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CAUGHT IN A CROSSFIRE

Preventing and Handling Conflicts of Interest: Guidelines for Texas Insurance Defense Counsel

(FIRST IN A SERIES)

I. SCOPE OF ARTICLE

This article examines Texas law as it governs the relationship between insurance companies, their insureds, and defense counsel,[1] discusses additional guidelines for dealing with potential conflicts of interest, and sets forth suggestions for avoiding problems in the course of insurance defense representation. The focus of the article is the insurance defense counsel's role and obligations when a real or potential conflict arises between the insurer and the insured. The article will address the ethical and legal requirements and guidelines for insurance defense counsel and the insurer and provide practical suggestions to assist insurance defense counsel in avoiding and handling problems that may arise while representing the insured.

II. THE TRIANGULAR RELATIONSHIP

A. The Contractual Right and Duty to Defend

Policyholders purchase liability insurance to protect against liability for damages caused by tortious or wrongful conduct.[2] An equally important benefit provided by liability insurance is the insurer's agreement to defend the insured against any covered lawsuit.[3] The insurer's promise to defend relieves the policyholder of the necessity of finding an attorney.[4] It also provides the policyholder with the benefit of the insurer's expertise in handling lawsuits.[5] Likewise, the insurer benefits from its involvement in the defense because its exposure is reduced or eliminated when a lawsuit is successfully defended.

Liability insurance, by its very nature, contemplates the involvement of lawyers and the creation of an attorney-client relationship. In essence, the insurer presells the services of an attorney.[6]

Courts have held the provision in the liability policy creating the duty to defend amounts to advance consent by the insured for the insurer to hire an attorney to defend the insured against any covered claims.[7] Relief from the burden of handling the defense of a covered claim is in fact exactly what the insured purchased when acquiring the policy.[8] The existence of the insurance contract, however, does not alter the fact that the relationship between the insurance defense counsel and the insured is that of attorney and client.[9]

B. The Tripartite Relationship

Under the typical liability policy, the obligation of the insurer to defend is triggered upon receipt of notice of a covered claim that has matured into a lawsuit.[10] The insurer must then fulfill its policy obligations by retaining an attorney to defend the claim against its insured.[11] At this point, a tripartite relationship is created involving the insurer, the insured, and the defense attorney.[12] The defense attorney acts on behalf of both the insurance company and the insured, which gives rise to what has been described as an "ethically sanctioned 'duality of representation.' "[13]

C. The Triangular Model

The relationship between a liability insurer, its insured, and the insurance defense counsel has also been described as triangular in nature.[14] Today, the triangle is perhaps best viewed with the insured at the apex and the insurer and defense counsel at the base. One

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[1] This article was written primarily with outside insurance defense counsel in mind. Much of what is written here, however, will also be applicable to insurance company staff counsel. For an article specifically addressing ethical conflicts facing staff counsel, *see* Leo J. Jordan & Hilde E. Kahn, *Ethical Issues Relating to Staff Counsel Representation of Insureds*, 30 TORT & INS. L.J. 25 (1994) (hereinafter Jordan & Kahn).

[2] *Brightwell v. Rabeck*, 430 S.W.2d 252 (Tex. Civ. App. — Fort Worth 1968, writ ref'd n.r.e.); ROWLAND LONG, THE LAW OF LIABILITY INSURANCE § 1.02[2] (1993) [hereinafter LONG].

[3] LONG § 5.01.

[4] Charles Silver, *Does Insurance Defense Counsel Represent the Company or the Insured?*, 72 TEX. L. REV. 1583, 1597 (1994)[hereinafter Silver]("Insureds are likely to find it particularly difficult to select, bargain with, and monitor defense counsel. Most insureds participate in litigation infrequently. Often they cannot tell bad lawyers from good ones, and they cannot distinguish bad lawyering from bad luck.").

[5] Long § 5.01; Silver at 1597.

[6] RONALD E. MALLEN & JEFFREY M. SMITH, LEGAL MALPRACTICE § 23.3 (1989) [hereinafter MALLEN & SMITH].

