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Hypothetical:

An insured is a defendant in a tort action. The insurer unconditionally undertakes to provide the insured with a defense and indemnification, and assigns defense counsel to defend the insured. More than two years into the litigation, the insurer issues a reservation of rights (ROR) letter, asserting for the first time that the insured's coverage for the claim is limited to much less than the policy's full limit of liability, and much less than the damages claimed by the plaintiff. The insured then retains its own lawyer and both defense counsel (*i.e.*, the one assigned by the insurer and the one retained by the defendant) thereafter conduct the defense together. A year later, the insurer again changes its position on coverage, agreeing to cover any verdict or settlement up to the policy's full limit of liability. Shortly thereafter, the trial begins. The case settles during trial. The insurer pays the entire settlement. What ethical issues may have confronted the defense counsel hired by the insurer during the lawsuit?

Who is the assigned defense counsel's client: the insurer or the insured?

Under a typical modern policy of liability insurance, the insurer undertakes to defend the insured against claims within the scope of the policy's coverage. If and when the insured is sued for a claim within the scope of that undertaking, the insurer normally fulfills its defense obligation by retaining counsel to defend the insured. The insured defendant is the lawyer's actual client in the case, but the lawyer's fees and expenses are paid by the insurance company. This arrangement is often referred to as the "tripartite [*i.e.*, three-party] relationship."

The Lawyer's Code of Professional Responsibility does not expressly approve or disapprove of the tripartite relationship, but implicitly acknowledges and condones its existence, so long as the client is properly protected. Regarding defense counsel's obligation to maintain professional independence, the Ethical Considerations include the following admonitions:

Desires of Third Persons

EC 5-21

The obligation of a lawyer to exercise professional judgment solely on behalf of the client requires disregarding the desires of others that might impair the lawyer's free judgment. The desires of a third person will seldom adversely affect a lawyer unless that person is in a position to exert strong economic, political, or social pressures upon the lawyer. These influences are often subtle, and a lawyer must be alert to their existence. A lawyer subjected to outside pressures should make full disclosure of them to the client; and if the lawyer or the client believes that the effectiveness of the representation has been or will be impaired thereby, the lawyer should take proper steps to withdraw from representation of the client.

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EC 5-22

Economic, political or social pressures by third persons are less likely to impinge upon the independent judgment of a lawyer in a matter in which the lawyer is compensated directly by the client and the professional work is exclusively with the client. On the other hand, if a lawyer is compensated from a source other than the client, the lawyer may feel a sense of responsibility to someone other than the client.

EC 5-23

A person or organization that pays or furnishes lawyers to represent others possesses a potential power to exert strong pressures against the independent judgment of those lawyers. Some employers may be interested in furthering their own economic, political, or social goals without regard to the professional responsibility of the lawyer to an individual client. Others may be far more concerned with establishment or extension of legal principles than in the immediate protection of the rights of the lawyer's individual client. On some occasions, decisions on priority of work may be made by the employer rather than the lawyer with the result that prosecution of work already undertaken for clients is postponed to their detriment. Similarly, an employer may seek, consciously or unconsciously, to further its own economic interests through the actions of the lawyers employed by it. Since a lawyer must always be free to exercise professional judgment without regard to the interests or motives of a third person, the lawyer who is employed by one to represent another must constantly guard against erosion of professional freedom.

Those ethical considerations are enforced in the Disciplinary Rules. N.Y. Disciplinary Rule 5-107 provides, in pertinent part, as follows:

DR 5-107 [22 N.Y.C.R.R. § 1200.26] Avoiding Influence by Others than the Client.

- A. Except with the consent of the client after full disclosure a lawyer shall not:
1. Accept compensation for legal services from one other than the client.
 2. Accept from one other than the client anything of value related to his or her representation of or employment by the client.
- B. Unless authorized by law, a lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal service for another to direct or regulate his or her professional judgment in rendering such legal services, or to cause the lawyer to compromise the lawyer's duty to maintain the confidences and secrets of the client under DR 4-101 [1200.19] (B).

