Course Materials

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Definitions

Dependent counsel

Panel counsel regularly hired by insurers who represent the interests of the insurer and the policyholder and has an attorney-client relationship with both. The succinct moniker "**de**pendent counsel" describes and differentiates its counterpart, "**in**dependent counsel." This phrase acknowledges that "[a]s a practical matter . . . in reality, the insurer's attorneys may have closer ties with the insurer and a more compelling interest in protecting the insurer's position, whether or not it coincides with what is best for the insured" (*Purdy v. Pacific Automobile Ins. Co.*(1984) 157 Cal.App.3d 59, 76), "[i]nsurance companies hire relatively few lawyers and concentrate their business. A lawyer who does not look out for the Carrier's best interest might soon find himself out of work" (*San Diego Navy Fed. Credit Union v. Cumis Ins. Society, Inc.* (1984) 162 Cal.App.3d 358, 364), and "defense counsel and the insurer frequently have a longstanding, if not collegial, relationship" (*Gulf Ins. Co. v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone* (2000) 79 Cal.App.4th 114, 131; *Unigard Ins. Group v. O'Flaherty & Belgum* (1995) 38 Cal.App.4th 1229, 1236-37). "In California, an attorney may usually, under minimum standards of professional ethics, represent dual interests as long as full consent and full disclosure occur." (*Lysick v. Walcom* (1968) 258 Cal.App.2d 136, 147; See, also *Ishmael v. Millington* (1966) 241 Cal.App.2d 520, 528.)

Disqualifying conflict of interest

A Rule 1.7 conflict of interest that requires dependent counsel to obtain the policyholder's informed written consent - or not accept representation "There is no talismanic rule that allows a facile determination of whether a disqualifying conflict of interest exists. Instead, '[t]he potential for conflict requires a careful analysis of the parties' respective interests to determine whether they can be reconciled ... or whether an actual conflict of interest precludes insurer-appointed defense counsel from presenting a quality defense for the insured.'" *Gulf Ins. Co. v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone* (2000) 79 Cal.App.4th 114, 131, quoting *Dynamic Concepts, Inc. v. Truck Ins. Exchange* (1998) 61 Cal.App.4th 999, 1007-1008.)

Independent counsel

A lawyer selected and directed by the policyholder who has no attorney-client relationship with the insurer. "An insurer usually provides a defense to its insured by hiring competent defense counsel, who represents the interests of both the insurer and the insured. In some cases, such as this one, there is a conflict of interest or a potential conflict of interest between the insurer and the insured. Usually, these conflicts involve the insured trying to obtain coverage and the insurer trying to avoid it. When this happens, defense counsel may not be permitted to represent both the insurer and the insured. The insurer may be required to provide the insured, at the insurer's expense, with independent counsel (i.e., Cumis counsel), who then controls the litigation." (*Assurance Co. of America v. Haven* (1995) 32 Cal.App.4th 78, 83-84.)

"The Cumis rule requires complete independence of counsel when an insurance company interposes a reservation of rights, the basis of which creates a conflict of interest. . . . Cumis counsel represents solely the insured. ¶ The basic premise for this view is well established. Since it is almost unavoidable that, in the course of investigating and preparing the insured's defense to the third party's action, the insured's attorney will come across information relevant to a coverage or similar issue, it is quite difficult for an attorney beholden to the insurer to represent the insured where the insurer is reserving its rights regarding coverage (unless, of course, the insured consents). ... [T]he Cumis doctrine 'intended to eliminate the ethical dilemmas and

temptations that arise along with conflict in joint representations ... through mandating the insured's right to Cumis counsel that represent[s] only the insured.' ¶ An important corollary of the Cumis doctrine is that if the insured is entitled to Cumis counsel, the insured is entitled to control the defense of the case." (*Id.* at 87.) "[T]here is no attorney-client relationship between Cumis counsel and the insurer." (*Id.* at 90.)

Informed written consent

Policyholder's written agreement to a proposed course of conduct after the lawyer has communicated and explained in writing (i) the relevant circumstances and (ii) the material risks, including any actual and reasonably foreseeable adverse consequences of the proposed course of conduct. (Rule 1.0.1(e, e-1).)

Reservation of rights

Liability insurer's warning to its policyholder that it may not fund a judgment or settlement although it will pay a lawyer to conduct the policyholder's defense. "[I]f the insurer adequately reserves its right to assert the noncoverage defense later, it will not be bound by the judgment. [T]he insurer can raise the noncoverage defense previously reserved." (*Gray v. Zurich Insurance Co.* (1966) 65 Cal.2d 263, 279 (ellipsis omitted).) A "judgment in the underlying action is conclusive as to the insurer's liability if factual matters upon which the issue of coverage turns are expressly or impliedly determined in the prior action [and] such determinations bind the insurer in the subsequent suit to enforce the provisions of the policy." (*Hogan v. Midland National Ins. Co.* (1970) 3 Cal.3d 553, 565 (citations and ellipsis omitted).) An "insurer can avoid being bound by the judgment against the insured if it . . . makes an adequate reservation of rights. . . . A nonwaiver agreement is a bilateral contract providing that the insurer will defend the tort suit while reserving its right to assert nonliability under the policy at a later date. A reservation of rights is very similar and the **assured's silence** will usually be deemed acquiescence." (*Val's Painting & Drywall, Inc. v. Allstate Ins. Co.* (1975) 53 Cal.App.3d 576, 586-87 (citations, quotation marks and ellipses omitted; emphasis added).)

A reservation of rights usually has three purposes: 1) Avoid waiver or forfeiture of contractual policy defenses to permit the reserving insurer too refuse to fund a settlement or adverse judgment; 2) Urge the policyholder to contribute toward a settlement or adverse judgment; and 3) Urge the plaintiff to accept less in settlement so as to avoid having to prosecute a second coverage lawsuit in order to collect.

The Narrow Situation

The factual predicate of this course applies when all of the following are true:

1. An injured third party asserts a claim against a defendant who has liability insurance;
2. The policyholder/defendant notifies the insurer who decides to accept the duty to defend while asserting a reservation of rights to later deny coverage;
3. The reserving insurer also decides to hire dependent counsel;
4. The liability insurer's reservation of rights always creates some conflict of interest between the insurer and the policyholder because each wants the other to pay. But **not** all reservations of rights necessarily create a disqualifying conflict of interest for dependent counsel. This situation arises hundreds of thousands, if not millions of times annually.

Caveat: Some Honorable Insurers And Their Dependent Counsel Do Comply With The Law

Reserving insurers and their dependent counsel are capable of fulfilling all of their respective duties to the policyholder/client. If they do, you need not take this course, nor read its materials. Thus, this course will hereafter assume that the reserving insurer and/or its dependent counsel will or have violated duties owed to the policyholder/client.

How Dependent Counsel Often Behave

Often dependent counsel behave very consistently. They do not get "involved" in coverage and refuse to speak of anything involving coverage, including any possible conflict of interest created by a reservation of rights. The result is that dependent counsel wholly ignores any reservation of rights, does not ask the insurer if it issued any reservation of rights, does no obtain a copy of it, nor read it, nor analyze it, nor disclose any analysis of whether the reservation of rights creates a disqualifying conflict of interest. They will not respond to questions about it, but will instead ask the policyholder to direct all questions about the reservation of rights to the claims agent. If pressed they will the policyholder to not worry about the reservation of rights, but will refuse to go on record of having ever said so.

Simple Solution To A Perplexing Problem

Policyholders should expressly withhold consent to representation until dependent counsel demonstrate that they comply with Rules of Professional Conduct (Rules) 1.7 (undivided loyalty) and 1.4 (disclosure). Replicate Nancy Reagan's famous phrase: "Just say 'No'"!

Delivery Package To Achieve Goals

This course and its materials consist of only two kinds of information: 1) objective, independently verifiable statements of law; and 2) subjective, non-verifiable statements of the author's opinions based on long, hard-earned experience. Most of the video presentation is stated in these materials. A goal of this course is for the policyholder to engage in an email campaign in which the reserving insurer and dependent counsel have possession of items 1-8 below. All of these items are supplied with this course. The policyholder should also formally complain to regulatory authorities, item 9. The policyholder will need to pose penetrating questions to a reserving insurer and dependent counsel and provide legal authority supporting the propriety of the questions. Anticipating that the policyholder will not know what to ask, the Questionnaires supply most of the questions. If asked how the policyholder got so smart to know what to ask, the truthful answer may be: "The internet." The result of this campaign should be the development of a body of admissible evidence which should urge dependent counsel to quit and the reserving insurer to agree to pay for independent counsel, to fully fund a prompt settlement, and lay a foundation for successful coverage litigation.

1. Reservation of rights letter
2. Insurance policy
3. Excerpts of Rules
4. Six Prongs of Rule 1.7
5. Ethical Compliance Questionnaire
6. Coverage Questionnaire
7. Memorandum of Law
8. Model Disclosure Letter
9. Complaints to State Bar and Department of Insurance

Ethical Compliance Is Hard For Dependent Counsel

If a client said to a lawyer: "I think you are unethical", the lawyer would likely take personal offense, deny it, but seek out discourse to resolve the client's concerns. As a lay person, the policyholder is entitled to be ignorant, ask questions, and to seek answers. The lawyer bears the entire burden of conflict of interest resolution. The Rules are strict and onerous on lawyers. Rule 1.7 compels undivided loyalty with six prongs and may require the policyholder's informed written consent. Rule 1.4 requires lawyers to educate the policyholder sufficiently that the clients can make informed decisions and may require informed consent. Rule 1.6 requires that dependent counsel protect the policyholder's confidential information regarding coverage from the reserving insurer and may require informed consent. Rule 1.8 requires policyholder informed written consent for a reserving insurer to compensate dependent counsel. Dependent counsel alone has the burden of satisfying whatever requirements are established by the Rules. The policyholder has no burden under any of the Rules. This disparity of burdens is a source of policyholder power.