[7] *Id.*

[8] *But see* John K. Morris, *Conflicts of Interest in Defending Under Liability Insurance Policies: A Proposed Solution*, 1981 UTAH L. REV. 457, 466.

[9] MALLEN & SMITH § 23.3; THE RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 215, Comment *f* (Proposed Final Draft No. 1, 1995) (hereinafter Restatement Final Draft No. 1).

[10] *Members Ins. Co. v. Branscum*, 803 S.W.2d 462, 466-67 (Tex. App. — Dallas 1991, no writ).

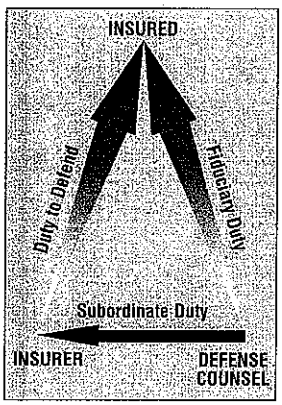
[11] The insurer may also owe a duty to investigate the circumstances of the occurrence if it is notified of the occurrence or a presuit settlement demand. *Ranger County Mut. Ins. Co. v. Guin*, 723 S.W.2d 656, 659 (Tex. 1987); *see also* Eric Holmes, *Third Party Excess Liability and Its Avoidance*, 34 ARK. L. REV. 525, 538-48 (1981).

[12] Silver at 1585 n.12.

[13] Michael J. Brady & Heather A. McKee, *Ethics in Insurance Defense Context: Isn't Cumis Counsel Unnecessary?*, 58 DEF. COUNSEL J. 230 (April 1991) [hereinafter Brady & McKee]; Richard L. Neumeier, *Serving Two Masters: Problems Facing Insurance Defense Counsel and Some Proposed Solutions*, 77 Mass. L. Rev. 66 (1992)[hereinafter Neumeier]; J. Henderson, *Ethics in the Settlement of Insurance Claims*, in Univ. of Houston, Handling Insurance and Tort Claims K-1 (1991).

[14] Robert E. O'Malley, *Ethics Principles for the Insurer, the Insured, and Defense Counsel: The Eternal Triangle Reformed*, 66 TUL. L. REV. 511 (1991) [hereinafter O'Malley]; Brooke Wunnicke, *The Eternal Triangle: Standards of Ethical Representation by the Insurance Defense Lawyer*, 31 FOR THE DEF. 7 (1989).

side of the triangle represents the contractual relationship between the insurer and the policyholder and the accompanying duty to defend;[15] the other represents the attorney-client relationship and the fiduciary duty owed by the defense counsel to the policyholder.[16] The base of the triangle represents the relationship and accompanying legal and ethical duties between the insurer and defense counsel. In some respects, the defense counsel's responsibility to the insurer is secondary to the duty owed to the insured and can be characterized as a subordinate duty.[17] In Texas, the insurance company is considered the insured's agent, and the defense counsel a sub-agent of the insured.[18]



Defense counsel occupies a potentially precarious place in the triangle since the side of the triangle connecting counsel to the insured and the base of the triangle connecting counsel to the insurer represent virtually one way obligations and duties running from the attorney to the insurer and the insured.[19] Thus, properly viewed, the triangle serves as an apt model for demonstrating the potential for conflict faced by the insurance defense counsel.[20] Although a general framework of rules and guidelines has developed over time to govern this triangular relationship, there remains a paucity of specific practical guidelines for the proper handling of problems raised by conflicts of interest.[21]

III. THE INSURANCE DEFENSE COUNSEL'S DUTY OF LOYALTY TO INSURED AND THE INSURER IN THE ABSENCE OF A CONFLICT OF INTEREST

In most cases, there is no real conflict of interest between the insurer and the insured, and the insurance defense counsel is able to discharge his/her duties to both without difficult ethical considerations.[22] "The three parties may be viewed as a loose coalition or alliance, sharing a common purpose that lasts during the pendency of the litigation against the insured."[23]

