Assessing Conflicts of Interest in the Tripartite Relationship

By Laura A. Foggan and Elizabeth Eastwood

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The “tripartite” relationship refers to the relationship among the three parties when a lawyer is hired by an insurer to defend a suit against its policyholder. That multifaceted relationship can present actual or potential conflicts between the interests of the insurer and insured. This article reviews the sources of law governing whether a conflict exists and a series of scenarios that may pose actual or potential conflicts between the interests of the insurer and its policyholder. We also discuss how these issues may arise in the particular context of environmentally related liability and coverage cases.

A variety of sources of law should be consulted in determining whether a conflict exists in the tripartite relationship when a lawyer is hired by an insurer to defend a suit against its policyholder. In particular, state statutes, the insurance contract itself, insurance case law, standards of professional ethics for attorneys, or some combination of these may provide important guidance in determining whether any true conflict of interest exists.

State Statutes

A few states—Alaska, California, and Florida—have enacted statutes that address when a conflict of interest exists between an insurer and its policyholder with respect to the defense of an underlying lawsuit.

The California statute provides that a conflict of interest “may” exist, “when an insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim . . . .”1 The statute explicitly provides that a conflict of interest does not exist as to (1) allegations or facts in the litigation for which the insurer denies coverage; (2) claims for punitive damages; or (3) claims for damages in excess of the insurance policy limits. If a conflict does exist, the statute requires the insurer to “provide independent counsel to the insured,” unless the insured waives, in writing, the right to independent counsel after disclosure of the conflict.2

Unlike the California statute, which draws distinctions between situations that do give rise to conflicts of interest and those that do not, Florida’s Claims Administration statute assumes a conflict of interest between the insurer and the policyholder whenever the insurer asserts a coverage defense. When the insurer does assert a coverage defense, the statute requires the insurer either to (1) obtain a nonwaiver agreement from the policyholder, after “full disclosure of the specific facts and policy provisions upon which the coverage defense is asserted and the duties, obligations, and liabilities of the insurer during and following the pendency of the subject litigation”; or (2) retain “independent counsel which is mutually agreeable to the parties.”3
Cases applying the Florida Claims Administration Statute have held that the term “coverage defense” as used in subsection (2) means only a “defense to coverage that otherwise exists and does not include disclaimer of liability based on complete lack of coverage for loss sustained.”

The Alaska statute, which became effective on July 1, 1995, bears substantial resemblance to the California statute. Like the California statute, the Alaska statute provides that a conflict of interest is not created by (1) a claim for punitive damages; (2) a claim for damages in excess of the policy limits; or (3) claims or facts in a civil action for which the insurer denies coverage. The statute further states, however, that (c) Notwithstanding (b) of this section, if the insurer reserves the insurer’s rights on an issue for which coverage is denied, the insurer shall provide independent counsel to the insured . . . .

Other states have considered proposed legislation to govern when a conflict of interest exists between an insurer and its policyholder that entitles a policyholder to representation by independent counsel. For example, the Washington state legislature has considered a bill, opposed by the insurers, that would create an absolute policyholder right to select independent counsel to defend it at its insurer’s expense whenever an insurer reserves its rights to contest indemnity coverage for an environmental claim.

If the approach is even-handed legislation governing the existence of conflicts of interest and the necessity for independent counsel can benefit everyone. A statute that provides clear guidance as to what constitutes a conflict of interest giving rise to a need for independent counsel, and which fairly takes into consideration the legitimate interests of both policyholders and insurers, can eliminate uncertainty and reduce litigation between insurers and their policyholders over these issues.

The Insurance Contract Itself and Insurance Case Law

Obviously, a direct source of the mutual rights and obligations of the insurer and its policyholder is the insurance contract. Many insurance contracts are silent on what constitutes a conflict of interest between the insurer and the policyholder, or what impact such a conflict of interests has on the insurer’s contractual rights relating to the defense of suits against the policyholder. Some insurance contracts minimize the potential for conflicts of interest in the tripartite relationship. For example, defense reimbursement policies under which the policyholder controls its own defense but defense costs reduce the limit of liability sidestep much of the potential for conflicts of interest in the defense of the underlying action. There may still be disagreement—and potential conflict—on issues such as the selection of counsel and settlement, however.

Nevertheless, most insurance contracts at least set out the insurer’s right to control the defense and settlement of suits against the insured or to designate counsel to defend the policyholder. For example, general liability and automobile liability policies often expressly endow the insurer with the unqualified right to “defend any suit against the insured” seeking damages on account of bodily injury or property damage to which the policy applies, and to “make such investigation and settlement of any claim or suit as it deems expedient…”

Notwithstanding the insurer’s unqualified contractual rights under the policy, both courts and legislatures have engrafted limitations on the insurer’s involvement in the policyholder’s defense.
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where there is a conflict of interest between the insurer and its policyholder. Some courts addressing this issue have explicitly suggested that the insurance contract itself should speak to the conflict of interest problem.