As discussed below, Rule 1.7 has six prongs, each of which must be satisfied to comply with the Rule. Many terms are not defined and are confusing. Still, dependent counsel is obligated to explain it all clearly to the policyholder.

Obtaining Evidence Is Easy For Policyholders

Policyholders should develop admissible evidence of dependent counsel's actual behavior regarding each of four categories, corresponding to four Rules.

Discussions focusing upon disclosure invoke Rule 1.4 and are likely to produce the most useful admissible evidence. Rule 1.4 is largely independent of the other Rules so that dependent counsel's violation of Rule 1.4 may support withholding consent to representation independently of whether the insurer's reservation of rights creates a disqualifying conflict of interest. Rule 1.4 says: "Talk to me!" Rule 1.4 requires dependent counsel to "inform", "consult", and "explain" so that the policyholder can make informed decisions about how the liability dispute should be defended. Since dependent counsel's usual behavior is to refuse to talk about the reservation of rights, they often play right into a violation of Rule 1.4.

Discussions focusing upon whether the reservation of rights creates a disqualifying conflict of interest will invoke Rule 1.7 (undivided loyalty). Because dependent counsel often ignore coverage altogether (See, How Dependent Counsel Often Behave, above), these discussions usually devolves into a third graders playground argument: "Are too! Am not! Are too! Am not!" As a result, it is very rare that any agreement is reached between the policyholder and dependent counsel that a reservation of rights does or does not create a disqualifying conflict of interest. Therefore, the question often requires litigation. Still the policyholder should continue asking about conflict of interest as long as dependent counsel will continue to speak.

Discussions focusing upon confidentiality will invoke Rule 1.6. Usually the most important piece of information to confirm is that dependent counsel has not read nor analyzed the reservation of rights. Dependent counsel's ignorance of the reservation of rights is important for two reasons. First, dependent counsel cannot make an informed decision whether or not to disclose to the insurer confidential coverage information obtained from the policyholder if dependent counsel does not fully understand the coverage issues. Second, some courts have permitted dependent counsel to control the policyholder's defense because dependent counsel has a **duty** to favor the policyholder over the insurer on coverage issues. This rationale is

troubling for three reasons. First, favoring either client over the other violates Rule 1.7, absent informed written consent, albeit the insurer is the one to complain. Second, dependent counsel cannot possibly know if s/he is or is not favoring the policyholder on coverage issues absent intimate knowledge of the grounds upon which the insurer has reserved its rights. Third, the mere existence of a higher duty to the policyholder does not guarantee that dependent counsel will in fact favor the policyholder on coverage matters. The economic forces working on dependent counsel to please the insurer over the policyholder remain unchecked. Those courts the hold faith in the mere existence of a duty do not concern themselves with whether dependent counsel actually fulfills this duty. Beyond this there simply is not much evidence to gather about confidentiality for two reasons. First, the policyholder should not provide any confidential information to dependent counsel until conflict of interests are cleared. Second, the policyholder simply cannot know whether dependent counsel and insurer are speaking to each other confidentially - because they will keep it confidential between themselves.

Discussions focusing upon insurer payment of dependent counsel's fees will invoke ABA Rule 1.8 or Cal. Rule 1.8.6 (payment). There are three important conjunctive elements to this Rule. The first element is that the insurer may not interfere with dependent counsel's independent professional judgment. The policyholder should inquire if the insurer has "litigation guidelines", which often require dependent counsel to obtain insurer consent before doing certain work or incurring certain expenses. If so, this may indicate that the insurer, not he policyholder controls decisions about how vigorously dependent counsel will defend the policyholder. The second element is maintaining confidentiality, discussed immediately above. The third element is informed written consent. This consent is untethered to any other Rule. However, there is little doubt that dependent counsel may be paid by the reserving insurer if there is not disqualifying conflict of interest. Comment [3] to the California Rule states: "This rule is not intended to abrogate existing relationships between insurers and insureds whereby the insurer has the contractual right to unilaterally select counsel for the insured, where there is no conflict of interest. (See *San Diego Navy Federal Credit Union v. Cumis Insurance Society* (1984) 162 Cal.App.3d 358 [208 Cal.Rptr. 494].)."

Goals Of This Course

1. Pressure a reserving insurer to limit or withdraw its reservation of rights.
2. Pressure a reserving insurer to promptly fund a settlement with no contribution by the policyholder.
3. Pressure unethical dependent counsel to withdraw from representation.
4. Encourage plaintiffs and their lawyers to alert policyholders of their rights.
5. Avoid expensive coverage litigation.
6. Complete the work to achieve these goals in as little as two weeks at little cost.

1. Principals Informing These Goals

A. **Power:** The Rules empower clients to compel lawyers to behave ethically.

B. **Burden:** Dependent counsel has the sole burden to clear conflicts of interest. The Rules informing lawyer's duties of undivided loyalty, disclosure, confidentiality, and payment are strict and multifaceted, making compliance difficult for conflicted lawyer to satisfy and easy for policyholders to challenge.

C. **Proof:** Actual behavior is easy to prove, while state of mind is not. Policyholders should develop admissible evidence of the actual conduct of dependent counsel and the reserving

insurer's claims agent. Insurers tend to win cases in jurisdictions that find that the policyholder failed to offer evidence of wrongdoing by dependent counsel or claims agents. Policyholder tend to win in jurisdictions in which the policyholder presented admissible evidence of actual conduct.

D. **Timing:** Do not delay in developing admissible evidence. Rule 1.7 requires dependent counsel to clear conflicts of interest **before** accepting representation of the policyholder. Because dependent counsel are often not hired until most the 30 days has expired that is allotted to respond to a summons and complaint, dependent counsel has very little time to clear conflicts of interest, as a practical matter. As a result, most dependent counsel accept representation and make an appearance in the liability lawsuit without clearing conflicts of interest. But doing so invites risk and ridicule. Making an appearance without the client's authority may expose dependent counsel to discipline. "Corruptly or wilfully and without authority appearing as attorney for a party to an action or proceeding constitutes a cause for disbarment or suspension." (Cal. Bus. & Prof. Code § 6104.)

E. **Uniformity:** Across the nation, liability insurers and their regularly hired lawyers (dependent counsel) uniformly behave unethically to protect their selfish interests by deceiving the policyholder/client. Most human behavior falls across a bell shaped curve, but not so in the narrow situation that informs this course. Why? Perhaps because the liability insurance industry and its companion insurance defense industry have agreed upon a uniform course of regular conduct. If so, then policyholders and their independent counsel may be able to anticipate the industry conduct, not unlike a Romanian gypsy with a crystal ball, Madam Sophia.

F. **Protection:** Policyholders can, and perhaps should, resist systemic violations of ethics so as to protect themselves from their own insurers and dependent counsel. How? Just say "No".

2. Techniques To Achieve These Goals

A. The policyholder (not any lawyer) should promptly engage dependent counsel, directly challenging the lawyer's ethics by a few emails, recorded telephone calls, and recorded Zoom meetings, placing the entire Delivery Package into the hands of dependent counsel and the reserving insurer and on the written record as admissible evidence. Suggested Model emails are included in the Course Materials so that lay policyholders may know to ask penetrating questions and make a record of industry responses.

B. Policyholders must be careful to comply with state wiretapping laws. California's Penal Code § 632 prohibits telephone and video recording of confidential communications without consent of all parties. "[A] conversation is confidential under section 632 if a party to that conversation has an objectively reasonable expectation that the conversation is not being overheard or recorded." (*Kearney v. Salomon Smith Barney, Inc.* (2006) 39 Cal.4th 95, 117, fn.7, quoting from *Flanagan v. Flanagan* (2002) 27 Cal.4th 766, 776-77.) "[T]his provision . . . simply prohibits . . . recording the conversation without first informing all parties . . . that the conversation is being recorded. If, after being so advised, another party does not wish to participate in the conversation, he or she simply may decline to continue the communication. A business that adequately advises all parties to a telephone call, at the outset of the conversation, of its intent to record the call would not violate the provision." (*Kearney v. Salomon Smith Barney, Inc.* (2006) 39 Cal.4th 95, 117-18.)

C. The policyholder expressly withholds consent to being represented by dependent counsel until the lawyer complies with two of the Rules: 1) Rule 1.7 (the duty of undivided loyalty); and 2) Rule 1.4 (the duty of disclosure). The Ethical Compliance Questionnaire

expressly withholds consent!

D. The policyholder reports dependent counsel to the State Bar and the reserving insurer to the Department of Insurance. (See Primary Jurisdiction Doctrine, below)

E. Plaintiffs and their lawyers may alert policyholders of their rights against the reserving insurer and dependent counsel. Parties can talk. The lawyer can attach the Delivery Package to the defendant's deposition transcript. The policyholder will have access to the information and may hire independent counsel to have a dialogue with plaintiff's lawyer.

F. The policyholder can file a motion to recuse one's own lawyer in the liability dispute. It is likely that dependent counsel will join in such a motion, just to be rid of a pesky client. But if dependent counsel resists, the policyholder should urge the court to address and resolve the question whether the reservation of rights does or does not create a disqualifying conflict of interest.