The relationship between the defense counsel and the insured is simply that of attorney and client, and the relationship imposes on the defense counsel the same duty of unqualified loyalty as if personally retained by the insured.[24] The relationship between defense counsel and the insurer, however, is more complex.[25] Insurance defense attorneys normally desire to maintain long term relationships with the insurers who send them business and are sometimes friends with the insurance company's representatives.[26] Nevertheless, when conflicts between the insurer and the insured arise the defense counsel must be completely loyal to the insured and must therefore be prepared to disregard those ties to the insurer.[27]

IV. THE DUTIES OF THE INSURANCE DEFENSE COUNSEL WITH RESPECT TO CONFLICTS OF INTEREST BETWEEN INSURED AND INSURER

In those cases where a conflict of interest[28] does arise between the insurer and the insured, the insurance defense counsel is caught in a crossfire, and the general guidelines available under Texas law are not particularly helpful in formulating a course of action that protects first and foremost the interests of the insured.[29] There is scant case law in Texas providing guidance to the insurance defense counsel in conflict of interest situations. In fact, the leading Texas case in this area, *Employers Casualty Co. v. Tilley*,[30] is over twenty years old and has been criticized as inadequate in its treatment of client confidentiality.

A. Employers Casualty v. Tilley

Tilley is the seminal Texas case governing the duties owed by insurance defense counsel where there is a conflict of interest between insurer and insured.[31] *Tilley* involved a situation where both the insurer and defense counsel knew at the outset of the litigation against the insured that the insurer might have a right to claim that it did not owe coverage to the insured.[32] Even though the conflict was

