POTENTIAL CONFLICTS: RETAINED COUNSEL'S DUTY TO ZEALOUSLY REPRESENT THE INSURED VS. THE INSURER'S RIGHT TO CONTROL THE DEFENSE[1]

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I. THE TRIPARTITE RELATIONSHIP

A tripartite relationship forms among defense counsel, the insurer, and the insured when the insurer retains counsel to defend the insured in a lawsuit pursuant to the duty to defend in a liability insurance policy. Some states, including Alabama and Minnesota, treat the insured and the insurer as the dual clients of retained defense counsel.[2] Other states, including Arizona and California, consider the insured the "primary client," suggesting defense counsel also owes a duty to the insurer.[3] Texas and New York treat the insured as the only client.[4]

Regardless of whether defense counsel has two clients, a primary client, or a single client, the tripartite relationship is fraught with potential conflicts. Justice Raul Gonzalez of the Texas Supreme Court described the uneasy relationship defense counsel must navigate as follows:

> The duty to defend in a liability policy at times makes for an uneasy alliance. The insured wants the best defense possible. The insurance company, always looking at the bottom line, wants to provide a defense at the lowest possible cost. The lawyer the insurer retains to defend the insured is caught in the middle. There is a lot of wisdom in the old proverb: He who pays the piper calls the tune. The lawyer wants to provide a competent defense, yet knows who pays the bills and who is most likely to send new business. This so-called tripartite relationship has been well documented as a source of unending ethical, legal, and economic issues.

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[2] *Mitchum v. Hudgens*, 533 So. 2d 194 (Ala. 1988) ("[w]hen an insurance company retains an attorney to defend an action against an insured, the attorney represents the insured as well as the insurance company in furthering the interest of each."); *Pine Island Farmers Coop v. Erstad & Riemer, P.A.*, 649 N.W.2d 444, 452 (Minn. 2002)(holding that in the absence of a conflict of interest between the insured and the insurer, the insurer can become a co-client of defense counsel").

[3] *See e.g. Paradigm Ins. Co. v. Langerman Law Offices*, 24 P.3d 593, 602 (Ariz. 2001)(although the insurer was not the "client," the defense lawyer nonetheless owed a duty to the insurer); *Gafcon, Inc. v. Ponsor & Associates*, 98 Cal.App.4th 1388, 1406 (2002)("In California, it is settled that absent a conflict of interest, an attorney retained by an insurance company to defend its insured under the insurer's contractual obligation to do so represents and owes a fiduciary duty to both the insurer and insured.")

[4] *Feliberty v. Damon*, 72 N.Y.2d 112 (1988) (holding that "[t]he paramount interest independent counsel represents is that of the insured, not the insurer."); *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625 (Tex. 1998)(holding that "the lawyer owes unqualified loyalty to the insured, [and accordingly] the lawyer must at all times protect the interests of the insured if those interests would be compromised by the insurer's instructions").

State Farm Mut. Auto. Ins. Co. v. Traver, 980 S.W.2d 625, 627-28 (Tex. 1998) (Gonzalez, J. concurring and dissenting) (citations omitted).

The language of the insurance policy generally sets out the rights and duties of the parties. Standard liability policies, for instance, place the right and duty to defend on the insurer, which goes hand-in-hand with the insurer's selection of counsel. The policy also typically places the right to settle in the hands of the insurer as well as the right to incur any other expense. The insuring agreement in a standard CGL policy provides as follows:

> We will pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies. We will have the right and duty to defend the insured against any "suit" seeking those damages. . . . We may, at our discretion, investigate any "occurrence" and settle any claim or "suit" that may result.[5]

Meanwhile, the policy includes certain language stating that the insured may not settle on its own accord or incur any other expense without the insurer's consent and imposes a duty to cooperate on the insured. Standard CGL policy language provides:

> No insured will, except at that insured's own cost, voluntarily make a payment, assume any obligation, or incur any expense, other than for first aid, without our consent.[6]
>
> You and other involved insured must:
>
> Cooperate with us in the investigation or settlement of the claim or defense against the "suit[.]"[7]

Juxtaposed with the above policy language are seemingly contradictory rules guiding defense counsel's conduct. One example is Rule 1.2 of the Model Rules of Professional Conduct, providing that "[a] lawyer shall abide by a client's decision whether to accept an offer of settlement

[5] CG 00 01 04 13 (ISO 2012).
[6] *Id.*
[7] *Id.*

of a matter." Thus, no matter what state in which counsel practices, she faces the dilemma of satisfying her duty to zealously defend the insured while simultaneously acknowledging the insurer's right to control costs and other aspects of the defense.