The Primary Jurisdiction Doctrine

The primary jurisdiction doctrine permits some courts to defer making any decision which it finds should be left to a regulatory agency. "'Primary jurisdiction' . . . applies where a claim is originally cognizable in the courts, and comes into play whenever enforcement of the claim requires the resolution of issues which, under a regulatory scheme, have been placed within the special competence of an administrative body; in such a case the judicial process is suspended pending referral of such issues to the administrative body for its views. . . . [T]he primary jurisdiction doctrine advances two related policies: it enhances court decision making and efficiency by allowing courts to take advantage of administrative expertise, and it helps assure uniform application of regulatory laws. (Citations.) No rigid formula exists for applying the primary jurisdiction doctrine. Instead, resolution generally hinges on a court's determination of the extent to which the policies noted above are implicated in a given case. This discretionary approach leaves courts with considerable flexibility to avoid application of the doctrine in appropriate situations, as required by the interests of justice." (*Farmers Ins. Exchange v. Superior Court* (1992) (1992) 2 Cal.4th 377, 390-92.)

Basic Insurance Defense Principles

1. Trigger Of The Duty To Defend

Determination of the duty to defend depends on a comparison between the allegations of the complaint and the terms of the policy. Unlike the obligation to indemnify, which is only determined when the insured's underlying liability is established, the duty to defend must be assessed at the very outset of a case. The defense duty arises upon tender of a potentially covered claim and lasts until the underlying lawsuit is concluded. If any facts suggest that a claim is potentially covered by the policy, the insurer's duty to defend arises. But if, as a matter of law, no facts indicate any basis for potential coverage, the duty to defend does not arise in the first instance. Any doubt as to whether the facts establish the existence of the defense duty must be resolved in the insured's favor. (See, Memorandum of Cumis Law.)

2. An Insurer Which Fails To Defend May Be Required To Pay An Adverse Judgment

An insurer's wrongful failure to defend its policyholder may be liable to pay a judgment for which the insurer would have had no contractual duty to indemnify. (*Mullen v. Glens Falls Ins. Co.* (1977) 73 Cal.App.3d 163, 173.)

3. An Insurer Which Agrees To Defend Must Warn Its Policyholder If It Wishes To Later Deny Coverage

An insurer that may later disclaim coverage and conducts the policyholder's defense must issue a reservation of rights. An unconditional defense constitutes a waiver or forfeiture of grounds to later deny coverage. (See, *Miller v. Elite Ins. Co.* (1980) 100 Cal.App.3d 739, 754.)

4. Dependent Counsel Must Comply With Canons Of Ethics

Lawyer ethics require an investigation and analysis of any disqualifying conflicts of interest created by a reservation of rights and require disclosure to the policyholder. When a disqualifying conflict of interest exists, dependent counsel cannot ethically accept the representation without informed written consent and the reserving insurer must pay for independent counsel. (See, *San Diego Navy Fed. Credit Union v. Cumis Ins. Society, Inc.* (1984) 162 Cal.App.3d 358, 375.)

5. Reimbursement Of Defense Costs

Liability insurers may reserve their rights to later seek reimbursement of some defense costs from the policyholder. "The insurer's duty to indemnify runs to claims that are actually covered, in light of the facts proved. By contrast, the insurer's duty to defend runs to claims that are merely potentially covered, in light of facts alleged or otherwise disclosed. It follows that, in a 'mixed' action, in which some of the claims are at least potentially covered and the others are not, the insurer has a duty to defend as to the claims that are at least potentially covered. . . . As to the claims that are at least potentially covered, the insurer may not seek reimbursement for defense costs. . . . As to the claims that are not even potentially covered, however, the insurer may indeed seek reimbursement for defense costs." (*Buss v. Superior Court* (1997) 16 Cal.4th 35, 50-53 (ellipses omitted).)

6. Reimbursement Of Settlement Costs

Liability insurers may reserve their rights to later seek reimbursement of some settlement costs from the policyholder. "[W] conclude an insurer may be reimbursed for a reasonable settlement payment made over the objection of its insureds. [The insurer] satisfied the prerequisites for seeking reimbursement for noncovered claims included in a reasonable settlement payment: (1) a timely and express reservation of rights; (2) an express notification to the insureds of the insurer's intent to accept a proposed settlement offer; and (3) an express offer to the insureds that they may assume their own defense when the insurer and insureds disagree whether to accept the proposed settlement." (*Blue Ridge Ins. Co. v. Jacobsen* (2001) 25 Cal.4th 489, 492-502 (ellipses omitted).) If an insurer does reserve its rights to seek reimbursement of settlement costs, consider exercising the "Third Option" discussed by a dissenting Justice in the *Blue Ridge* case.

7. Reimbursement Of Defense Costs From Independent Counsel

Liability insurers may seek reimbursement of some excessive defense costs from independent counsel. "We conclude . . ., the insurer may seek reimbursement directly from *Cumis* counsel. If *Cumis* counsel, operating under a court order that expressly provided that the insurer would be able to recover payments of excessive fees, sought and received from the insurer payment for time and costs that were fraudulent, or were otherwise manifestly and objectively useless and wasteful when incurred, *Cumis* counsel have been unjustly enriched at the insurer's expense." (*Hartford Cas. Ins. Co. v. J.R. Marketing* (2015) 61 Cal.4th 988, 992-93.)

Policyholders Have Power Over Dependent Counsel

1. Withhold consent to representation: Rule 1.7
2. Enforce dependent counsel's burden to clear conflicts - Rule 1.7
3. Withhold consent to compensation: Rule 1.8.6
4. Withhold consent to limit scope of representation - Rule 1.2
5. Compel investigation, analysis and disclosure of significant - Rules 1.0.1, 1.4
6. Compel disclosure of settlement offers - Rule 1.4.1
7. Compel protection of confidential of coverage information - Rules 1.6, 1.8.2, 1.9, 1.18
8. Avoid contributing to settlement - ABA Rule 1.8(g)
9. Report dependent counsel to the State Bar: Rules 3.10, 4.3, 7.1
10. Withhold limiting dependent counsel's liability - Rule 1.8.8
11. Discharge dependent counsel - Rule 1.16

Policyholders Have Power Over Reserving Insurers

1. Compel insurer communication: Code of Regs. § 2695.5(b).
2. Compel insurer to make disclosure, cooperate with and assist the insured to obtain benefits that might reasonably be payable and determine the extent of the insurer's liability: Cal. Code Regs. § 2695.4(a).
3. Compel insurer to accept or deny a claim, in whole or in part, in writing and explain all factual and legal bases for each denial in detail: Cal. Code Regs. § 2695.7(b)(1).
4. Report a reserving insurer to the Department of Insurance: Cal. Code Regs. § 2695.7(b)(3).

Policyholders Have Power To Develop Admissible Evidence

The evidence needed to prove dependent counsel's violations of duties is different from the evidence needed in most lawsuits because much of the wrongdoing that may need to be presented at a coverage trial simply has not happened yet!

Most lawsuit focus on historical events. Discovery in these cases focuses on securing admissible evidence of what happened in the past. For example, when two automobile collide, most discovery focuses on the few historical seconds or minutes immediately preceding and during the accident and attaching monetary value to those past events.

In contract, when a policyholder gets served with a civil summons and complaint, the insurance company does not yet even know about it nor has it hired any lawyer to defend the claim. Thus, if the insurer violates any duties it owes to its policyholder, the good or bad conduct can only occur in the future. Similarly, if dependent counsel does or does not violate any Canons of Ethics, this conduct too can only occur in the future. At the moment of service of a summons and complaint, there simply are no witnesses nor many documents to establish violations of duty that will or will not occur in the future. Liability insurers and their dependent counsel know all of this and also know that making a record of admissible evidence about their future conduct is not in their interests. In contrast, policyholders, injured plaintiffs, and their respective lawyers usually do not know their rights and are not likely to be educated by the adverse insurer nor its dependent counsel. This course and its materials provided seek to fill this information void.

This evidentiary void creates a valuable opportunity for the policyholder to develop and manage the development of needed evidence. The void may be filled by the policyholder simply asking penetrating questions and insist on meaningful answers.

Of course, no one can just make things up. Evidence to be developed against dependent counsel should focus on two primary duties, each originating in a Rule: 1) the duty of undivided loyalty (Rule 1.7); and 2) the duty of disclosure (Rule 1.4).

The duty of confidentiality (Rule 1.6) is also very important, but it is often very difficult for a policyholder to develop evidence of any violation. If dependent counsel is unethically providing confidential information to the reserving insurer that may undermine the policyholder's coverage, such communications are likely to be oral (leaving no documentary record) or in writings under the exclusive control of the reserving insurer and dependent counsel, who are not likely disclose it to the policyholder, short of litigation.

Proving a lawyer's violation of the duty of undivided loyalty (Rule 1.7) can be very expensive and difficult because a complex legal analysis is required of the allegations of the civil complaint, the convoluted policy language, the content of the reservation of rights, and sometimes an intricate legal analysis by a judge.

In contrast, proving a lawyer's violation of the duty of disclosure (Rule 1.4) can be very simple, efficient, cheap, powerful, and effective. The core principle is for the policyholder to ask penetrating questions on the record, insist upon responses, and make an accurate written record of whatever happened.