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15 *See Enserch Corp. v. Shand Morahan & Co., Inc.*, 952 F.2d 1485 (5th Cir. 1992).
16 *See Employers Cas. Co. v. Tilley*, 496 S.W.2d 552, 558 (Tex. 1973).
17 *See Bradt v. West*, 892 S.W.2d 56 (Tex.App. — Houston [1st Dist.] 1994, n.w.h.); *see also* O'Malley; *see generally* Silver (discussing the relationship between insurance defense counsel, the insurer, and the insured in the context of malpractice liability and criticizing the notion that the insurer is not a client of the defense counsel, but recognizing the weight of authority supports the conclusion that the defense counsel must show special regard for the interests of the insured).
18 *Ranger County Mut. Ins. Co. v. Guin*, 723 S.W.2d 656, 659 (Tex. 1987).
19 "Defense counsel must be particularly sensitive to the varying interests of the insured and the insurer which produce complex and often conflicting relationships." *American Centennial Ins. Co. v. Canal Ins. Co.*, 843 S.W.2d 480, 484 (Tex. 1992). "From the moment of retention until final judgment or settlement, counsel retained to represent the insured professional faces an array of issues and dilemmas not encountered in typical litigation." Debra A. Winniarski, *Walking the Fine Line: A Defense Counsel's Perspective*, 28 TORT & INS. LAW J. 596 (1993) [hereinafter Winniarski]; *see also* Silver at 1587 ("The tripartite relationship is deeply and unavoidably vexing."); *but see* O'Malley at 511 ("these issues are neither as complex nor as difficult to resolve as they appear").
20 Insurance defense counsel who have been stung by an ethical conflict may be tempted to refer to it as the "Bermuda Triangle" of insurance defense representation. "Balancing the responsibilities of this dual representation is often as challenging as defending the underlying litigation, if not more so." Gary L. Fontana & Mary L. Diepenbrock, *Ethical Considerations That Arise In The Context of Insurance Coverage And Defense Litigation*, in COMPREHENSIVE GENERAL LIABILITY POLICIES 1993: INSURANCE CLAIMS AND COVERAGE LITIGATION 1993, at 191 (PLI Commercial Law and Practice Course Handbook Series No. A4-4415) [hereinafter Fontana & Diepenbrock].
21 K. Bowdre, *Conflicts of Interest Between Insurer and Insured: Ethical Traps For the Unsuspecting Defense Counsel*, 17 AM. J. TRIAL ADVOC. 101 (1993); *see also Moritz v. Medical Protective Co.*, 428 F. Supp. 865, 872 (W.D. Wis. 1977) (noting that existing guidelines for insurance defense counsel are "surprisingly unclear"). The International Association of Defense Counsel (IADC) has charged its Special Committee on Professional Responsibility with the task of developing guidelines for defense counsel, but work on the project is not currently underway. Silver at 1585-86 n.13. As the co-authors of a recent legal article noted, "The appetite of the American public for lists of rules, especially those packaged in groups of ten, is apparently insatiable." Michael S. Quinn & L. Kimberly Steele, *Insurance Coverage Opinions*, 36 S. Tex. L. Rev. 479, 552 n. 145 (1995). Perhaps a decalogue of rules for insurance defense counsel will someday emerge.
22 Eric M. Holmes, *A Conflict of Interest Roadmap For Insurance Defense Counsel: Walking An Ethical Tightrope Without A Net*, 26 WILLAMETTE L. REV. 1, 2-3 (1989) [hereinafter Holmes]; Annotation, *Malpractice: Liability of Attorney Representing Conflicting Interests*, 28 A.L.R. 3d 389 (1969) [hereinafter Annotation: Malpractice]; *see also* Silver at 1609.
23 *American Mut. Liab. Ins. Co. v. Superior Court*, 38 Cal.App. 3d 579, 592, 113 Cal.Rptr. 561, 571 (1974); Holmes at 3; *but see* John H. Mattias, Jr., Thomas A. Marrinson & Brent D. Stratton, *Tripartite Relationships and Reservation of Rights Letter: The Need For Independent Counsel*, in INSURANCE COVERAGE LITIGATION: 1994, (PLI Litigation and Administrative Practice Course Handbook Series No. H4-5209) (describing the arrangement as an "uneasy alliance").
24 Thomas A. Gordon. *Claims Handling and Pre-trial Litigation Considerations*, in ENVIRONMENTAL INSURANCE COVERAGE CLAIMS AND LITIGATION: 1993 AND BEYOND 1993, at 44, 46-47 (PLI Comm'l Law and Practice Course Handbook Series No. 660, 1990)[hereinafter Gordon].
25 J. Stratton Shartel. *Tensions Between Insurers, Outside Counsel Remain Near the Boiling Point*, 7 No. 10 Inside Litig. 1 (Prentice-Hall 1993) [hereinafter Shartel]; *see also* Silver at 1602-14 (discussing the division of opinion among the authorities and practicing insurance defense counsel on the status of the insurer as a client).
26 *See generally* Bruce L. Gelman, *The Insurance Company or the Insured: Where Does Defense Counsel's Loyalty Really Lie?*, 70 U. Det. Mercy L. Rev. 215 (1992).
27 *See generally* O'Malley.
28 "A conflict of interests between an insurer and its insured exists whenever the defense counsel's representation of one is rendered less effective or is materially limited by reason of his or her representation of the other." Fontana & Diepenbrock at 191.
29 In the past, it was less clear that the insurance defense counsel's primary obligation was to the insured. *See* State Bar of Texas, Comm. on Interpretation of the Canons of Ethics, Op. 179 (1958). In Opinion 179, which dealt with a situation involving a conflict of interest between the insured and the insurer, the Committee stated that an insurance defense counsel does not owe a greater duty to the insured than to the insurer.
30 496 S.W.2d 552 (Tex. 1973).
31 *Id.*
32 *Id.* at 554.