This paper addresses some of those dilemmas with a focus on Texas and New York law. It is not intended to be exhaustive regarding the potential conflicts that may arise or the law that addresses such conflicts. And, although unsatisfying to some, this paper does not offer solutions. Rather, the purpose is merely to spark discourse among the players in the tripartite relationship: insurers, insureds, and insurer-retained defense counsel.

II. POTENTIAL CONFLICTS BETWEEN THE INTERESTS OF THE INSURER AND THE INSURED

There are innumerable potential conflicts arising from the tripartite relationship. Just a few examples are discussed below.

A. RESERVATION OF RIGHTS LETTERS

In the famous case of *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y, Inc*., a California Court of Appeal held that an insurance company must hire an independent attorney to represent its insured when the carrier reserves the right to deny coverage at a later date. 162 Cal. App. 3d 358 (1984). The *Cumis* case was later narrowed and codified in California. CAL. CIV. CODE § 2860. Under the California statute, "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, a conflict of interest *may* exist." CAL. CIV. CODE § 2860 (b) (emphasis added). But the right to independent counsel is not automatic. "There must … be evidence that 'the outcome of [the] coverage issue can be controlled by counsel first retained by the insurer for the defense of the [underlying] claim.'" *Gafcon, Inc. v. Ponsor & Associates* 98 Cal.App.4th 1388, 1421 (2002). "'It is only when the basis for the reservation of rights is such as to cause assertion

of factual or legal theories which undermine or are contrary to the positions to be asserted in the liability case that a conflict of interest sufficient to require independent counsel, to be chosen by the insured, will arise.'" *Id.* at 1421–1422.

New York essentially follows the reasoning set forth in the *Cumis* case rather than broader California statue, i.e. when the insurer issues a reservation of rights letter, independent counsel for the insured is required. The case law states the rule more subtly, "Independent counsel is only necessary in cases where the defense attorney's duty to the insured would require that he defeat liability on any ground and his duty to the insurer would require that he defeat liability only upon grounds which would render the insurer liable. When such a conflict is apparent, the insured must be free to choose his own counsel whose reasonable fee is to be paid by the insurer." *Public Serv. Mut. Ins. Co. v. Goldfarb*, 425 N.E.2d 810, 815 n.* (N.Y. 1981). Of course, the dichotomy spelled out above in *Goldfarb* exists whenever there are both covered and uncovered claims. In such a situation, the insurer has likely issued a reservation of rights triggering the insured's right to independent counsel. In *Mundry v. Great American Insurance Co.*, the Second Circuit held that under both Connecticut and New York law, an insurer must notify its insured if it disputes insurance coverage, to allow the insured to exercise its right to "retain independent counsel and to take over the defense, and either settle the case or conduct the defense more vigorously than the insurer would after announcing an intention to disclaim." 369 F.2d 678, 681-82 (2d Cir. 1966).

Later New York cases spell out the insured's right to independent counsel transparently: "It is well settled that where a conflict of interest is probable, such as here, where the insurer has conditioned its defense on a reservation of rights, the insured is entitled to an attorney of its own choosing." *City of New York v. Clarendon Nat'l Ins. Co.*, 309 A.D.2d 779, 779 (N.Y. App. Div, 2003)(citations omitted).

Like California today, Texas does not require independent counsel based solely on the fact that a reservation of rights letter is issued, finding instead that a reservation of rights letter merely creates a potential conflict. *Northern County Mut. Ins. Co. v. Davalos,* 140 S.W.3d 685, 689 (Tex. 2004). The *Davalos* court held that when an insurer issues a reservation of rights letter and the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends, the conflict of interest becomes disqualifying, preventing the insurer from conducting the defense. *Id.*[8] The court noted, on the other hand, when the disagreement concerns coverage, and the insurer defends unconditionally, no potential for a conflict of interest exists.