Principles Of Developing Admissible Evidence

1. Because the attorney-client relationship is fiduciary in nature, lawyer are required by law to answer reasonable client questions.
2. Because the insurer-policyholder relationship is fiduciary-like in nature, insurers are required by law to initiate explanations of the factual and legal basis for a reservation of rights and to answer reasonable policyholder questions.
3. The substance of the evidence is likely to differ depending on when the evidence is developed. If the policyholder asks penetrating questions while being represented by dependent counsel, the lawyer's conduct will establish that s/he is acting ethically or not. Alternatively, if questioning is deferred until after the attorney-client relationship ends, the questions will necessarily be speculative (what would you have done if asked) and the after-the-fact, hindsight responses will likely be in the nature of: "Of course I would have responded ethically - and incidentally, how dare you challenge my ethics!"
4. Developing admissible evidence permits the policyholder to use that evidence in subsequent coverage litigation to educate the trial judge in the law long before finalizing jury instructions. Similarly, this evidence may educate the jury in the law so that they can simultaneously receive evidence that the reserving insurer and dependent counsel acted in a certain fashion and that such conduct was unlawful when they did it, and that they knew is was unlawful. A prong to show a violation of Ins. Code § 790.03(h) is that bad acts were "knowing" committed. Knowing violations may support policyholder's claims for failure to adhere to required standards of conduct, but may also support claims of bad faith and punitive damages. Similarly, developed evidence may support policyholder's claims against dependent counsel for breach of fiduciary duty and punitive damages.
5. Evidence which is limited to communications among the policyholder, a reserving insurer, and its dependent counsel maximizes the probability that a trial court will admit it at trial because the evidence shows the conduct of the parties. In contrast, some trial judges may refuse to admit into evidence lawyer letters as mere colloquy of counsel. Thus, counsel representing the policyholder should **NOT** be the person who develops this evidence. The

policyholder should do all the talking and writing. Policyholder counsel may and should quietly guide the policyholder, but only from behind a curtain. The mere existence of coverage counsel advising the policyholder may undermine the reserving insurer's and dependent counsel's duties of investigation, analysis and disclosure - why bother when the policyholder is already protected? Dependent counsel owes ethical duties to the client, but owes none to another lawyer. The reserving insurer owes duties to its policyholder, but not to some annoying lawyer. Policyholder counsel who openly participates in the development of evidence may be precluded from testifying at trial as a percipient witness. Jurors are unlikely to care about what appears to be a complicated fight among lawyers, while in contrast they might be very sympathetic to a dispute between a lay policyholder (just like the jurors), reserving insurer, and its dependent counsel. Policyholders appear to be vulnerable, while lawyers do not. Policyholder counsel who may be reticent to take action against fellow lawyers, can truthfully say to dependent counsel: "Don't blame me, John. She is getting this information off of the internet. I can't stop her!"

6. The policyholder should politely and sincerely offer to accept any dependent counsel who complies with the law. Dependent counsel who actually complies with the Rules of Professional Conduct and promises on the written record to fulfill the duties of undivided loyalty, investigation, analysis, disclosure, and confidentiality could very well be the policyholder's best choice of defense counsel. Any misstep by such dependent counsel could invite a suit for breach of fiduciary duty.
7. During the communication campaign, the policyholder should never DEMAND that the insurer agree to pay independent counsel for many reasons. The policyholder risks shifting the focus of the communication campaign from ethical non-compliance by dependent counsel to greed by independent counsel.
   If an initial communication campaign results in dependent counsel withdrawing from representation, then the policyholder should simply ask the reserving insurer to provide some other lawyer on the insurer's panel. Then start the campaign all over again - and keep going until the insurer has no more lawyers to propose. A record that not one single one of the insurer's dependent counsel will comply with the law creates a strong record, if litigation becomes necessary. A policyholder who hires and pays for independent counsel without insurer consent and without first conclusively determining that the reservation of rights creates a disqualifying conflict of interest risks losing a lawsuit to recover unpaid costs of defense. By the time a bad faith case goes to trial, most reserving insurers will have fully funded a settlement of the liability dispute, will not seek reimbursement from the policyholder, and will have fully paid dependent counsel - putting a halo on its head. Thus, it usually best for the policyholder to secure the reserving insurer's consent to pay independent counsel.

Policyholder's Guide To Deliver The Package

Policyholder may consider adapting and sending the following model emails and sending other documents included in the Delivery Package if they want some of all of the following:

- Limit the scope of an insurer's reservation of rights;
- Encourage prompt settlement of a liability dispute at no cost to the policyholder;
- Pressure unethical dependent counsel to withdraw from representation;
- Avoid expensive coverage litigation; and
- Do all of this in as little as two weeks.

Policyholders should anticipate that dependent counsel will likely telephone rather than email in response to policyholder emails (perhaps to avoid making a written record that will be difficult to later justify). Policyholders should accept such telephone calls, take copious notes, and send a strictly factual and accurate letter recording whatever was said. (See, Dependent counsel Letter#4.) Also, attempt to record oral communications. Many states have wiretapping statutes making it illegal to electronically record audio or video communications. But if dependent counsel insurance or the insurer's claims agents objects to being recorded, it is important to make a written record of this fact. Why don't they want to be recorded? What do they have to hide? Are they planning to lie to you?

A goal of this email campaign is to obtain information from dependent counsel and claims agents that may be introduced into evidence, it the need arises, but also to challenge them to behave lawfully or not.

In the experience of the author and as mentioned above, the behavior of dependent counsel and insurance claims agents is remarkably uniform. The following emails anticipate that dependent counsel's and claims agent's behavior will be predictable. Each experience will not likely conform to the following script, so policyholders will need to adjust to circumstances. However, the following script is not strict. The goal is to: 1) Challenge dependent counsel's ethics promptly; 2) get dependent counsel and claims agent talking; and 3) make a written record of whatever actually occurs. The details of achieving this goal may vary.

Policyholders are not practices at having these challenging encounters with dependent counsel and claims agent, who also are unaccustomed to such challenges. Good rules of thumb for the policyholder are: 1) If dependent counsel and claims agent ask the policyholder to do something, don't; 2) If they want to negotiate a compromise, don't. Instead, policyholder should demand strict compliance with the law by dependent counsel and claims agent.

Dependent counsel Letter #1 (A Legend defining terms surrounded by "&&" is provided below.)

Dear &DC&:

&InsCo& tells me that you are to defend me in &CaseName& as my lawyer. Would you please tell me whether you have any conflicts of interest?

Do not have copies of &InsCo&'s reservation of rights letter and my policy?

Thank you.

&PH&

cc: &ClmAgt&

Dependent counsel Letter #2

[If dependent counsel calls or emails to say that s/he has no conflicts of interest, then it will be important to establish the dependent counsel disclaims any conflicts of interest **before** establishing that s/he has not even considered the source of conflict, the reservation of rights letter and policy.]

Dear &DC&:

This will confirm that you told me that you have not read or analyzed &InsCo&'s reservation of rights letter or my policy. Attached are copies.

I found this on the internet: “Canons of Ethics impose upon lawyers hired by the insurer an obligation to explain to the insured and the insurer the full implications of joint representation in situations where the insurer has reserved its rights to deny coverage. If the insured does not give an informed consent . . . , counsel must cease to represent both.” (*San Diego Navy Fed. Credit Union v. Cumis Ins. Society, Inc.* (1984) 162 Cal.App.3d 358, 375.)”

Since my insurer has reserved its rights, would you please explain to me the full implications of your representation of me as to each ground upon which my insurer says that it may deny coverage to me?

Until this is cleared up, you do not have my consent to accept compensation from my insurance company to represent me.

Since you have not even seen the reservation of rights letter, how can know what confidential information that may impact my insurance coverage you should withhold from &InsCo&?
Thank you.
&PH&
cc: &ClmAgt&

_____

Dependent counsel Letter #3
(If dependent counsel says that the tripartite relationship eliminates conflicts of interest, or that s/he does not represent the insurer, or that s/he does not get involved in coverage, or asks you to identify the conflict of interest, dependent counsel Letter #3 may help advance the information exchange.)

Dear &DC&:

Enclosed is an Ethical Compliance Questionnaire and Excerpts of Rules of Professional Conduct. Please complete the Questionnaire and return it to me.
Thank you.
&PH&
cc: &ClmAgt&

_____

Dependent counsel Letter #4 - (Form of confirming letter)
Dear &DC& and &ClmAgt&:

Thank you for joining my Zoom meeting (telephone call) on &Date&.

As I told you, I recorded the meeting. Enclosed is a transcript of the recorded meeting. You told me that you refused to participate in a recorded Zoom/call, so I stopped the recording.

After ending the recording, you said . . . I said . . .

&DC& told me that you would not complete nor return to me the Ethical Compliance Questionnaire I sent to you. I asked you each of the questions on the Questionnaire during our call. Enclosed is the completed Ethical Compliance Questionnaire.

&ClmAgt& told me that you would not complete nor return to me the Coverage Questionnaire I sent. I asked you each of the questions on the Questionnaire during our call. Enclosed is the completed Coverage Questionnaire.

Please email me with additions or corrections of this summary that you believe will accurately state the substance of our discussion.
Thank you.

&PH&

Dependent counsel Letter #5
Dear &DC& and &ClmAgt&:

Enclosed are copies of [everything not previously provided, such as:] Six Prongs of Rule 1.7; Memorandum of Law; Completed Coverage Questionnaire; Completed Ethical Compliance Questionnaire; excerpts of Rules of Professional Conduct; Model Disclosure Letter; and reservation of rights letter and policy if not previously sent.]