In many jurisdictions there is substantial case law specifically addressing what constitutes a conflict of interest between an insurer and a policyholder, and what consequences flow from the existence of such a conflict. Even when there is no authority squarely addressing the conflict issue, guidance may be offered by insurance case law on related topics, including the application of the “common interest” doctrine and other issues surrounding the disclosure of information relating to underlying claims.

Standards Governing Professional Ethics of Attorneys

Guidance on insurer-policyholder conflict of interest issues is also afforded by standards governing the professional ethics of attorneys, which are found in sources including the Model Code of Professional Responsibility, the Model Rules of Professional Conduct, state-specific ethics rules, ethics opinions, and the Restatement (Third) of the Law Governing Lawyers (Proposed Final Draft No. 1, March 1996). Case law relating to attorney malpractice and attorney disqualification may also be relevant.

Many sources on attorney professional ethics provide guidance to insurers by way of analogy because they focus on the attorney-client relationship rather than the insurer-policyholder relationship. Model Rule 1.7 does include two comments that directly address the tripartite relationship. In discussing situations in which a party other than the client pays the attorney, one comment states that “when an insurer and its insured have conflicting interest in a matter arising from a liability insurance agreement, and the insurer is required to provide special counsel for the insured, the arrangement should assure the special counsel’s professional independence.”

A second relevant comment addressing the duties of independent counsel states that “[t]he representation of an insured by the insurance company’s lawyer also presents a potential conflict of interest. For example, problems arise when a course of action would be beneficial to the client-insured but would be detrimental to the insurer that employs or pays the lawyer. The Comment to Rule 1.7(b) states that while a lawyer’s fee may be paid by a source other than the client, the client must be informed of that fact and must consent . . . Rule 1.7 requires that the arrangement not compromise the lawyer’s duty to loyalty to the client.”

The Restatement (Third) of the Law Governing Lawyers may also have a direct application to these issues. Although the Restatement has not yet been finalized, drafts of the document have included specific, and highly controversial, comments concerning the tripartite relationship that arises when a lawyer is hired by an insurer to defend a suit against its policyholder.

Common Situations Giving Rise to Potential Clients

A host of situations may pose actual or potential conflicts between the interests of the insurer and its policyholder, and, in some of these situations, courts have explicitly concluded that independent counsel must be afforded to the insured. Examples of common areas where conflicts may arise are reviewed below, together with observations about whether they call for the use of
independent counsel to protect the interests of the insureds. Several situations that may arise in cases involving coverage for environmental liabilities are highlighted.

**Insurer Covers Multiple Insureds with Adverse Interests**

In many cases an insurer will have a duty to defend two insureds whose interests are adverse to each other, and may be adverse to the insurer. The classic illustration of this situation is in the context of auto liability insurance. For example, in *Murphy v. Urso*, 430 N.E.2d 1079 (Ill. 1981), a passenger injured in an auto accident filed suit against the driver and the owner of the vehicle, and an issue existed as to whether the driver had permission to use the vehicle. The driver’s interests conflicted with those of the owner, and with those of the insurer, because the driver would not be insured under the owner’s policy unless he was operating the vehicle with permission. Under these circumstances, the Illinois Supreme Court held that the conflicts of interest prevented the insurer from controlling the defense of the driver. 430 N.E.2d at 1085.

It is also relatively common for two drivers who are involved in an accident, and who by coincidence are insured by the same carrier, to sue one another, thus triggering the insurer’s duty to defend each against the other. In this situation the insurer is not permitted to control the defense of either policyholder, and must retain independent counsel for each.\(^{10}\)

Of course, the problem of multiple insureds whose interests conflict is not limited to the auto liability context.\(^{11}\) When the interests of multiple insureds conflict with one another, by definition the insurer cannot share all interests in common with each of its policyholders. In this situation, the insurer may be required to provide not only separate, but independent counsel for its insureds.

In environmental cases, there are several contexts where an insurer may have multiple insureds – sometimes with adverse interests – involved in the same claim. A claim may arise due to activities of a subcontractor or lessee that is an additional insured under the policy of an insured that is also named in the suit. Alternatively, multiple policyholders may be sued for cleanup at the same site, perhaps with different types of responsibility for the loss. For example, an insurer may have issued coverage to a site owner-operator, as well as to a generator or transporter of hazardous waste. In these cases, if a defense obligation exists, it is necessary for the insurer to ensure that the defense is conducted consistent with the interests of each insured.