Some would argue the *Davalos* rule is essentially *Cumis* in disguise because the facts to be adjudicated in the liability lawsuit are frequently the same facts upon which coverage depends. Post-*Davalos* cases, however, reveal circumstances in which a reservation of rights letter does not in fact require independent counsel in Texas. For instance, in *Downhole Navigator, L.L.C. v. Nautilus Ins. Co.*, the court found that no conflict existed where the carrier issued a reservation of rights relying on a number of exclusions related to testing services. 686 F.3d 325 (5th Cir. 2012). The only issue to be decided by the jury was broad, i.e. whether the insured was negligent. Since the jury would never decide any narrower issues about testing that governed the coverage, no conflict existed.

[8] In reaching this conclusion, the court looked to a treatise authored by Allan Windt, a recognized authority in the insurance arena. *See* Allan D. Windt, INSURANCE CLAIMS AND DISPUTES REPRESENTATION OF INSURANCE COMPANIES AND Insureds § 4:20, at 370-71 (4th ed. 2001). Interesting, although Windt notes that the existence of a reservation of rights does not automatically give rise to a conflict of interest between the insurer and the insured with regard to the conduct of the insured's defense, he then goes on to say that such a conflict does exist where the facts to be adjudicated in the lawsuit are the same facts upon which the existence of coverage depends. His only authority for that proposition comes from the *Cumis* reasoning that an automatic conflict always exists upon issuance of a ROR letter because the counsel selected by the insurer would necessarily work against the interests of the insured. *Id.* at 371 n.7.

A straight *Cumis* approach is certainly simpler to follow than the Texas variation, but some may assert it is overly broad. The Texas approach is more difficult to navigate but does allow for insurers to retain defense counsel even when issuing a reservation of rights letter. Which approach is better is debatable.

B. BILLING AUDITS

In 2000, the Texas Committee on Professional Ethics issued Opinion 532 addressing the duty of confidentiality and the effect of the insurer's use of third-party auditors. The question presented to the Committee was whether, without the informed consent of the insured, counsel retained by the insurer, may be required by the insurer to submit fee statements to a third-party auditor. The answer to the question was "No." In reaching its conclusion, the Committee relied on well established Texas law that the defense counsel's only client is the insured. *See* Op. Tex. Ethics Comm'n No. 532 (2000).

The Committee noted the insurer will have typically notified counsel that he or she must submit all invoices to an independent, third-party auditing company retained by the insurer. The guidelines of the audit company require the fee statements to be in a certain format and set forth in detail the legal work performed. Statements for legal services that do not comply will not be paid. The stated purpose of the guidelines is to enable the outside auditor to determine and inform the insurer whether the legal work performed was necessary and whether the time spent doing the work was reasonable.

In its discussion, the Committee noted that Rule 1.08(e) provides that a lawyer shall not accept compensation for representing a client from a person or entity other than the client unless there is no interference with the lawyer's independent professional judgment or with the client-

lawyer relationship and information relating to the representation of a client is protected as required by Rule 1.05. TEX. RULES DISCIPLINARY P.R. 1.05(b).

Rule 1.05 provides, in pertinent part as follows:

> (a) "Confidential information" includes both "privileged information" and "unprivileged client information."..."Unprivileged client information" means all information relating to a client or furnished by the client, other than privileged information, acquired by the lawyer during the course of or by reason of the representation of the client.
>
> (b) Except as permitted by paragraphs (c) and (d), or as required by paragraphs (e) and (f), a lawyer shall not knowingly:
>
> (1) Reveal confidential information of a client or a former client to:
>
> (i) a person that the client has instructed is not to receive the information; or
>
> (ii) anyone else, other than the client, the client's representatives, or the members, associates, or employees of the lawyer's law firm…
>
> (4) Use privileged information of a client for the advantage of the lawyer or of a third person, unless the client consents after consultation.
>
> (c) A lawyer may reveal confidential information:
>
> (1) When the lawyer has been expressly authorized to do so in order to carry out the representation.
>
> (2) When the client consents after consultation….

TEX. RULES DISCIPLINARY P.R. 1.05.