Please investigate and analyze potential conflicts of interest created by &InsCo&'s reservation of rights letter to later deny coverage to me under my policy and report your findings to me in writing, preferably using the enclosed Model Disclosure Letter as your guide.
Thank you.
&PH&

Claims agent Letter #1
Dear &ClmAgt&:

Thank you for agreeing to defend me in &CaseName&.

Enclosed is a Coverage Questionnaire. Please complete it and return it to me.

I found this on the internet. "Canons of Ethics impose upon lawyers hired by the insurer an obligation to explain to the insured and the insurer the full implications of joint representation in situations where the insurer has reserved its rights to deny coverage. If the insured does not give an informed consent . . . , counsel must cease to represent both. Moreover, . . . where there are divergent interests brought about by the insurer's reservation of rights, . . . the insurer must pay the reasonable cost for hiring independent counsel by the insured. The insurer may not compel the insured to surrender control of the litigation." (*San Diego Navy Fed. Credit Union v. Cumis Ins. Society, Inc.* (1984) 162 Cal.App.3d 358, 375.) Thank you.
&PH&
cc: &DC&

Dependent counsel & claims agent Letter #
Dear &DC& and &ClmAgt&:

I have reported &DC& to the State Bar and reported &InsCo& to the Department of Insurance.
Thank you.
&PH&

Legend:
&ClmAgt& means the insurer's claim agent
&DC& means dependent counsel
&PH& means policyholder

At the close of the email campaign, the policyholder should have delivered to dependent counsel and the claims agent all of the following documents:
1) the policy;
2) the reservation of rights letter;
3) the completed Coverage Questionnaire;
4) the completed Ethical Compliance Questionnaire;
5) excerpts of Rules of Professional Conduct;
6) Six Prongs of Rule 1.7;
7) the Memorandum of Law; and
8) the Model Disclosure Letter.

The policyholder should have also communicated that dependent counsel does not have the policyholder's consent to:
1) represent the policyholder (so stated in the Ethical Compliance Questionnaire);
2) appear in court for the policyholder (so stated in the Ethical Compliance Questionnaire); nor
3) accept compensation from the insurer.

The policyholder should have also questioned how conflict-ignorant dependent counsel can fulfill the duty of confidentiality.

Excerpts of ABA Model Rules of Professional Conduct

Rule 1.7 Conflict Of Interest: Current Clients

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
(1) the representation of one client will be directly adverse to another client; or
(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.
(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:
(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
(2) the representation is not prohibited by law;
(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
(4) each affected client gives informed consent, confirmed in writing.

Excerpts of General Principles

[1] Loyalty and independent judgment are essential elements in the lawyer's relationship to a client. Concurrent conflicts of interest can arise from the lawyer's responsibilities to another client, a former client or a third person or from the lawyer's own interests.
[2] Resolution of a conflict of interest problem under this Rule requires the lawyer to: 1) clearly identify the client or clients; 2) determine whether a conflict of interest exists; 3) decide whether the representation may be undertaken despite the existence of a conflict, i.e., whether the conflict is consentable; and 4) if so, consult with the clients affected under paragraph (a) and obtain their informed consent, confirmed in writing. The clients affected under paragraph (a) include both of the clients referred to in paragraph (a)(1) and the one or more clients whose representation might be materially limited under paragraph (a)(2).
[3] A conflict of interest may exist before representation is undertaken, in which event the

representation must be declined, unless the lawyer obtains the informed consent of each client under the conditions of paragraph (b). To determine whether a conflict of interest exists, a lawyer should adopt reasonable procedures.
[4] If a conflict arises after representation has been undertaken, the lawyer ordinarily must withdraw from the representation, unless the lawyer has obtained the informed consent of the client under the conditions of paragraph (b).
[8] Even where there is no direct adverseness, a conflict of interest exists if there is a significant risk that a lawyer's ability to consider, recommend or carry out an appropriate course of action for the client will be materially limited as a result of the lawyer's other responsibilities or interests.
[9] In addition to conflicts with other current clients, a lawyer's duties of loyalty and independence may be materially limited by responsibilities to . . . other persons.
[10] The lawyer's own interests should not be permitted to have an adverse effect on representation of a client.
[13] A lawyer may be paid from a source other than the client, including a co-client, if the client is informed of that fact and consents and the arrangement does not compromise the lawyer's duty of loyalty or independent judgment to the client. See Rule 1.8(f). If acceptance of the payment from any other source presents a significant risk that the lawyer's representation of the client will be materially limited by the lawyer's own interest in accommodating the person paying the lawyer's fee or by the lawyer's responsibilities to a payer who is also a co-client, then the lawyer must comply with the requirements of paragraph (b) before accepting the representation, including determining whether the conflict is consentable and, if so, that the client has adequate information about the material risks of the representation.
[18] Informed consent requires that each affected client be aware of the relevant circumstances and of the material and reasonably foreseeable ways that the conflict could have adverse effects on the interests of that client. See Rule 1.0(e) (informed consent). The information required depends on the nature of the conflict and the nature of the risks involved. When representation of multiple clients in a single matter is undertaken, the information must include the implications of the common representation, including possible effects on loyalty, confidentiality and the attorney-client privilege and the advantages and risks involved.
[20] Paragraph (b) requires the lawyer to obtain the informed consent of the client, confirmed in writing. Such a writing may consist of a document executed by the client or one that the lawyer promptly records and transmits to the client following an oral consent. . . . The requirement of a writing does not supplant the need in most cases for the lawyer to talk with the client, to explain the risks and advantages, if any, of representation burdened with a conflict of interest, as well as reasonably available alternatives, and to afford the client a reasonable opportunity to consider the risks and alternatives and to raise questions and concerns. Rather, the writing is required in order to impress upon clients the seriousness of the decision the client is being asked to make and to avoid disputes or ambiguities that might later occur in the absence of a writing.
[29] In considering whether to represent multiple clients in the same matter, a lawyer should be mindful that if the common representation fails because the potentially adverse interests cannot be reconciled, the result can be additional cost, embarrassment and recrimination. Ordinarily, the lawyer will be forced to withdraw from representing all of the clients if the common representation fails. . . .
[30] A particularly important factor in determining the appropriateness of common representation is the effect on client-lawyer confidentiality and the attorney-client privilege.

[31] As to the duty of confidentiality, continued common representation will almost certainly be inadequate if one client asks the lawyer not to disclose to the other client information relevant to the common representation.

Rule 1.4 Communication - Client-Lawyer Relationship

(a) A lawyer shall:

(1) promptly inform the client of any decision or circumstance with respect to which the client's informed consent, as defined in Rule 1.0(e), is required by these Rules;

(2) reasonably consult with the client about the means by which the client's objectives are to be accomplished;

(3) keep the client reasonably informed about the status of the matter;

(4) promptly comply with reasonable requests for information; and

(5) consult with the client about any relevant limitation on the lawyer's conduct when the lawyer knows that the client expects assistance not permitted by the Rules of Professional Conduct or other law.

(b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.

Excerpts of General Principles

[1] Reasonable communication between the lawyer and the client is necessary for the client effectively to participate in the representation.

[2] If these Rules require that a particular decision about the representation be made by the client, paragraph (a)(1) requires that the lawyer promptly consult with and secure the client's consent prior to taking action.

[3] Paragraph (a)(2) requires the lawyer to reasonably consult with the client about the means to be used to accomplish the client's objectives. In some situations . . . this duty will require consultation prior to taking action. . . . [P]aragraph (a)(3) requires that the lawyer keep the client reasonably informed about the status of the matter, such as significant developments affecting the timing or the substance of the representation.

[4] A lawyer's regular communication with clients will minimize the occasions on which a client will need to request information concerning the representation. When a client makes a reasonable request for information, however, paragraph (a)(4) requires prompt compliance with the request. . . . A lawyer should promptly respond to or acknowledge client communications.

[5] The client should have sufficient information to participate intelligently in decisions concerning the objectives of the representation and the means by which they are to be pursued, to the extent the client is willing and able to do so. Adequacy of communication depends in part on the kind of advice or assistance that is involved.

[6] Ordinarily, the information to be provided is that appropriate for a client who is a comprehending and responsible adult.

[7] . . . A lawyer may not withhold information to serve the lawyer's own interest or convenience or the interests or convenience of another person.

Rule 1.6: Confidentiality of Information

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

(7) to detect and resolve conflicts of interest arising from the lawyer's change of employment or

from changes in the composition or ownership of a firm, but only if the revealed information would not compromise the attorney-client privilege or otherwise prejudice the client.
(c) A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client.

Rule 1.8 Conflict Of Interest: Current Clients: Specific Rules

(f) A lawyer shall not accept compensation for representing a client from one other than the client unless:
(1) the client gives informed consent;
(2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and
(3) information relating to representation of a client is protected as required by Rule 1.6.
(g) A lawyer who represents two or more clients shall not participate in making an aggregate settlement of the claims of or against the clients, . . . unless each client gives informed consent, in a writing signed by the client. The lawyer's disclosure shall include the existence and nature of all the claims or pleas involved and of the participation of each person in the settlement.