* * *

Thus, counsel assigned by an insurer to defend an insured owes that insured the same professional duties – including duties of loyalty and independent professional judgment – as if the insured had itself retained the lawyer and was paying him as personal counsel. The fact that an insurer happens to be paying the bills does not alter the lawyer's ethical obligations to his actual client, the insured. *Hartford Fire Ins. Co. v. Masternak*, 55 A.D.2d 472, 390 N.Y.S.2d

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949, 953 (4th Dep't 1977); *Schwartz v. Sar Corp.*, 19 Misc.2d 660, 195 N.Y.S.2d 496, 503, *rev'd on other grounds*, 9 A.D.2d 910, 195 N.Y.S.2d 819 (2nd Dep't 1959). In addition to the Code of Professional Responsibility, defense counsel's duties of loyalty and independence are affirmed in additional sources of ethical guidance. See generally, ABA MODEL RULES OF PROFESSIONAL CONDUCT 1.7, 1.8(f), and 5.4(c); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 134 (2000).

It is not well-settled whether the insurance company may also be deemed defense counsel's "client," at least in some contexts and for some purposes. For example, defense counsel apparently may disclose to the carrier otherwise privileged information regarding the defense and evaluation of a claim, even if such information might indirectly prejudice the insured. *E.g.*, *Goldberg v. American Home Assur. Co.*, 80 A.D.2d 409, 439 N.Y.S.2d 2 (1981) [proper for assigned defense counsel to send carrier reports on the facts of the lawsuit, even if those reports might be used by the carrier in defending its other insureds against defendant's cross-claims]. On the other hand, some courts have held that a lawyer defending the insured pursuant to an insurance policy does not thereby also represent the carrier. *Emons Indus., Inc. v. Liberty Mut. Ins. Co.*, 749 F.Supp. 1289, 1297, n. 7 (S.D.N.Y.1990) [lawyer defending insured did not thereby also represent its insurer, and so would not be disqualified by concurrent involvement in coverage litigation against same insurer]. Many view the insurer as nothing more than a third-party payer that is in no sense defense counsel's "client." See generally, O'Malley, Robert, *Ethics Principles for the Insurer, the Insured and Defense Counsel: the Eternal Triangle Reformed*, 66 TULANE L. REV. 511 (1991); Silver, Charles, *Does Insurance Counsel Represent the Company or the Insured?*, 72 TEX. L. REV. 1583 (1994).

Even if assigned defense counsel owes no ethical duty to the insurer as a client, he will undoubtedly still feel some commercial allegiance to it as a customer: it is the insurer that actually assigns the work to defense counsel, pays defense counsel, and might assign additional work in the future. In the context of the tripartite relationship, the Ethical Considerations and Disciplinary Rules quoted above are intended to protect the insured defendant from any improper effects that commercial allegiance might cause. Those parts of the Code of Professional Responsibility are also enforced in case law.

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For example, courts have held that assigned defense counsel may not advise or assist the insurer to assert any coverage defense against the insured, or deliberately notify the carrier of grounds to reserve its rights or deny coverage. *E.g.*, *Parsons v. Continental Nat'l. American Group*, 113 Ariz. 223, 550 P.2d 94 (1976) [improper for defense counsel to notify insurer of facts indicating that insured had committed an intentional tort, which was excluded from coverage; insurer issued reservation of rights based on that information]; *Employers Cas. Co. v. Tilley*, 496 S.W.2d 552, 561 (Tex. 1973) [at the carrier's request, and without the insured's knowledge, defense counsel unearthed facts to support the carrier's late notice defense to coverage, and supplied the carrier with evidence, research, and advice to support a denial of coverage on those grounds; carrier estopped from denying coverage]. As both a matter of professional ethics and law firm risk management, retained defense counsel should avoid arguing either for or against the existence of coverage, and should attempt to confine his efforts to interposing a zealous defense against the plaintiff's claim.