The Committee noted if the lawyer's fee statement describes the legal services rendered, it includes information relating to a client acquired by reason of the representation and therefore contains confidential information of the client as defined by Rule 1.05(a). The Committee further

opined that such fee statements do not come within any of the exceptions set forth in the balance of Rule 1.05. Therefore, the only way retained defense counsel can ethically submit the information in the fee statement is when the insured consents after consultation. That consent must be informed, meaning the client must be informed of the implications or possible adverse consequences of disclosure, including the possibility that revealing the fee statement may result in a loss or waiver of the attorney-client privilege.

The New York State Bar Association Committee on Professional Ethics Opinion 716 in 1999 is virtually identical to the Texas opinion discussed above. The question presented to the New York Committee was: "When an insurance company compensates a lawyer for defending its policyholder in civil litigation pursuant to an insurance contract that requires the insurer to pay for the policyholders defense, must the lawyer obtain the clients informed consent before submitting legal bills to an auditor employed by the insurance company?" The Committee answered affirmatively: "[W]e conclude that the clients legal bills and related records are subject to the lawyers duty of confidentiality. Consequently, under longstanding principles governing the lawyer client relationship, these documents may be disclosed only with the clients informed consent. To enable the client to make a voluntary, informed decision whether to authorize the lawyer to submit the clients legal bills to the auditor, the lawyer must provide advice that is competent and that is designed exclusively to promote the client's interests, not those of the insurer or the lawyer."

Obtaining informed consent from the insured before submitting bills to a third-party auditor is not likely something defense counsel typically does. In fact, abiding by this requirement would likely confuse the average insured and make them wary of defense counsel. It is unclear how compliance can be achieved in a manner beneficial to all in the tripartite relationship. Query whether an insurance company's use of third-party billing auditors is ethical at all, or whether

counsel should reject any such audits as a matter of course. In any event, it behooves defense counsel to explain to the insured in writing that bills will be submitted in this manner and to obtain the insured's consent. Certainly, one such agreement at the outset of the litigation should satisfy the ethics rules, rather than having to obtain consent separately for each bill that goes out.

C. BILLING GUIDELINES

In 2000, the Texas Committee on Professional Ethics issued Opinion 533 addressing the issue of litigation/billing guidelines which place certain restrictions on how retained counsel should conduct the defense of the insured. The question presented to the Committee was whether a lawyer retained by an insurance company to represent an insured can ethically comply with those guidelines. The answer to the question was that it is impermissible for counsel to agree to restrictions which interfere with the exercise of independent professional judgment in rendering legal services to the insured/client. Once again, in reaching its conclusion, the Committee noted that it was well established law that the defense counsel's only client is the insured. *See* Op. Tex. Ethics Comm'n No. 533 (2000).

The Committee noted lawyers involved in defense practice for which insurers pay are faced with litigation/billing guidelines, placing certain restrictions on how they conduct the defense of the insured, including, but not limited to, discovery limitations and means of periodic reporting to the insurer. Examples listed by the Committee include:

1. Whether to hire an expert;
2. What, if any, legal research may be conducted;
3. What, if any, depositions may be taken;
4. Whether the defense counsel may investigate the claims made against the insured;
5. Whether particular depositions may be videotaped;

6. Whether any motions, including motions to dismiss or for summary judgment, may be filed; and

7. Whether the lawyer or a paralegal should engage in the preparation of various documents.

The Committee noted loyalty is an essential element of the lawyer's representation, and the lawyer, in advising or otherwise representing a client, should exercise independent professional judgment and render candid advice, citing Rules 1.01(b), 1.06, 1.08, 2.01, and 5.04(c) of the Texas Disciplinary Rules of Professional Conduct.

Rule 5.04(c) specifically provides as follows:

> A lawyer shall not permit a person who recommends, employes or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services.

TEX. RULES DISCIPLINARY P.R. 5.04(c).

Among other requirements, Rule 1.08 provides a lawyer shall not accept compensation for representing the client from one other than the client unless there is no interference with the lawyer's independence of professional judgment or with the attorney-client relationship. TEX. RULES DISCIPLINARY P.R. 1.08(e)(2). The Committee noted litigation/billing guidelines which interfere with the lawyer's professional judgment not only violate the above mentioned rules but also Rule 1.01(b), which broadly prohibits a lawyer from failing to conduct completely the obligations the lawyer owes to a client. TEX. RULES DISCIPLINARY P.R. 1.01(b). As the Texas Supreme Court noted in *Traver*, loyalty to the client/insured demands that the lawyer must at all times protect the interests of the insured if those interests would be compromised by the insurer's instructions. *Traver*, 980 S.W.2d at 628.