Rule 1.0 Terminology

(a) "Belief" or "believes" denotes that the person involved actually supposed the fact in question to be true. A person's belief may be inferred from circumstances.
(b) "Confirmed in writing," when used in reference to the informed consent of a person, denotes informed consent that is given in writing by the person or a writing that a lawyer promptly transmits to the person confirming an oral informed consent. . . .
(d) "Fraud" or "fraudulent" denotes conduct that is fraudulent under the substantive or procedural law of the applicable jurisdiction and has a purpose to deceive.
(e) "Informed consent" denotes the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct.
(f) "Knowingly," "known," or "knows" denotes actual knowledge of the fact in question. A person's knowledge may be inferred from circumstances.
(h) "Reasonable" or "reasonably" when used in relation to conduct by a lawyer denotes the conduct of a reasonably prudent and competent lawyer.
(i) "Reasonable belief" or "reasonably believes" when used in reference to a lawyer denotes that the lawyer believes the matter in question and that the circumstances are such that the belief is reasonable.
(j) "Reasonably should know" when used in reference to a lawyer denotes that a lawyer of reasonable prudence and competence would ascertain the matter in question.
(l) "Substantial" when used in reference to degree or extent denotes a material matter of clear and weighty importance.
(n) "Writing" or "written" denotes a tangible or electronic record of a communication.
which the interests of the clients actually conflict."

Excerpts of California Rules of Professional Conduct

Rule 1.7 Conflict of Interest: Current Clients

(a) A lawyer shall not, without informed written consent from each client and compliance with paragraph (d), represent a client if the representation is directly adverse to another client in the same or a separate matter.
(b) A lawyer shall not, without informed written consent from each affected client and

compliance with paragraph (d), represent a client if there is a significant risk the lawyer's representation of the client will be materially limited by the lawyer's responsibilities to or relationships with another client, a former client or a third person, or by the lawyer's own interests.
(c) (omitted)
(d) Representation is permitted under this rule only if the lawyer complies with paragraphs (a), (b), and (c), and:
(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
(2) the representation is not prohibited by law; and
(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal.
(e) (omitted)
Excerpts of Comments
[1] Loyalty and independent judgment are essential elements in the lawyer's relationship to a client. The duty of undivided loyalty to a current client prohibits undertaking representation directly adverse to that client without that client's informed written consent. Thus, absent consent, a lawyer may not act as an advocate in one matter against a person the lawyer represents in some other matter, even when the matters are wholly unrelated. . . .
[3] . . . [P]aragraph (a) does not apply with respect to the relationship between an insurer and a lawyer when, in each matter, the insurer's interest is only as an indemnity provider and not as a direct party to the action.
[4] Even where there is no direct adversity, a conflict of interest requiring informed written consent under paragraph (b) exists if there is a significant risk that a lawyer's ability to consider, recommend or carry out an appropriate course of action for the client will be materially limited as a result of the lawyer's other responsibilities, interests, or relationships, whether legal, business, financial, professional, or personal.
[8] Paragraph (d) imposes conditions that must be satisfied even if informed written consent is obtained as required by paragraphs (a) or (b).
Rule 1.4 Communication with Clients
(a) A lawyer shall:
(1) promptly inform the client of any decision or circumstance with respect to which disclosure or the client's informed consent is required by these rules or the State Bar Act;
(2) reasonably consult with the client about the means by which to accomplish the client's objectives in the representation;
(3) keep the client reasonably informed about significant developments relating to the representation, including promptly complying with reasonable requests for information and copies of significant documents when necessary to keep the client so informed; and
(4) advise the client about any relevant limitation on the lawyer's conduct when the lawyer knows that the client expects assistance not permitted by the Rules of Professional Conduct or other law.
(b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.
Rule 1.6 Confidential Information of a Client
(a) A lawyer shall not reveal information protected from disclosure by Business and Professions Code section 6068, subdivision (e)(1). . . .

[Bus. & Prof. Code § 6068 "It is the duty of an attorney to do all of the following: (e) (1) To maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client."]

Rule 1.8.6 Compensation from One Other Than Client

A lawyer shall not enter into an agreement for, charge, or accept compensation for representing a client from one other than the client unless:

(a) there is no interference with the lawyer's independent professional judgment or with the lawyer-client relationship;

(b) information is protected as required by Business and Professions Code section 6068, subdivision (e)(1) and rule 1.6; and

(c) the lawyer obtains the client's informed written consent . . . at or before the time the lawyer has entered into the agreement for, charged, or accepted the compensation, or as soon thereafter as reasonably practicable . . . .

Excerpts of Comment

[3] This rule is not intended to abrogate existing relationships between insurers and insureds whereby the insurer has the contractual right to unilaterally select counsel for the insured, where there is no conflict of interest. (See *San Diego Navy Federal Credit Union v. Cumis Insurance Society* (1984) 162 Cal.App.3d 358 [208 Cal.Rptr. 494].).

Rule 1.8.2 Use of Current Client's Information

A lawyer shall not use a client's information protected by Business and Professions Code section 6068, subdivision (e)(1) to the disadvantage of the client unless the client gives informed consent,* except as permitted by these rules or the State Bar Act.

Rule 1.8.7 Aggregate Settlements

(a) A lawyer who represents two or more clients shall not enter into an aggregate settlement of the claims of or against the clients, . . . unless each client gives informed written consent. The lawyer's disclosure shall include the existence and nature of all the claims . . . involved and of the participation of each person in the settlement.

Rule 1.0.1 Terminology

(e) "Informed consent" means a person's agreement to a proposed course of conduct after the lawyer has communicated and explained (i) the relevant circumstances and (ii) the material risks, including any actual and reasonably foreseeable adverse consequences of the proposed course of conduct.

(e-1) "Informed written consent" means that the disclosures and the consent required by paragraph (e) must be in writing.

(i) "Reasonable belief" or "reasonably believes" when used in reference to a lawyer means that the lawyer believes the matter in question and that the circumstances are such that the belief is reasonable.

(n) "Writing" or "written" has the meaning stated in Evidence Code section 250. A "signed" writing includes an electronic sound, symbol, or process attached to or logically associated with a writing and executed, inserted, or adopted by or at the direction of a person with the intent to sign the writing.

California Rule 1.0.1 does not define the phrase "directly adverse", but Comment 1 gives examples, including: "(i) a lawyer accepts representation of more than one client in a matter in which the interests of the clients actually conflict."

Six Prongs Of Rule 1.7

Most states adopt the ABA Rules of Professional Conduct. California has adopted its own language which substantially mirrors the ABA Rules. California Rule 1.7 frequently uses the conjunctive word "and", while the ABA Rule implies the conjunctive. Rule 1.7 enunciates six separate prongs, each of which must be satisfied to comply with the Rule.

First Prong:

"A lawyer shall not, without informed written consent from each client . . . represent a client if the representation is directly adverse to another client. . . ."

Second Prong:

"A lawyer shall not, without informed written consent from each affected client . . . represent a client if there is a significant risk the lawyer's representation of the client will be materially limited by the lawyer's responsibilities to or relationships with another client, a former client or a third person. . . ."

Third Prong:

"A lawyer shall not, without informed written consent from each affected client if there is a significant risk the lawyer's representation of the client will be materially limited . . . by the lawyer's own interests."

Fourth Prong:

"Representation is permitted under this rule only if . . . the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client."

Fifth Prong:

"Representation is permitted under this rule only if . . . the representation is not prohibited by law."

Sixth Prong:

"Representation is permitted under this rule only if . . . the representation does not involve the assertion of a claim by one client against another client represented by the lawyer.

ETHICAL COMPLIANCE QUESTIONNAIRE

I do not consent for you to represent me nor to accept compensation from my insurer, nor do I authorize you to appear in court for me. However, I may be willing to do so if you would please answer the following questions and explain all of your responses.

	YES	NO
Do you and I have an attorney-client relationship?	☐	☐
Will you promptly solicit an offer to settle the claim against me (Claim) within my policy limit and recommend that may insurer accept it?	☐	☐
Do you have an attorney-client relationship with my insurer?	☐	☐
Do you represent my insurer as a party in any separate matter?	☐	☐
Have you been hired to protect my insurer's interests in the lawsuit against me?	☐	☐
Does my insurer require you to obey its litigation and billing guidelines?	☐	☐
Do you need my insurer's approval to incur any expense regarding my defense?	☐	☐
Are you required to obtain my consent to limit the scope of your representation of me?	☐	☐
Do you owe duties to me of undivided loyalty, disclosure, and confidentiality?	☐	☐
Have you analyzed my policy and my insurer's reservation of rights letter (ROR)? If not how can you know if you have a conflict of interest or how to avoid disclosing my confidential coverage information to my insurer?	☐	☐
Are there any questions of fact or law raised by the ROR that are common to the Claim such that it could be defended to my insurer's benefit at my expense?	☐	☐
Is your representation of me directly adverse to your representation of my insurer?	☐	☐
Is there a significant risk that your representation of me will be materially limited by your responsibilities to or relationship with my insurer?	☐	☐
Do you have an objectively reasonable belief that you can provide competent and diligent representation of me and my insurer?	☐	☐
Is your representation of me prohibited by law?	☐	☐
Does your representation of me involve the assertion of a coverage claim by my insurer against me?	☐	☐
Will you write to me with your analysis of conflicts of interest created by the RoR?	☐	☐
Do you need my consent to accept compensation from my insurer?	☐	☐
If you refuse to complete this Questionnaire, will you violate Rule 1.4?	☐	☐
Do you typically defend all claims assigned to you by insurers the same way you treat me?	☐	☐

Please provide me with a copy of all of your correspondence with my insurer regarding the lawsuit against me, its litigation and billing guidelines, your employment contract with my insurer, and the hourly rates it has agreed to pay to you.

COVERAGE QUESTIONNAIRE

I do not consent to be represented by the attorneys you have hired to defend me, nor do I authorize you to compensate them, nor do I authorize them to appear in court for me. However, I may be willing to do so if you would please answer the following questions and explain your responses.