**Coverage not Disputed, but Policyholder’s Exposure Exceeds Limits**

Claims for damages in excess of the applicable policy limits raise the potential for a conflict of interest between an insurer and its policyholder. This is true because the insurer and policyholder may take opposing views as to whether and when a claim should be settled. The policyholder will usually prefer to have a case settled quickly and within policy limits to minimize any possibility of an excess judgment. The insurer, whose exposure is capped at its policy limits, may prefer to try the case, or to attempt to negotiate a more favorable settlement than that initially offered by the claimant.\(^{12}\)

The fact that a policyholder’s exposure in a given suit exceeds the coverage limits, standing alone, generally will not entitle the policyholder to representation by independent counsel.\(^{13,14}\) Instead, courts often give the insurer an additional incentive to consider its policyholder’s
interests in settlement by allowing the policyholder to recover against the insurer where the latter’s bad faith (or in some jurisdictions merely negligent) refusal to settle within limits ultimately results in an excess judgment against the policyholder.

Because environmental cleanups are often costly and because a responsible party can often be held jointly and severally liable for the entire cost, hazardous waste related actions frequently involve the potential for an excess verdict. As noted above, the potential of excess liability above the indemnity limits of a defending primary insurer will not—standing alone—create a conflict requiring independent counsel.

**Coverage not Disputed, but Policyholder Has Large Deductible**

Where the policyholder has a large deductible, the incentives discussed previously may be reversed—under these circumstances, a potential conflict exists because the insurer might prefer to settle for an amount within, or close to, the deductible while the policyholder might prefer to try the case in the hope of avoiding liability altogether. This potential conflict, however, generally does not entitle the policyholder to independent defense counsel.

Moreover, where the relevant insurance contract explicitly entitles the insurer to make any settlement it deems expedient, courts generally uphold the insurer’s right to settle, notwithstanding its policyholder’s objection, even when the settlement will require the policyholder to pay large deductible amounts. Still, a minority of courts, have held that where a substantial deductible is involved, the insurer must obtain the policyholder’s consent to settlement, even in the absence of policy language imposing such a requirement. However, even these courts have not suggested that the existence of a large deductible, standing alone, entitles the policyholder to representation by independent counsel.

**Coverage not Disputed, but Insurer Sharply Restricts Defense Expenditures**

The interests of the insurer and its policyholder may also conflict “when the insured expects the best possible defense and the insurer expects a cost-effective defense.” As one commentator points out, extreme cost containment measures imposed by insurers may expose the insurer to bad faith liability—and the defense counsel to malpractice liability—for inadequate defense preparation and trial presentation.

Douglas Richmond, “The Tripartite Relationship Between Insurer, Insured and Insurance Defense Counsel.” 73 Neb. L. Rev. 265 (1994), has observed that the opposite problem can arise if an insurance policy gives the insurer the right to control the defense but provides that defense costs reduce the policy limit.

Mr. Richmond states that in this situation, “[a]n insured is potentially prejudiced every time her appointed counsel acts, since every dollar the attorney earns in fees reduces the available coverage.” Richmond therefore opines that in such cases, “insureds must always be timely informed of defense expenditures and the amount of remaining coverage.” This situation is not likely to arise very frequently, however, because most insurance policies that contain defense-in-limits provisions require the insurer to reimburse the policyholder’s defense costs rather than giving the insurer the right to control the policyholder’s defense. Further, even Mr. Richmond
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does not assert that the conflict he describes should require that the insured be afforded independent counsel subject to only the policyholder’s control of the defense.

The potential for conflict caused by cost-containment efforts plainly does not entitle the insured to independent counsel, however. Indeed, it is clear that the insurer need only pay reasonable fees of defense counsel, even when independent counsel is required.

Some environmental cases may be candidates for disputes over the necessity of expansive defense expenditures. For example, an insured may wish to obtain advice or testimony from multiple consultants on issues relating to liability or a cleanup plan. The question of whether the fees for such scientific testimony are necessary and reasonable can prompt disputes between the policyholder seeking a “gold-plated” defense and the insurer seeking to impose reasonable constraints on costs and attorney’s fees.

Coverage Not Disputed, But Insurer and Policyholder Disagree on Manner in Which Defense Should Be Conducted

A policyholder will occasionally contend that a conflict of interest exists between itself and its insurer because the two disagree at the outset—as a matter of judgment not tied to any objective conflict of interest—as to how the underlying claim should be defended. Where the insurance contract expressly gives the insurer the right to control the defense, courts usually enforce that right, but a policyholder may be entitled to independent counsel where the insurer proposes to handle the defense in a manner that could severely harm the policyholder (e.g., if it would put the policyholder out of business).