Does the insurer's ROR create a conflict of interest between the insured and insurer?

If an insurer undertakes to defend the insured unconditionally, there is usually no potential conflict between the insurer and the insured that is likely to involve defense counsel: the defendant and its carrier are usually united in interest in their desire to defend against the claim.

The potential for a conflict typically arises when the insurer agrees to defend only subject to a reservation of its rights. A minority of courts takes the view that **any** reservation of an insurer's rights automatically creates a conflict of interest between the insurer and the insured. *E.g.*, *Mobil Oil Corp. v. Maryland Cas. Co.*, 288 Ill.App.3d 743, 681 N.E.2d 552 (Ill.App. 1997) [the hypothetical at the beginning of this section is a simplified version of this case]. Under this view, there is a "conflict of interest" every time an insurer reserves its rights because a complaint demands damages in excess of a policy's applicable limit of liability, or demands uninsured punitive damages, or demands uninsured equitable relief. This minority view is apparently based on the feeling that a carrier — if it believes there might be either no coverage, or only limited coverage — may be tempted to provide only a token defense, or to reject reasonable opportunities to settle that would be advantageous to the insured. That is, where the potential exposures of the carrier and insured are significantly different, the carrier might be tempted to breach its

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contractual obligation of providing a good-faith defense. That reasoning is not persuasive: the potential for a breach lurks in every contractual relationship. Just because the carrier's and insured's interests are *not identical* does not mean they are necessarily *in conflict*, and not every situation in which a carrier might be tempted to breach its contractual obligation of good faith presents a true conflict of interest.

Most courts take the view that not every reservation of rights automatically creates a conflict between the carrier and its insured. Instead, a true conflict of interest arises only when the facts to be adjudicated in the lawsuit include the same facts that will determine the existence or non-existence of coverage. That is, a true conflict of interest exists only when the outcome of the coverage issue can be controlled or influenced by the way in which the case is defended. *E.g.*, *Public Service Mut. Ins. Co. v. Goldfarb*, 53 N.Y.2d 392, 442 N.Y.S.2d 422, 425 N.E.2d 810, 815 (1981) [claim of sexual abuse by dentist in course of dental treatment; true conflict existed because, assuming liability, insurer's interest would best be served by verdict of intentional injury outside course of dental services, but insured's interest would best be served by verdict of unintended injury in course of dental services]; *Rimar v. Continental Cas. Co.*, 50 A.D.2d 169, 376 N.Y.S.2d 309, 313 (4th Dep't 1975) [accounting malpractice case; true conflict existed because, assuming liability, insurer's interests would be best served if liability were premised on finding of fraud, but insured's interests would be best served if liability were premised on finding of negligence]; *Utica Mut. Ins. Co. v. Cherry*, 45 A.D.2d 350, 358 N.Y.S.2d 519, 523 (2nd Dep't 1974), *aff'd*, 38 N.Y.2d 735, 381 N.Y.S.2d 40, 343 N.E.2d 758 (1975) [wrongful death case; true conflict existed because, assuming liability, insurer's interests would best be served by verdict that defendant had intentionally caused harm, but defendant's interests would best be served by verdict that he had been merely negligent]; *Steinman v. Silbowitz*, 276 A.D.2d 299, 714 N.Y.S.2d 209 (1st Dep't 2000) [no true conflict where defendant and insurer share a single, common interest in defeating the claim made against defendant; disagreements about trial or settlement strategy, without more, do not present a conflict of interest]; *Ottaviano v. Genex Cooperative, Inc.*, 3 Misc.3d 1024, 775 N.Y.S.2d 802 (Sup. Ct., Erie Co., 2004) [true conflict exists between interests of insured and insurer if a policy exclusion exempts some, but not all, of insured's potential liability from coverage, such that insurer's interest in minimizing covered liabilities conflicts with insured's interest in minimizing all its liabilities].