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known at the outset, the *Tilley* court attempted to set guidelines not only for cases where a conflict arises before the insured has actually been sued, but also for more difficult cases where the conflict arises after the lawsuit is already in progress.[33]

1. FACTS

Tilley was a declaratory judgment action.[34] In a separate lawsuit, Douglas Starky sued Joe Tilley to recover damages for personal injury. Tilley told his insurer, Employers Casualty, that he did not know of Starky's injury until he was sued nearly two years later.[35] Employers believed it had evidence to the contrary and while providing Tilley with a defense against Starkey's claim, filed a declaratory judgment action seeking a ruling that Tilley's failure to timely notify Employers of the claims against him relieved Employers of any obligation to defend Tilley against the claim.[36] Employers defended Tilley against Starky's claim under a "standard" non-waiver agreement.[37] The attorney retained by Employers to defend Tilley was aware of Employers' late notice defense to coverage but failed to so advise Tilley.[38]

In addition to failing to tell Tilley about the insurer's potential coverage defense, the defense counsel also "performed services for Employers which were adverse to Tilley on the question of coverage."[39] In essence, defense counsel was both defending Tilley against Starky's lawsuit and working with the insurer to develop its coverage defenses against Tilley. All the while, Tilley was oblivious that his attorney was assisting his insurer to mount a coverage defense against him. The services that Tilley's insurance defense counsel performed for Employers on the coverage question included the following:

- taking a statement from Tilley's foreman to establish that Tilley had notice through the foreman of the accident giving rise to the lawsuit;
- taking statements from other Tilley employees seeking to establish that they had informed Tilley of the accident;
- briefing the legal question of late notice for Employers without advising Tilley of his actions or findings;
- interviewing two other persons at the request of Employers to establish the late notice defense asserted by Employers; and
- writing numerous letters and engaging in numerous conversations with Employers about how to develop a coverage defense, suggesting additional investigation, and advising as to the legal possibilities of establishing such a defense.[40]

Tilley urged the court to find defense counsel's conduct estopped Employers from avoiding coverage.

2. HOLDING

At the outset, the Texas Supreme Court observed that the insurance policy between the parties provided that the attorney hired to represent the insured is to be selected, employed, and paid by the insurance company.[41] Even so, held the court, the insurance defense counsel becomes the legal representative of the *insured* and owes the insured the same type of unqualified loyalty as if he had been originally employed by the insured.[42] Accordingly, defense counsel must immediately advise the insured of any conflict arising between the interests of the insurer and the insured.[43] Quoting from an earlier Commission of Appeals case, the *Tilley* court emphasized that defense counsel becomes the unqualified attorney of record for the insured and thus owes a duty to conscientiously represent him.[44] Neither Tilley's insurer, Employers, nor the defense counsel retained by Employers, adhered to the duty recognized by the *Tilley* court. Hence, the court held Employers was estopped to deny coverage for the claims against Tilley.[45]

The *Tilley* court based its holding that Employers was estopped from asserting the late notice coverage defense in part on the Texas Code of Professional Responsibility and on a set of "Guiding Principles" issued by the American Bar Association (ABA) National Conference of Lawyers.[46] The Guiding Principles have since been withdrawn,[47] and the Texas State Bar has replaced the Code of Professional Responsibility with a modified version of the Model Rules of Professional Conduct (the Texas Disciplinary Rules of Professional Conduct).[48] Nonetheless, the supreme court has never modified *Tilley*, and it is therefore the supreme court's last word on the duties owed by insurance defense counsel.

3. ABA GUIDING PRINCIPLES

It is instructive to review the ABA Guiding Principles approved by the *Tilley* court. The *Tilley* court specifically approved the portions of Guiding Principles IV and V quoted below. Guiding Principle IV stated insurance defense counsel should promptly inform *both the insured and the insurer* of any coverage questions the attorney discovers:

> **IV. CONFLICTS OF INTEREST GENERALLY — DUTIES OF ATTORNEY.** In any claim or in any suit where the attorney selected by the company to defend the claim or action becomes aware of facts or information which indicate to him a question of coverage in the matter being defended or any other conflict of interest between the company and the insured with respect to the defense of the matter, the attorney should promptly inform both the company and the insured, preferably in writing, of the nature and extent of the conflicting interest. . . .[49]