In Roussos v. Allstate Insurance Co., 655 A.2d 40, 44 (Md. Ct. Spec. App.), cert. denied, 663 A.2d 73 (Md. 1995), one court has explicitly refused “to extend an insurer’s duty to provide independent counsel to a situation where the insured merely disagrees with the manner in which he or she is being defended.” In Roussos, the policyholder challenged her insurer’s right to control the defense of a personal injury action arising from an auto accident. The insurer believed the policyholder was likely to be found liable and wanted to settle the action expeditiously, while the policyholder, who believed that she had been sued unjustly and wished to maintain her clean driving record, opposed settlement. Based on this disagreement, the policyholder contended that she was entitled to representation by counsel of her own choosing, at the insurer’s expense. Rejecting this argument, the Maryland Court of Special Appeals reasoned that “[a]lthough these objectives are not identical, they are simply not adverse.” The Roussos court also rejected the policyholder’s arguments that she was entitled to representation by independent counsel because (1) the claimant sought damages in excess of her policy limits; and (2) she and the insurer were adversaries in two proceedings before the state insurance commission regarding the amount of coverage provided by her policy. The court further stated that “[a]n insurer’s right to control the litigation against its insured is essential to protect the insurer’s financial interest in the outcome of the suit.”

A disagreement concerning defense strategy may entitle a policyholder to separate counsel, however, where the insurer’s proposed course of action could result in severe adverse consequences to the policyholder. For example, in 69th Street and 2nd Ave. Garage Associates, L.P. v. Ticor Title Guarantee Co., 622 N.Y.S.2d 13, 14 (App. Div., 1st Dept.), appeal denied,
661 N.E.2d 999 (N.Y. 1995), a New York appellate court held that a policyholder was entitled to counsel of its own choosing where the policyholder and the insurer disagreed on defense strategy, and where the continued viability of the policyholder’s business arguably depended on a quick resolution of the underlying suit, whereas the insurer could afford to proceed at a “leisurely” pace. The court stated as follows:

The interests of Garage Associates and Ticor diverged seriously here, though each wished to defeat the claim of the cond-op. Ticor, having insured the title of a heavily mortgaged property, could proceed leisurely. Garage Associates needed a quicker resolution to keep open the possibility of refinancing, to retain customers and employees, and to stay in business. There was a crucial conflict of interests between them, and Garage Associates had the right to its own attorneys.25

The court acknowledged that the insurance contract entitled the insurer to control the policyholder’s defense, but concluded that the insurer’s right was “overridden” by the policyholder’s right to independent counsel in a conflict of interest situation.26 Although most courts enforce the insurer’s contractual right to control its policyholder’s defense, a few courts will “override” if the stakes which rest on the contested defense strategy are high enough for the policyholder.

**Coverage Not Disputed, But Policyholder Opposes Settlement (e.g., Due to Reputational Damage)**

Some cases raise the potential for conflicts in the resolution of the claim because the policyholder, fearing damage to its reputation or some similar harm, opposes any settlement, even a settlement completely within policy limits.27

Courts typically have not treated this situation as creating a conflict of interest that entitles a policyholder to separate counsel. Indeed, at least where the insurance policy gives the insurer the right to make any settlement that it deems expedient and does not expressly require the insurer to obtain policyholder’s consent to settlement, courts generally uphold an insurer’s decision to settle even over its policyholder’s objections.28

Where the insurance contract at issue is silent as to whether the insurer has the exclusive right to settle, however, an insurer may be required to obtain the policyholder’s consent before settling, even if the proposed settlement amount would fall entirely within the policy limits.29

**Underlying Complaint Seeks Punitive Damages**

A conflict of interest between an insurer and its policyholder may also be found to exist when the underlying complaint against the policyholder seeks punitive damages and the insurance policy expressly excludes coverage for punitive damages, or the relevant jurisdiction prohibits insurance coverage for punitive damages on public policy grounds. In this situation, some courts believe that independent counsel is required because the insurer may not have a sufficient incentive to defend vigorously against the punitive damage claim.

Treatment of this situation varies among jurisdictions. As noted earlier, California Civil Code § 2860 explicitly provides that a claim against the insured for punitive damages, standing alone,
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does not entitle the insured to independent counsel at the insurer’s expense. The same is true of the applicable Alaska statute. Alaska Stat. § 21.89.100(b)(1).

On the other hand, in *Nandorf, Inc. v. CNA Insurance Cos.*, 479 N.E.2d 988, 992 (Ill. App. 1st Dist. 1985), an Illinois appellate court held that independent counsel was required where the insured was sued for a relatively small amount of compensatory damages and a much larger amount of punitive damages. The *Nandorf* court stated, however, that it did not intend “to imply that an insured is entitled to independent counsel whenever punitive damages are sought in the underlying action.” The court reasoned that independent counsel was necessary in the case before it because punitive damages formed a substantial portion of the policyholder’s potential liability, such that the insurer’s disclaimer of coverage for punitive damages “left Nandorf with the greater interest and risk in the litigation.”