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Courts following this majority view examine each case individually, to determine whether – in the specific factual and legal context of the case – a particular reservation of rights presents an actual or potential conflict of interest. Most courts would therefore say that the hypothetical ROR above does not present a true conflict of interest, unless the insured can point to some way in which the outcome of the coverage issue (*i.e.*, the dispute over the amount of the policy’s applicable limit of liability) can be controlled or influenced by the way in which the underlying claim is defended.

If there is a true conflict between the interests of the carrier and those of the insured, what should the assigned defense counsel do about it?

If a conflict arises between the interests of an insurer and its insured, the interests of the defendant/insured must – repeat: **must** – be paramount as far as defense counsel is concerned. Defense counsel’s primary and overriding allegiance must be to the defendant he represents in the action, not to the carrier. *Jackson v. Trapier*, 42 Misc.2d 139, 247 N.Y.S.2d 315, 316 (1964) [the insured is defense counsel’s client, even though an insurer may have retained that counsel and is paying him; defense counsel may not represent any interest adverse to the insured, not even the carrier’s]; *American Employers Ins. Co. v. Goble Aircraft Specialties, Inc.*, 205 Misc. 1066, 131 N.Y.S.2d 393, 401 (Sup.Ct., N.Y.Co., 1954), *appeal withdrawn*, 1 A.D.2d 1008, 154 N.Y.S.2d 835 (1st Dep’t 1956) [defense counsel, retained by an insurer to defend its insured, owes the insured “an undeviating and single allegiance;” he must give the insured a vigorous defense and it “is immaterial that such procedure increases the cost to the carrier beyond the coverage limit” of the policy; *dicta*].

When and if such a conflict arises, defense counsel should not simply ignore it and hope it will go away (it probably will not). Rather, defense counsel should address and attempt to resolve the problem. At the very least, defense counsel has an obligation to bring the conflict to the insured’s attention and explain its potential significance. *Employers Cas. Co. v. Tilley*, 496 S.W.2d 552 (Tex. 1973). Defense counsel may also attempt:

- to persuade the insurer to change its position, especially if it is mistaken or ill-advised;
- to advise the insured whether to demand that the insurer agree to pay for independent counsel, selected by the insured, to represent the insured’s interests;
 - In most states, including New York, a true conflict between the insurer and insured entitles the insured to retain independent counsel at the insurer’s expense, either

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instead of or in addition to the defense counsel assigned by the insurer. *E.g.*, *Public Service Mut. Ins. Co. v. Goldfarb*, 53 N.Y.2d 392, 442 N.Y.S.2d 422, 425 N.E.2d 810, 815 (1981). While the failure of an attorney to advise the client of the right to retain independent counsel at the insurer's expense could give rise to a violation of the Disciplinary Rules and the imposition of sanctions, such failure does not by itself create a legally cognizable claim for legal malpractice. *Sumo Container Station, Inc. v. Evans, Orr, Pacelli, Norton & Laffan, P.C.*, 278 A.D.2d 169, 170-171, 719 N.Y.S.2d 223, 224 (1st Dep't 2000); *Schafrann v. N.V. Famka, Inc.*, ___ A.D.2d ___, 787 N.Y.S.2d 315, 316 (1st Dep't 2005).

- to advise the insured whether to retain independent counsel at its own expense, to represent the insured against the insurer; *e.g.*, as an adversary in a declaratory judgment action.

Assigned defense counsel is usually not obligated actually to represent the insured *against* the insurer. Assigned counsel is typically hired, not to service all of an insured's legal needs, but only for the limited purpose of defending against a specific claim; an attorney hired to do a specific thing does not act wrongfully or commit malpractice if he declines to assume additional obligations outside the scope of that engagement. In addition, representing the insured against the insurance company will, in many instances, run afoul of Disciplinary Rule 5-101(a):

DR 5-101 [1200.20] Conflicts of Interest - Lawyer's Own Interests.