	YES	NO
Do you unconditionally waive all bases upon which you may deny coverage to me?	☐	☐
If a judgment includes punitive damages, will you pay all compensatory damages?	☐	☐
Will you settle the claim against me (Claim) within my policy limit?	☐	☐

If you answered all of these questions "yes", you need not answer the remaining questions.

Have you told me all grounds upon which you may deny coverage to me?	☐	☐
Will you write to me to explain how will you decide whether you will indemnify me for the Claim?		
Will you expressly waive any of the grounds to deny coverage stated in your reservation of rights letter (ROR) for the Claim?	☐	☐
Have you denied or rejected the Claim, and if so please explain all factual and legal bases for your decision?	☐	☐
Will you promptly pay for independent counsel to defend me, and if not will you write to me to explain the factual and legal bases for your decision?	☐	☐
Do you agree unconditionally that you have a duty to defend me against the Claim and that your ROR creates a duty to pay for independent counsel to defend me?	☐	☐
Do you have an attorney-client relationship with the lawyers you hired to defend me (Lawyers)?	☐	☐
Did you hire Lawyers to protect your interests in defending the Claim?	☐	☐
Do you require the Lawyers to comply with your litigation and billing guidelines, and with the Rules of Professional Conduct?	☐	☐
Do the Lawyers need your approval to incur any expense regarding my defense?	☐	☐
Do the Lawyers represent you in as a party any separate matter?	☐	☐
Have you given my policy and your ROR to the Lawyers, and if not how do they know what confidential information relating to my coverage to withhold from you?	☐	☐
Are there any questions of fact or law raised by your ROR that are common to the Claim such that it could be defended to your benefit at my expense?	☐	☐
Do you assert that I must reimburse you for any costs of defense or settlement?	☐	☐
Do you typically defend all claims the same way you have agreed to defend me?	☐	☐

Please provide me with a copy of your written standards to investigate and process claims, your claim file, your claims manual, your litigation guidelines, your billing guidelines, your contract with the lawyers you hired to defend me, and the hourly rates you pay these lawyers.

MODEL DISCLOSURE LETTER

[You may use the "find and replace" feature of word processor software to customize this model letter for all terms surrounded by "&".]

Dear &PH& and &ClmAgt&:

I am &Blank&, a partner in the law firm of &Firm&. &Blank& Insurance Company (&InsCo&) has assigned &Firm& to defend &Policyholder& (&PH&) against a lawsuit brought by &Blank& (&InjPlf&).

Although I have not yet accepted this assignment and do not yet represent nor have an attorney-client relationship with &PH&, I owe fiduciary duties to you both even at this very early stage of our relationship. This letter is protected from disclosure to others by my duty of confidentiality. (See, *State Farm Mutual Automobile Ins. Co. v. Federal Ins. Co.* (1999) 72 Cal.App.4th 1422, 1429.)

I write to you both now for several reasons.

First, &InsCo& has determined that it is obligated to defend &PH& and has asserted a reservation of rights. All reservations of rights always create some conflict of interest between a liability insurer and its policyholder because by it nature, each of you want the other to pay.

Second, I am required to explain to you both the facts and the law that impact my compliance with the Rules of Professional Conduct (Rule). Attached is a Memorandum of Law, explaining some points of law which may be applicable. I urge you to read it carefully and contact me with your questions.

Third, I am required to investigate and analyze whether &InsCo&'s reservation of rights creates the kind of conflict of interest between you two that will disqualify me from ethically representing you both without your informed written consent .

Fourth, &InsCo& is my client with which I and &Firm& have an attorney-client relationship and a longstanding and valuable legal, business, and financial relationship. &Firm& generates most of its income from assignments to it by &InsCo& and other liability insurers.

I have read the complaint, the policy, and &InsCo&'s reservation of rights letter. I have spoken by telephone with counsel for &InjPlf&, &PH&, and &ClmAgt&. &ClmAgt& also advised that &InsCo& does not agree to defend &PH& nor does it does agree unconditionally to pay for independent counsel, which I discuss further below.

&ClmAgt& advised that &InsCo& will not pay compensatory damages if punitive damages are assessed against &PH& because punitive damages require of finding of "malice" on the part of &PH&. &ClmAgt& also advised that &InsCo& will not pay for &PH&'s liability to &InjPlf& if &PH& is found to be liable for breach of contract even if &PH& also has tort liability to &InjPlf& for the same conduct.

I believe that &InsCo&'s reservation of rights letter accurately summarizes &InjPlf&'s allegations, recites pertinent policy language, and lists numerous bases upon which &InsCo& asserts that it may later deny coverage to &PH&. Although &InsCo& has asserted a reservation of rights, in my opinion, &InsCo& remains a potential indemnitor that would be affected substantially by resolution of the complaint. &InsCo&'s reservation of rights letter specifies each of the following grounds upon which it may deny coverage to &PH&:

[Address all six prongs of Rule 1.7]

- Yours and the insurer's interests are directly adverse and here is why.
- There is a significant risk that my representation of you will be materially limited by my responsibilities to or relationships with the insurer and here is why.

- There is a significant risk that my representation of you will be materially limited by my own interests and here is why.
- I sincerely and objectively believe that I can represent you and the insurer competently and diligently and here is why.
- My representation of you is a prohibited by law and here is why.
- The liability dispute does involve the assertion of a claim of no coverage by the insurer against you and here is why.

I conclude that each of the above stated grounds upon which &InsCo& reserves its rights creates a disqualifying conflict of interest for me. In reaching this conclusion, I apply Rule 1.7, the holding of *San Diego Navy Fed. Credit Union v. Cumis Ins. Society, Inc.* (1984) 162 Cal.App.3d 358, and the Restatement of Law, Liability Insurance § 16.

If you consent to my representation, &InsCo&, &PH&, and I will have what is know as a "tripartite relationship" in which &InsCo& finances the defense, &PH& acts as a witness, and I am a warrior for you both. This relationship is usually harmonious when there is no conflict of interest between you two. However, when an insurer asserts a reservation of rights, the relationship often turns dissonant. "The tranquility of this [tripartite relationship] coalition is disturbed however, where, as here, disagreement arises between the members. The situation has changed. Partners have become adversaries." (*American Mut. Liab. Ins. Co. v. Superior Court* (Nork) (1974) 38 Cal.App.3d 579, 592-93.)

In my opinion, &PH& is entitled to choose independent counsel to defend the lawsuit and &InsCo& will be obligated to pay the reasonable and necessary fees charged by them. Also, I conclude that conflicts of interest may arise which may require &InsCo& to pay for &PH&'s independent counsel during settlement negotiations.

In my opinion, Civil Code § 2860 does not apply to this case for two reasons. First, while &InsCo& has agreed to defend, it has not done so "unconditionally." Second, &InsCo& does not agree "unconditionally" that its reservation of rights creates a disqualifying conflict of interest for us. (See, *Handy v. First Interstate Bank* (1993) 13 Cal.App.4th 917, 926.) Civil Code § 2860 has a rate limitation provision, which in my opinion does not apply. Therefore, if &PH& decides to select and direct independent counsel, &InsCo&'s obligation to pay for independent counsel will not be limited to the hourly rates that it pays us.

In my opinion, if &InsCo& agrees "unconditionally" to defend and that its reservation of rights does create a disqualifying conflict of interest, then Civil Code § 2860 will apply. As a result, the rate limitation provision will apply. Also, the statute will allow me to "participate" in the defense. Even if &PH& does not give us informed written consent to represent &her/him/it&, I request that &PH& consent to my participation in the defense in a supporting role with &PH&'s independent counsel.

I understand that &PH& wishes to sue &InjPlf&. In my opinion, &InsCo& is not required to pay my firm nor &PH&'s independent counsel to prosecute &PH&'s lawsuit against &InjPlf&. Therefore, any attorney who represents &PH& will have an ethical obligation to represent all of &PH&'s interests in the litigation, both offense and defense unless &PH& gives informed written consent to limit the representation (ABA Model Rule 1.2(c); *Janik v. Rudy, Exelrod & Zieff* (2004) 119 Cal.App.4th 930, 940; *Nichols v. Keller* (1993) 15 Cal.App.4th 1672, 1684.) Absent such consent, any lawyer will need to allocate between fees incurred for offense and defense.

Since &InjPlf& and &PH& will sue each other, it is possible that each may recover damages from the other. A rule of "set-off" sometimes requires that when parties are entitled to collect money from each other, the recovery by one simply reduces the recovery of the other so as to result in a judgment only for the net amount in favor of the party with the larger recovery. In

my opinion, the set-off rule does not apply when both parties have liability insurance. (See, *Jess v. Herrmann* (1979) 26 Cal.3d 131, 143.)

I respectfully request that &PH& and &InsCo& give us your informed written consent to accept &InsCo&'s assignment. You should both consult with independent counsel of your choice to determine whether this disclosure letter is sufficient and whether you choose to give us your informed written consent to represent you both. If you decide to give us informed written consent, please sign and return this letter to us.

If you have any questions or desire any further explanation, please let me know. If you consent, please sign in the appropriate place below and send your signature to all other recipients of this letter.

Very truly yours,

&Firm&

&Blank& Insurance Company	&PH&
_____	_____
By: &Blank& Approved as to content and form	By: &PH&
_____	_____
Independent Counsel for &InsCo&	Independent Counsel for &PH&

Defenses Asserted By Reserving Insurers And Dependent Counsel

Many reserving insurers and dependent counsel often challenge virtually everything just reported in the Memorandum. However, few will back up their naysaying with supporting authority.