It is possible that a private action seeking recovery for environmental harm might seek modest compensatory damages but substantial punitive damages. As it is in other claim contexts, this scenario is likely to be fairly rare in hazardous waste settings. However, there may be other scenarios in environmental cases where the bulk of the policyholder’s potential liability is uninsured. In a Superfund cleanup action, for example, an insured may face uninsured injunctive or equitable relief, perhaps combined with more modest exposure for the insured damages. In such a setting, the policyholder may contend that it should have the ability to influence defense strategy.

**Insurer Disputes Coverage and Reserves Rights**

Conflict of interest questions most frequently arise in situations where the insurer has a duty to defend the policyholder, but disclaims (in whole or in part) a duty to indemnify based on one or more coverage defenses. The issuance of a reservation of rights as to indemnity coverage is characteristic of most environmental coverage cases today. This is true because of the widespread use of pollution exclusions, the coverage issues relating to the nature of relief sought in cleanup cases (for example, whether cost-recovery claims seek insured “damages”), the potential for environmental harm that is expected or intended because it results from routine business practices, and a host of other coverage issues that are not unique to the environmental setting (for example, late notice, voluntary payments, and so forth). Courts and legislatures in some jurisdictions have determined that a policyholder is entitled to representation by independent counsel whenever the insurer issues a reservation of rights. Courts and legislatures in other jurisdictions, however, have declined to adopt such a *per se* rule and instead determine whether independent counsel is necessary based on (1) whether the insurer would be able to direct the insured’s defense in a manner adverse to the insured on the disputed coverage issue; and/or (2) which party, insurer or insured, bears the greater financial stake in the underlying litigation.

The following jurisdictions appear to have adopted a *per se* rule that the policyholder is entitled to independent counsel whenever an insurer issues a reservation of rights:

**Alabama:** *L & S Roofing Supply Co., Inc. v. St. Paul Fire & Marine Ins. Co.*, 521 So. 2d 1298, 1303 (Ala. 1987) (adopting holding of Washington Supreme Court that insurer defending under
reservation of rights is subject to an “enhanced obligation of good faith,” which includes an understanding that defense counsel’s only client is the insured

**Arizona:** *United Services Auto. Assoc. v. Morris*, 741 P.2d 246, 251-52 (Ariz. 1987) (en banc) (“[t]he insurer’s reservation of the privilege to deny the duty to pay relinquishes to the insured control of the litigation”)

**Florida:** F.S.A. § 627.426(1)(b)3 (West 1996) (absent non-waiver agreement, when insurer reserves rights, insured is entitled to “mutually acceptable” independent counsel)

**Kentucky:** *Medical Protective Co. v. Davis*, 581 S.W.2d 25, 26 (Ky. App.), review denied (Ky. Ct. 1979) (when insurer offers defense under reservation of rights, “the insured has the right to refuse the proffered defense and conduct his own defense”)

**Louisiana:** *National Union Fire Ins. Co. v. Circle, Inc.*, 915 F.2d 986, 991 (5th Cir. 1990) (Louisiana law) (insurer that reserves rights discharges contractual obligation to defend by engaging separate counsel to represent insured); *Dugas Pest Control of Baton Rouge, Inc. v. Mutual Fire, Marine and Inland Ins. Co.*, 504 So. 2d 1051, 1054 (La. Ct. App. 1st Cir. 1987) (“[i]f insurer chooses to represent the insureds but deny coverage, it must employ separate counsel”)

**Massachusetts:** *Three Sons, Inc. v. Phoenix Ins. Co.*, 257 N.E.2d 774, 776-77 (Mass. 1970) (insured did not breach duty to cooperate by refusing to accept insurer’s defense under reservation of rights)

**Missouri:** *State Farm Mut. Auto Ins. Co. v. Ballmer*, 899 S.W.2d 523, 526 (Mo. 1995) (en banc) (insured has the right to reject defense under reservation of rights); *Butters v. City of Independence*, 513 S.W.2d 418, 424-25 (Mo. 1974) (same)

**Texas:** *Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 120 (5th Cir. 1983) (Texas law) (when insurer proposes to defend under reservation rights, insurer may refuse insurer’s offer and pursue his own defense, and insurer remains liable for insured’s attorneys’ fees); *Britt v. Cambridge Mutual Fire Ins. Co.*, 717 S.W.2d 476, 481 (Tex. App., San Antonio 1986) (same); *Western Casualty & Sur. Co. v. Newell Manufacturing Co.*, 566 S.W.2d 74, 76 (Tex. Civ. App., San Antonio) (if insured refuses insurer’s offer to defend under reservation of rights, “insurer cannot stubbornly continue with the defense and still preserve its right to assert policy defenses”) (citations omitted), writ ref’d n.r.e., (Sept. 20, 1978).