- A. A lawyer shall not accept or continue employment if the exercise of professional judgment on behalf of the client will be or reasonably may be affected by the lawyer's own financial, business, property, or personal interests, unless a disinterested lawyer would believe that the representation of the client will not be adversely affected thereby and the client consents to the representation after full disclosure of the implications of the lawyer's interest.

When an insurer defends under a reservation of rights that creates a true conflict, assigned defense counsel should carefully consider how that might affect the defense of the case, and should keep alert to the conflict at every stage of the litigation. For example, in a case mixing covered and non-covered claims, if defense counsel gets all covered claims dismissed — leaving only non-covered claims in the case — the insurer will probably regard its defense obligation as ended and withdraw from the case, leaving the insured to pay for his own defense. Or, an insurer might press defense counsel to devote all his time and effort to defending against only covered claims, and to the neglect of the non-covered claims. These are just two possible examples of how a true conflict of interest might affect the defense of a case: myriad scenarios presenting such problems could be imagined, and there is no one best way to resolve them all. Although each case is *sui generis*, successfully resolving such issues will always depend on

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assigned defense counsel's (a) being alert to the potential coverage consequences of his own decisions, (b) remaining undeviatingly loyal to his client, the insured, (c) making independent professional judgments to protect the insured's interests, and (d) consulting closely with the insured and keeping him informed.

Assume the plaintiff offers to settle within the insurer's policy limit, but for more than the reduced policy limit asserted in the insurer's ROR. If the insured and its privately retained counsel demand that the insurer accept plaintiff's offer, but the carrier refuses, what are counsel's obligations?

The assigned defense counsel is obligated to make his own independent assessment of the insured's exposure, including the likelihood of a defense verdict and, assuming liability, the likely amount of the insured's exposure. In making that assessment, assigned defense counsel should consider the insured's potential exposure to liability that would not be covered by insurance; *e.g.*, liability for a non-covered claim, for amounts in excess of applicable policy limits, or for punitive damages. Assigned counsel should candidly advise both the insurer and the insured of that assessment and the range of likely outcomes, including the risks to the insured's uninsured interests. Depending on that independent assessment, assigned defense counsel may either:

- recommend accepting plaintiff's settlement offer;
- recommend settlement, but only at a lower figure or on different terms; or
- recommend against settlement.

In making his recommendations, assigned counsel should not simply adopt the insurer's view as his own, but must exercise his own independent professional judgment. Of course, that does not mean assigned counsel may simply agree to the proposed settlement without the insurer's authority; if he does, he will ultimately pay the settlement out of his own funds.

Note that, under the majority rule explained above, a difference of opinion about whether to settle at a particular figure would not present a true conflict of the kind that would require the insurer to pay for the insured to retain independent counsel. It could, however, present a potential breach of the insurer's duty of good faith. In the hypothetical case outlined above, the insured already has his own retained counsel. That retained counsel should do what he can to (a) persuade the insurer to accept the proposed settlement and (b) create a documentary record to support a bad-faith claim if the defendant winds up facing an excess-of-policy-limits judgment.

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In real life, an insured will seldom have his own retained counsel involved in a case. If the insured favors a particular settlement, but the insurer refuses to settle at that figure (or at all), it would be appropriate for the assigned defense counsel to:

- provide both the insured and the insurer with a straightforward evaluation of the range of likely outcomes and the risks they pose for the insured, pointing out that the most certain way to protect the insured's uninsured interest would be to settle within the policy limits;
- advise the insured to demand that the carrier settle the case;
- advise the carrier that the insured is concerned about his potential uninsured excess exposure and has demanded the case be settled; and
- advise the insured concerning his right to retain his own personal counsel, at his own expense, to try to persuade the insurer to settle and to create a documentary record to support a potential bad-faith claim.