The opinion is consistent with national precedent.[9] Virtually every state addressing the issue has reached an identical result. Jay Old, *Walking the Ethical Tightrope An Insurance Defense Lawyer's Perspective on Third Party Audits and Billing Guidelines*, 64 TEX. B. J. 61, 64 (Jan. 2001). It does not appear that New York has addressed the issue of retained counsel following an insurer's litigation or billing guidelines, but it would likely fall in line with the majority. The Montana Supreme Court has gone so far to conclude that the requirement of prior approval from the insurer fundamentally interferes with the counsel's exercise of independent judgment and creates a substantial appearance of impropriety in its suggestion that it is insurers rather than counsel who control the day-to-day details of a defense. *In re Rules of Professional Conduct & Insurer Imposed Billing Rules & Procedures*, 2 P.3d 806, 815 (Mont. 2000).

One may argue that defense counsel cannot reject the insurer's guidelines and expect to be paid, let alone be hired again. Thus, defense counsel typically tries to follow the guidelines. If defense counsel finds something in the guidelines, which is at odds with its zealous defense, it can discuss the situation with the insurer and attempt to obtain approval to make certain modifications. If the insurer does not agree, however, defense counsel is likely left with the Hobson's choice of doing the task without compensation or not doing it at all, to the possible detriment of the insured. Additionally, defense counsel should consider providing a copy of the guidelines to the insured.

D. THE INSURED'S LACK OF COOPERATION

In 2018, the Texas Committee on Professional Ethics issued Opinion 669, addressing whether a lawyer retained by an insurance company may notify the insurance company of what it

[9] Courts and several state bar associations alike have stated that unreasonable billing guidelines, assessed on a case-by-case basis, may violate the insurer's duty to defend if they interfere with the defense and/or impact defense counsel's ethical responsibilities to exercise their independent professional judgment in rendering legal services. *See*, *e.g.*, *Dynamic Concepts v. Truck Ins. Exch.*, 71 Cal. Rptr. 2d 882, 889 (Cal. Ct. App. 1998); *In re The Rules of Professional Conduct*, 2 P.3d 806 (Mont. 2000); Rhode Island Supreme Court Ethics Advisory Panel Opinion No. 99-18 (Oct. 1999); Utah Ethics Opinion 02-01, 2002 WL 340262 (Utah State Bar 2002); West Virginia Office of Disciplinary Counsel L.E.I. 2005- 01 (2005).

perceived to be the insured's lack of cooperation in defense of the lawsuit. The answer to the question was that the lawyer should withdraw from the representation while refraining from disclosing to the insurer the reason for the withdrawal. *See* Op. Tex. Ethics Comm'n No. 669 (2018).

The Committee discussed a situation in which the insured initially cooperated in defending the lawsuit, but then stopped communicating with the attorney. The attorney tried contacting the insured by various methods, including hiring an investigator who contacted the insured and requested he contact the attorney. The insured refused to do so. The attorney then advises the insured, through the investigator, that the attorney will file a motion to withdraw. Again, the insured fails to contact the attorney.

The Committee notes it is permissible under the Rules of Professional Conduct for the lawyer to withdraw. TEX. RULES DISCIPLINARY P.R. 1.15(b). But when the attorney files his motion to withdraw, he must comply with all applicable rules, including TEX. R. CIV. P. 10, which requires a showing of good cause. However, the attorney must continue to preserve the client's confidential information under TEX. RULES DISCIPLINARY P.R. 1.05. A client's failure to communicate with the attorney is confidential client information, which cannot be disclosed to the insurer. The Committee determined that when filing the motion to withdraw, a statement to the court and to the insurer "that professional considerations require termination of the representation" ordinarily should be sufficient. New York appears not to have addressed this issue directly.

Texas P.R. 1.05 raises some practical considerations. Not disclosing the insured's lack of cooperation to the insurer may put defense counsel's ongoing relationship—and source of business—in jeopardy; additionally, defense counsel would be hard-pressed to avoid a question that the court may pose as to the reason for withdrawal. Perhaps notification to the insured of the

withdrawal can also note that failure to contact the attorney may endanger coverage to the extent that defense counsel is required to disclose information that the insurer could use to support a lack of cooperation defense.