**Washington:** *Tank v. State Farm Fire & Casualty Co.*, 715 P.2d 1133, 1137 (Wash. 1986) (en banc) (when defense is provided under reservation of rights, insurer’s enhanced obligation of good faith requires recognition that “only the insured is the client” of retained defense counsel)

Jurisdictions that have appear to have adopted a fact-dependent test for determining the necessity of independent counsel include **California, Illinois, New York, Ohio, Oklahoma and Pennsylvania**.
The applicable California statute provides that the policyholder may have a right to independent counsel when “insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim.” Cal. Civ. Code § 2860(b) (emphasis added). Thus, by implication, an insurer’s reservation of rights might not entitle the policyholder to independent counsel if defense counsel would not be able to manipulate the outcome of the coverage issue.

The New York Court of Appeals took a similar approach in Public Service Mut. Ins. Co. v. Goldfarb, 425 N.E.2d 810 (N.Y. 1981). The Goldfarb court concluded that independent counsel would be required only when the defense attorney’s duty to the insured would require a defense on any grounds, but his duty to the insurer would require a defense only on those grounds that would defeat insurer liability. As an example of a case of covered and non-covered claims that would not create the necessity for independent counsel, the Goldfarb court offered a hypothetical case in which the policy covered only personal injury, but the policyholder was sued for personal injury and property damage. The Goldfarb court reasoned that separate counsel would not be necessary because the question of coverage would not be connected with the question of the insured’s liability.

Illinois courts have taken a similar view. In determining whether a conflict of interest creating a right to independent counsel exists, Illinois courts consider “whether, in comparing the allegations of the complaint to the policy terms, the interest of the insurer would be furthered by providing a less than vigorous defense to those allegations.” According to these courts, an insurer’s interest in negating coverage does not, standing alone, create a sufficient conflict of interest to prevent the insurer from assuming control of its policyholder’s defense; such a conflict may exist, however, when an underlying action asserts claims that are covered as well as claims against which the insurer has a duty to defend but asserts are not covered by its policy. Illinois Masonic, 522 N.E.2d at 614; Nandorf, 479 N.E.2d at 992.

Federal courts applying Pennsylvania law have also concluded that an insurer’s reservation of rights does not always entitle the policyholder to representation by separate counsel. Pennbank v. St. Paul Fire and Marine Ins. Co., 669 F. Supp. 122, 126-27 (W.D. Pa. 1987); St. Paul Fire & Marine Ins. Co. v. Roach Brothers Co., 639 F. Supp. 134, 139 (E.D. Pa. 1986) (existence of both covered and non-covered claims raises potential for conflict, “but actual conflict is not inevitable”). The court acknowledged that independent counsel would be required in a situation where an insurer could be “tempted to construct a defense which would place any damage award outside policy coverage,” but it concluded that separate counsel was not necessary merely because punitive damages, for which the insurer denied coverage, were sought against the policyholder. The court reasoned that such a danger did not exist in this case because findings against the insured that would support an award of punitive damages also would “guarantee a large award of compensatory damages.”

New Jersey takes a unique approach to the independent counsel issue. Under New Jersey law, an insurer cannot defend its policyholder if (1) the trial will leave the question of coverage unresolved so that the policyholder may later be called upon to pay; or (2) the case may be so defended by a carrier as to prejudice the policyholder thereafter on the issue of coverage. Where a conflict prevents an insurer from assuming the defense of its policyholder, the insurer is not...
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obligated to provide ongoing funding for the policyholder’s defense. Instead, under Burd, [Burd v. Sussex Mut. Ins. Co., 267 A.2d 7, 10 (N.J. 1970)] the insurer’s duty to defend is translated into an obligation “to reimburse the insured if it is later adjudged that the claim was one within the covenant to pay.” Burd, 267 A.2d at 10 (emphasis added).


There is one very common set of facts that is almost certain to give rise to an independent counsel requirement, even in jurisdictions that do not apply a per se rule -- if an underlying complaint alleges mutually exclusive theories of recovery (such as negligence and intentional tort), some of which would be covered under the policy and some of which would not. Courts addressing the situation have generally concluded that separate representation for the policyholder is necessary.36

Courts have found a conflict of interest where the underlying complaint alleges both negligence and intentional torts (or some other set of mutually exclusive covered and non-covered theories of recovery) because of the danger that an insurer might deliberately defend the policyholder in a manner that would result in a finding of liability only on non-covered claims. Under the fact-dependent approach to determining conflicts adopted in states such as California and New York, only this type of situation is deemed to raise a conflict of interest sufficient to require independent counsel for the policyholder. In contrast, courts adopting a per se rule that a policyholder is entitled to independent counsel any time an insurer reserves its rights have reasoned that the insurer’s contractual right to control the defense of suits against its policyholder presupposes that the insurer will pay any judgment resulting from such suits, and that where the duty to pay the judgment may fall on the policyholder instead of the insurer, the right to defend should also belong to the policyholder.

