiffs violated the cooperation clause. At this time, that case will likely be stayed pending the resolution of the underlying case and pending the appeal of the conflict of interest issue.