In the ordinary course, counsel, however, must make sure that the insurance company does not abuse the cooperation clause by "turning it into a sword" to use against its insured in the dispute over coverage. Insurance companies may use the cooperation provision to try to compel the insured to produce material related to areas on which the insurer has denied coverage or reserved their rights to deny coverage. This is a misuse of the cooperation clause which must be opposed, as it creates a conflict of interest between the insurance company and the insured. Thus, at the earliest stage, after prompt notice has been provided, the insured should analyze the underlying claims, the insurance policy, and the ROR letter. Where there is a conflict between the interests of the insured and those of its insurance company with respect to the defense of the underlying claims, an insured should resist providing the insurance company with privileged and work-product information that relate to the disputed coverage issues. This, of course, assumes a sophisticated insured.

Disclosure of attorney-client or work-product documents that may contain defense counsel's analysis of issues in the underlying case—particularly if it also relates to an uncovered claim or an area of dispute in the coverage case—could result in a finding that the insured has waived the attorney-client privilege. Many insurance companies understand this latter concern, and their own interest, in keeping this material away from plaintiff's counsel.

Many practical solutions to these problems have been agreed to by insurance companies. At a minimum, any disclosures should be made pursuant to a confidentiality agreement. If possible, that confidentiality agreement should be "so ordered" by a court, and provide that the disclosure

does not affect a broader waiver of the attorney-client or work product privileges. The confidentiality agreement and order also should provide that the documents are to be used by the insurance company solely for purposes of assisting in the defense of the underlying case, setting reserves, and keeping reinsurance companies informed, and will not be used against the insured in an insurance dispute.

Some insurance companies maintain a wall between those persons designated to assist in the defense of the case and those handling the coverage dispute. In such a case, the insurance company should agree that the confidential information will not be viewed by those involved in the insurance-coverage dispute.

E. REVEALING OR DEVELOPING COVERAGE DEFENSES

Defense counsel are generally well aware that they cannot ethically share coverage defenses with the insurer or develop such defenses for the insurer. On the other hand, defense counsel generally do not study the insurance policy, the reservations of rights letter and/or conduct coverage research. Indeed, in many cases, they are advised against doing so. However, there are situations in which defense counsel may inadvertently (or perhaps negligently) violate these well understood rules.

A case in point is *Cosgrove v. National Fire & Marine Insurance Company*, No. 2:14-cv—2229-HRH, 2017 U.S. Dist. LEXIS 223352, *1 (April 10, 2017). In *Cosgrove*, the plaintiff hired WTM Construction ("WTM") to remodel her house. WTM retained various subcontractors to perform the work. The plaintiff was unsatisfied with WTM's work and sued WTM. WTM was insured by National Fire & Marine Insurance Company ("National"), which agreed to defend WTM subject to a reservation of rights. National reserved its rights to deny coverage on the "Subcontractor Exclusion" among others. The exclusion precluded coverage for work

performed by subcontractors unless the subcontractors agreed in writing to (1) defend, indemnify, and hold the general contractor harmless from claims arising out of the subcontractor's work, (2) obtain certain insurance coverage, and (3) have the general contractor named as an additional insured on obtained insurance policies.

During the course of litigation, defense counsel reported to National that he had been unable to locate written subcontracts between WTM and its subcontractors. Based on this information, among other things, the insurer's claims adjuster determined that National had an 80% likelihood of defeating coverage. Accordingly, it was only willing to offer 20% of the recommended settlement authority to resolve the case. As WTM was unwilling to fund the majority of any settlement, the case went to trial. On the eve of trial, plaintiff and WTM reached a settlement that included a stipulated judgment, a covenant not to execute against WTM's assets, and an assignment of WTM's claims against National.

The plaintiff then filed a separate suit against National. The plaintiff moved for summary judgment, arguing that National should be estopped from denying coverage based on the Subcontractor Exclusion because the information on which the insurer based its defense was obtained through defense counsel's attorney-client relationship with the insured in the underlying lawsuit. National countered that the information regarding the existence of subcontracts was not confidential or privileged and could have been discovered independently. The court agreed with the plaintiff, holding that "there is no requirement that the information in question be independently confidential," only that it "have been obtained via the attorney-client relationship and that the disclosure of the information be to the detriment of the insured." The court indicated the outcome might have been different had the insurer "done its own investigation of WTM's

claims, rather than relying on the information disclosed by the attorney retained to represent WTM."