Conclusion

It is often difficult to determine whether there exists a true conflict between an insurer’s interests and those of its policyholder such that independent counsel will be required. These questions arise in virtually all environmental cases where an attorney is retained by an insurer to defend a suit against its policyholder. The law in this area remains undeveloped on key points in many jurisdictions. Even in states where a per se rule has been articulated, there may be room for debate. Many of the cases engendering a broad statement that independent defense counsel must be afforded if a reservation of rights is issued by the insurer involved coverage defenses that were intertwined with issues in the underlying claim. It is unclear whether these states would apply a per se rule if a coverage issue wholly unrelated to the underlying claim were at stake. Further, the law governing the independent counsel question is in flux. The Restatement of the Law Governing Lawyers will soon be finalized and will contain new language bearing on this issue. The firestorm of commentary and concern about the proposed Restatement provisions may prompt other efforts to influence this area of the law, particularly in the legislative arena. Given

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the uncertain and potentially shifting standards, it is important to consider all relevant sources of law in resolving whether an actual conflict requiring independent counsel exists.

About the Author
Laura A. Foggan is co-chair of Wiley Rein’s Appellate Practice and a member of its Insurance Practice. She has more than 20 years of trial and appellate experience in insurance-related litigation. Consistently named as a leading lawyer for insurers in commercial insurance work, Ms. Foggan is recognized for her contributions to the development of key insurance law precedents and the effective presentation of insurer views through industry amicus submissions in the courts. She serves as co-chair of the Insurance Coverage Litigation Committee of the ABA Litigation Section, as well as the Insurance Law Forum of the DC Women’s Bar Association. For more information, please contact her at 202.719.3382 or lfoggan@wileyrein.com.

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2 Id. at §2860(a).
4 See, e.g., AIU Ins. Co. v. Block Marina Inv., Inc., 544 So.2d 998 (Fla 1989).
5 Alaska Stat. §21.89.100(c) (1996).
7 See, e.g., Brohawn v. Transamerica Ins. Co., 347 A.2d 842 (Md. 1975) (insurer should have provided for contingency that its interests would conflict with those of its policyholder); Employers Fire Insurance Co. v. Beals, 240 A.2d 397, 404 (R.I. 1968) (insurer failed to provide any degree of clarity for this contingency when it drafted the insurance contract), abrogated on other grounds sub nom. Peerless Ins. Co. v. Viegas, 667 A.2d 785 (R.I. 1995).
8 Annotated Model Rules of Professional Conduct, Rule 1.7 (ABA 1992) (citations omitted).
10 See, e.g., First Insurance Co. of Hawaii v. State, 665 P.2d 648, 655-56 (Hawaii 1983) (where conflict of interest existed between the policyholder, a public contractor, and an additional insured, the State of Hawaii, insurer could not discharge its duty to the latter by providing counsel to defend the former; separate counsel was required); Wolpaw v. General Accident Ins. Co., 639 A.2d 338, 340 (N.J. Super. Ct., App. Div. 1994) (homeowners’ insurer breached policy by assigning single law firm to represent three insureds with conflicting interests); Bituminous Ins. Co. v. Pennsylvania Manufacturers’ Assoc. Ins. Co., 427 F. Supp. 539, 555 (E.D. Pa. 1976) (where contractor’s interests conflicted with those of subcontractor, and insurer had duty to defend both, insurer was required to provide separate counsel).
12 See id; Alaska Stat. § 21.89.100(b); Cal. Civ. Code § 2860(b).
13 See, e.g., Campbell, 639 A.2d at 659, State Farm Mut. Auto Ins. Co. v. Hollis, 554 So. 2d 387 (Ala. 1989) (finding jury issue as to whether insurer was negligent in refusing to settle within limits); Hartford Accident & Indem. Co. v. Foster, 528 So. 2d 255, 265 (Miss. 1988) (“the insurer has a fiduciary duty to look after the insured’s interest at least to the same extent as its own, and to make a knowledgeable, honest and intelligent evaluation of the claim commensurate with its ability to do so. If the carrier fails to do this, then it is liable to the insured for all damages occasioned thereby”); Commercial Union Ins. Co. v. Liberty Mutual Ins. Co., 393 N.W.2d 161, 164 (Mich. 1986)
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(“[i]f the insurer is motivated by a selfish purpose or by a desire to protect its own interest at the expense of its insured’s interest, bad faith exists, even though the insurer’s actions were not actually dishonest or fraudulent”); *Rova Farms Resort, Inc. v. Investors Insurance Co.*, 323 A.2d 495 (N.J. 1974) (where underlying claimant’s injury was substantial, and potential liability of insured “should have been reasonably obvious” despite advice of counsel, insurer’s failure to offer $50,000 policy limit was in bad faith and rendered it liable for entire $225,000 judgment against insured); *Crisci v. Security Ins. Co.*, 426 P.2d 173 (Cal. 1967) (insurer liable for unwarranted rejection of a reasonable settlement offer where it refused a settlement demand within its $10,000 limit and $101,000 judgment entered against insured; showing of dishonesty, fraud or concealment on the part of the insurer not required).