Guiding Principle V stated an insurance defense attorney should not continue defending the insured after discovery of a coverage question unless the insured consents to the continued representation after being advised of the coverage question:

> **V. CONTINUATION BY ATTORNEY EVEN THOUGH THERE IS A CONFLICT OF INTERESTS.** Where there is a question of coverage or other conflict of interest, the company and the attorney selected to defend the claim or suit should not thereafter continue to defend the insured in the matter in question unless, after a full explanation of the coverage question, the insured acquiesces in the continuation of such defense . . . .[50]

In approving Guiding Principles IV and V, the *Tilley* court commented that those principles "conform to the public policy of this State heretofore enunciated by this Court in our Canons of Ethics. They follow the same general principles earlier recognized by Texas courts."[51] In sum, these provisions required the insurance defense counsel who learned of facts that might constitute a defense to coverage to inform *both the insured and the insurer* and to withdraw from the representation unless the insured consented to continued representation after full disclosure of the potential conflict of interest.[52] As explained later, the *Tilley* court's holding that defense counsel must inform both the insured and the insurer is inappropriate in most situations.[53]

(To be continued in next issue)

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33 *Id.* at 558-59.
34 *Id.* at 554.
35 *Id.*
36 *Id.*
37 The court's use of the term "standard non-waiver agreement" is misleading. There is no such thing as a "standard" non-waiver agreement or reservation of rights letter. Moreover, there is little case law in Texas on what must be contained in a reservation of rights letter. One Texas court, however, has held that an insurer need not specifically reserve the right to file a declaratory judgment action to resolve coverage questions. *Colony Ins. Co. v. H.R.K., Inc.*, 728 S.W.2d 848, 852 (Tex. App. — Dallas 1987, no writ); *see also Ideal Mut. Ins. Co. v. Myers*, 789 F.2d 1196, 1201 (5th Cir. 1986) (discussing requisites of a reservation of rights letter).
38 496 S.W.2d at 554.
39 *Id.* at 556.
40 *Id.*
41 *Id.* at 558.
42 *Id.; see also American Physicians Ins. Exchange Co. v. Garcia*, 876 S.W.2d 842, 844 n.6 (Tex. 1994); *American Centennial Ins. Co. v. Canal Ins. Co.*, 843 S.W.2d 480, 484 (Tex. 1992).
43 *Tilley*, 496 S.W.2d at 558.
44 *Id.*
45 *Id.* at 561.
46 *Id.* at 559.
47 Note, *Confusion Over Conflicts of Interest: Is There a Bright Line for Insurance Defense Counsel?* 41 DRAKE L.REV. 731 at n.244 ("The ABA adopted the 'Guilding Principles' proposed by the National Conference of Lawyers and Liability Insurers in 1972 to guide liability insurers that furnish legal counsel for their insureds"); O'Malley at 513 ("The guiding principles were rescinded by the ABA under pressure from the Antitrust Division of the Justice Department in August 1980").
48 *Ayres v. Canales*, 790 S.W.2d 554 (Tex. 1990).
49 *Tilley*, 496 S.W.2d at 559.
50 *Id.*
51 *Id.* "The Guiding Principles are now widely disregarded, having been contradicted by subsequent case law, ethics opinions, and the widespread adoption of the Model Rules of Professional Conduct." Douglas R. Richmond, *Walking a Tightrope: The Tripartite Relationship Between Insurer, Insured, and Insurance Defense Counsel*, 73 NEB. L. REV. 265 (1994)[hereinafter Richmond].
52 The exception allowing the defense attorney to continue the representation after full disclosure of the potential conflict of interest has been criticized as having "little or no practical significance." ALLAN D. WINDT, INSURANCE CLAIMS AND DISPUTES § 4:19 (1988). According to Windt, an insured that allows itself to be represented by attorneys who also represent the conflicting interests of the insurer, even though the insured could have insisted on independent counsel, cannot be deemed to have given informed consent.
53 *See infra* notes 73-98 and accompanying text.