Defense counsel apparently was unaware of the impact of his revelation about the lack of written subcontracts. He believed this information was well-known in the litigation and not something that was a secret. Nonetheless, *Cosegrove* demonstrates the defense counsel must be exceedingly careful not to do anything that may contribute to a denial of coverage for the insured. *Cosgrove* teaches that defense counsel should at least study the reservation of rights letter and refrain from reporting any information relating to the reserved grounds.

F. POLICY LIMITS DEMANDS

Defense counsel may feel as though she or he is caught in the middle when underlying plaintiff makes a settlement demand within the insurance policy's limit of liability. In some sense, a settlement within policy limits almost always behooves the insured. If defense counsel's sole duty is to the insured, then defense counsel should theoretically also favor any settlement within policy limits to avoid placing the insured's money at risk. The insurer, on the other hand, may be more willing to forgo a policy limits demand in the hopes of ultimately achieving a lower verdict. Courts have imposed excess liability on insurers in order to increase their risk aversion in the face of policy limits demands.

Under Texas law, an insurer must act with "that degree of care and diligence which an ordinarily prudent person would exercise in the management of his own business" in responding to settlement demands within policy limits. *G.A. Stowers Furniture Co. v. Am. Indem. Co*., 15 S.W.2d 544, 547-48 (Tex. Comm'n App. 1929, holding approved). If the insurer chooses not to settle, it may be compelled to pay a verdict exceeding its policy limits. This risk of additional exposure deters an insurer from failing to settle within limits when presented with a reasonable

opportunity to do so. *See American Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 849 (Tex. 1994).

Pursuant to what is commonly referred to as the "*Pavia*" rule, New York also holds a liability insurer responsible for verdicts in excess of policy limits if the insurer acts with gross disregard of the insured's interests when rejecting a settlement demand within policy limits. *See Pavia v. State Farm Mutual Automobile Ins. Co*., 626 N.E.2d 24, 27 (N.Y. 1993).The Court of Appeals held that "to establish a prima facie case of bad faith, the plaintiff [insured] must establish that the insurer's conduct constituted a 'gross disregard' of the insured's interests — that is, a deliberate or reckless failure to place on equal footing the interests of its insured with its own interests when considering a settlement offer. In other words, a bad-faith plaintiff must establish that the defendant insurer engaged in a pattern of behavior evincing a conscious or knowing indifference to the probability that an insured would be held personally accountable for a large judgment if a settlement offer within the policy limits were not accepted." *Id.* at 27–28.

The "gross disregard" standard requires "more than ordinary negligence and less than a showing of dishonest motives." *Id.* This standard may not completely relieve the insurer of any responsibility to communicate settlement negotiations and demands to the insured. While there is "no unqualified duty to inform the insured of settlement offers such that the failure to do so establishes liability as a matter of law." *Smith v. General Accident Ins. Co*., 697 N.E.2d 168, 171 (N.Y. 1998). Yet, the failure of an insurer to communicate with the insured about settlement offers and negotiations is evidence of bad faith where an insurer would ordinarily do so or customarily does so. *Id.* at 172. Thus, in New York, an insurer should follow industry practice or custom in deciding whether to involve the insured in the settlement process to avoid liability for an excess judgment.

Defense counsel's dilemma in the face of a policy limits demand is lessened by the insurer's own risk of paying an excess judgment. Nonetheless, defense counsel may still want to keep the insurer happy by settling for as little money as possible. Thus, a policy limits demand creates an uncomfortable situation for defense counsel, especially when the case against the insured is strong.

III. CONCLUSIONS

The potential conflicts discussed above are all too real. Defense counsel must struggle with them on a daily basis. The lure of keeping the insurer happy and coming back, however, likely means retained defense counsel will continue to avoid withdrawal at almost any cost, adhere to billing audits and client guidelines, and attempt to settle cases as inexpensively as possible. A different scenario is difficult to imagine. Yet, this situation creates serious ethical questions for defense counsel and speaks to vigilance on the part of the insured.