14 See, e.g., *American Home Assurance Co., Inc. v. Hermann’s Warehouse Corp.*, 563 A.2d 444 (N.J. 1989) (insurer entitled to reimbursement for deductible amount where insurer settled, over policyholder’s objection, for amount substantially in excess of deductible but well within policy limits); *Casualty Ins. Co. v. Town & Country Pre-School Nursery, Inc.*, 498 N.E.2d 1177 (Ill. App., 1st Dist. 1986) (requiring policyholder, which did not approve settlement, to reimburse insurer for $1800 settlement amount which fell within its $2000 deductible, despite claims adjuster’s belief that policyholder was not liable).

15 Of course, Fortune 500 companies and other policyholders that choose to bear large deductibles will often negotiate with their insurers for specific contractual provisions that give the policyholder control over settlement of claims likely to fall within the deductible amount.

16 See, e.g., *Employers’ Surplus Line Ins. Co. v. City of Baton Rouge*, 362 So. 2d 561 (La. 1978) (where insurer settled claim for $75,000 and policy had a $10,000 deductible, insurer could not recover $10,000 deductible from policyholder unless policyholder consented to the settlement); see also, *National Service Indus., Inc. v. Hartford Accident & Indem. Co.*, 661 F.2d 458 (5th Cir. 1981) (applying Georgia law) (where insurer proposed to settle claim in a manner that would require policyholder to pay deductible under two policies instead of one, insurer was required to obtain policyholder’s consent).


18 Id. at 260-61; see *Kooyman v. Farm Bureau Mut. Ins. Co.*, 315 N.W.2d 30, 35-37 (Iowa 1982) (triable issue as to whether defense counsel’s inadequate investigation and trial preparation evidenced insurer’s indifference to insured’s interests which would establish insurer’s bad faith.); cf. *Bevevino v. Saydjar*, 76 F.R.D. 88, 94 (S.D.N.Y. 1977) (refusing insurer’s request to set aside unwarranted malpractice verdict against its policyholder where verdict was result of insurer’s having “deliberately decided not to provide the [policyholder] with the semblance of a defense”), aff’d 574 F.2d 676 (2d Cir. 1978).)

19 73 Neb. L. Rev. at 279.
20 Id.
21 Id.
22 655 A.2d at 43-44.
23 Id. (citing 7C Appleman, § 4681 (1979)).
24 Id. at 14.
25 Id. at 15.
26 The potential for conflict when a policyholder opposes settlement because of possible reputational harm can be, and frequently is, addressed by an express contractual provision requiring the policyholder’s consent to settlement. Such contract provisions often appear in medical malpractice insurance policies, for example.

authority to settle within policy limits because a policyholder “cannot be injured by a settlement to be wholly paid by the insurer”).


30 479 N.E.2d at 993.

31 Id. at 993-94 (emphasis added).

32 Cases holding that a policyholder is entitled to separate counsel whenever an insurer issues a reservation of rights generally do not, but probably should, distinguish between (1) an insurer’s reservation of rights based on a coverage defense that is apparent on the face of the underlying complaint; and (2) an insurer’s reservation of the right to assert any coverage defenses that might later reveal themselves as additional facts are developed. The second situation arguably raises only a speculative potential for a conflict of interest, such that independent counsel should not be required until and unless the insurer actually asserts that a defense to coverage applies.


34 *Illinois Masonic Medical Center v. Turegum Insurance Co.*, 522 N.E.2d 611, 613 (Ill. App. 1st Dist. 1988) (citations omitted) (policyholder entitled to independent counsel where underlying complaint alleged negligence treatment during one or more of three hospitalizations, one during policy period and two after policy’s expiration); *Nandorf, Inc. v. CNA Insurance Cos.*, 479 N.E.2d 988, 992 (Ill. App. 1st Dist. 1985) (policyholder entitled to independent counsel where complaint sought minimal compensatory damages for which coverage was acknowledged, but substantial punitive damages for which coverage was disputed).

35 Id. at 127. See also *Lusk v. Imperial Casualty and Indem. Co.*, 603 N.E.2d 420, 423 (OH. App. 1992) (fact that two insurers reserved rights did not entitle policyholder to independent counsel where policyholder definitely had coverage and dispute was only as to which insurer provided it; conflict entitling policyholder to separate counsel only where insurer’s disclaimer would “render it impossible for such company, in making defense, to protect both its own interests and those of the insured”) (citing *Socony-Vacuum Oil Co. v. Continental Casualty Co.*, 59 N.E.2d 199, 204-205 (Oh. 1945)).