1. The Tripartite Relationship Eliminates Conflicts Of Interest

The so called tripartite relationship (described at length above) is a phrase which describes a harmonious team effort to minimize or defeat an injured plaintiff's liability claim in which the insurer acts as financier, the policyholder serves as witness, and dependent counsel represents the interests of both as warrior. Many reserving insurers and dependent counsel assert that because the three members of in the tripartite relationship share common interests, it is just not possible for the members to have opposing interests.

Contrary to this assertion, the cases describing the tripartite relationship are uniformly clear that its harmony dissolves into dissonance when conflicts of interest arise. More strikingly, this defense makes no sense. The fact that insurer, policyholder, and common dependent counsel can and should always work to minimize or defeat an injured plaintiff's liability claim, these shared interest do not of themselves eliminate any possibility that the trio may have simultaneous conflicting interest that divide them. The USA may oppose China, and North Korea on many issues, but the USA and China can agree that neither benefits by North Korea developing nukes.

2. Dependent Counsel Does Not Represent The Insurer Or Its Interests

When an injured plaintiff sues a policyholder, extremely rarely is the insurer added as a party to the litigation. Many reserving insurers and dependent counsel argue that since the insurer is not a party, it does not qualify as a "client", which in turn leads to the conclusion that dependent counsel cannot have a disqualifying conflict of interest. A few jurisdictions concur with this view - a foolish result in the opinion of the author.

By definition, a liability insurer is an indemnitor of the policyholder's potential liability. A liability insurer that agrees to defend and indemnify its policyholder bears all of the financial risk of a liability suit (except for a modest deductible and a possible judgment in excess of the policy limit) and therefore is usually permitted by contract and the courts to take full control of the policyholder's defense (except when a conflict of interest arises) because the insurer alone bears the financial burden of paying for the legal defense and paying an adverse judgment, up to the policy limit.

Even when an insurer reserves its rights to later deny coverage, it must bear the costs of defense and possibly the cost of indemnification. As a consequence, the insurer always has financial interest to protect in the conduct of its policyholder's defense. The lawyers it hires to conduct the policyholders defense owe to the insurer the same duties owed to the policyholder and a breach of any of those duties may result in lawyer being liable to the insurer for legal malpractice. (See e.g., *Gulf Ins. Co. v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone* (2000) 79 Cal.App.4th 114.)

Separately, ABA and California Rule 1.7(b) is explicit that: "A lawyer shall not, without informed written consent from each affected client . . . represent a [policyholder] if there is a significant risk the lawyer's representation of the [policyholder] will be materially limited by the lawyer's responsibilities to or relationships with . . . a third person." Even if not considered by some courts to qualify as a "client" because the insurer is not a party to liability lawsuit, a reserving insurer is a "third person" with whom dependent counsel has a longstanding and valuable relationship and to whom dependent counsel has responsibilities to protect its financial interest in conducting the liability defense. Thus, dependent counsel always represents the interests of the insurer. The language of Rule 1.7 itself makes clear that dependent counsel's duty

of undivided loyalty applies in the reserving insurer-policyholder relationship.

3. Dependent Counsel Does Not Get Involved In Coverage

Uniformly, reserving insurers and dependent counsel assert that the insurer hires dependent counsel to defend the policyholder against the liability lawsuit and not to give coverage advise to either the reserving insurer or the policyholder. However, this fact does not excuse dependent counsel from ethical compliance for two reasons.

First, while it is true that a lawyer may not give legal advise to dual clients regarding matters on which the clients' interests conflict, it does not follow that the lawyer is thereby excused from compliance with the Rules to clear conflicts of interest before accepting a representation. Conflicts of interest created by a reservation of rights are no different from conflicts of interest that may arise in any other circumstance that divides the interests of dual, dueling clients. Of course the common lawyer cannot ethically advise either client how to advance one's interests to the detriment of the other. But the lawyer must still fulfill duties of undivided loyalty, disclosure, and confidentiality or obtain informed written consent of both clients before accepting the representation.

Second, Rule 1.2(b) requires that a "lawyer may limit the scope of the representation if . . . the client gives informed consent." Therefore, dependent counsel must obtain the policyholder oral informed consent to limit the scope of a representation.

4. The Policyholder Has The Burden To Establish Conflicts Of Interest

As discussed above, the reserving insurer has a regulatory burden to evaluate and disclose to the policyholder the factual and legal basis for asserting a reservation of rights that always creates some sort of conflicts of interest. Similarly, dependent counsel has the same burden. One of the reasons that many reserving insurers and dependent counsel seek to cajole the policyholder into ignoring conflicts of interest until the liability dispute is concluded is that if the policyholder is forced to sue dependent counsel and the reserving insurers, the policyholder may bear the evidentiary burden to prove that a reservation of rights creates a disqualifying conflict of interest. "(A) party has the burden of proof as to each fact the existence or nonexistence of which is essential to the claim for relief or defense that he is asserting." (Evid. Code § 500.) While a policyholder may bear a litigation burden to prove the existence of a disqualifying conflict of interest, this truth does not excuse either the reserving insurer or dependent counsel from making required disclosures and clearing conflicts before dependent counsel accepts representation of the policyholder.

5. Establishing A Disqualifying Conflict Of Interest Requires Litigation

Many policyholders sue their reserving insurers (and perhaps dependent counsel) to recover costs of defense expended for independent counsel to defend the policyholder against the liability lawsuit. In such a suit, the policyholder is usually required to carry the burden of proof to establish that the insurers reservation of rights letter created a disqualifying conflict of interest. Such litigation is time consuming, stressful, and expensive and risks that a court may conclude that the insurers reservation of rights letter sis not create a disqualifying conflict of interest so that the reserving insurer is not required to pay for the policyholder's independent counsel.

Forcing the policyholder to file coverage litigation is a powerful tactic which often discourages policyholders from seeking or obtaining insurer payment for independent counsel. But the non-litigation techniques which this memorandum tries to explain may create an opportunity to obtain the reserving insurer's consent to pay for independent counsel's attorneys fees and costs by making a record of admissible evidence that the insurer has no ethical attorneys on its panel who will fulfill their duties of undivided loyalty and disclosure to the policyholder.

6. A Policyholder's Failure To Accept Ethically Conflicted Dependent Counsel Violates The Cooperation Clause

Many reserving insurers claim that any policyholder who does not accept dependent counsel as one's lawyer regardless of ethical compliance violates the cooperation clause of the policy, the consequence of which may be that the policyholder losses all coverage. Diligent legal research has revealed no reported opinion that so holds. To the contrary, case law is clear that cooperation clause requires the policyholder to show up and testify truthfully in discovery and at trial - but nothing more.

While virtually all liability policies include a cooperation clause, the language varies widely. But many policies have very amorphous language. A standard CGL policy states: "You . . . must . . . Cooperate with us in the investigation or settlement of the claim or defense against the 'suit'." A legal malpractice policy reads: "The Insured shall cooperate with the Insurer and provide the Insurer such information as it may reasonably require in the investigation, defense or settlement of any Claim." Some policies spell out a policyholder's duties: "The Insured shall cooperate with the Company . . . and assist in making settlements, in the conduct of the suits, and . . . the Insured shall provide copies of all pertinent documents to the Company, provide reasonable reports regarding the Claim to the Company, attend depositions, hearings, mediations and trials and assist in securing-and-giving evidence and obtaining the attendance of witnesses." Yet another reads: "The Insured will cooperate with the Company in the defense, investigation and settlement of any claim. Upon the Company's request, the Insured will attend hearings, depositions and trials and assist in effecting settlements, securing and giving evidence, obtaining the attendance of witnesses and in the conduct of suits and proceedings in connection with a claim." No standard policy has language that excuses dependent counsel from ethical compliance nor requires the policyholder to accept representation by unethical dependent counsel.

"An insurer may assert defenses based upon a breach by the insured of a condition of the policy such as a cooperation clause, but the breach cannot be a valid defense unless the insurer was substantially prejudiced thereby." (*Campbell v. Allstate Ins. Co.* (1963) 60 Cal.2d 303, 305.) "[I]n order to establish it was prejudiced by the failure of the insured to cooperate in his defense, must establish at the very least that if the cooperation clause had not been breached there was a substantial likelihood the trier of fact would have found in the insured's favor." (*Hall v. Travelers Ins. Co* (1971) 15 Cal.App.3d 304, 308 (citations, quote marks, and ellipses omitted).)

"[T]he burden of proving that such a breach resulted in prejudice is on the insurer." (*Hall v. Travelers Ins. Co* (1971) 15 Cal.App.3d 304, 308.) "(B)reach by an insured of a cooperation or notice clause may not be asserted by an insurer unless the insurer was substantially prejudiced thereby; (2) that prejudice is not presumed as a matter of law from such breach; (3) that the burden of proving prejudicial breach is on the insurer; and (4) that, although the issue of prejudice is ordinarily one of fact, it may be established as a matter of law by the facts proved." (*Northwestern Title Security Co. v. Flack* (1970) 6 Cal.App.3d 134, 141.)

I may constitute a violation of the cooperation clause for the policyholder to collude with the insurer or the injured plaintiff to subvert the judicial process. "[A] cooperation clause may not be expanded to require the assured 'to combine with the insurer to present a sham defense.'" (*Valladao v. Fireman's Fund Indem. Co.* (1939) 13 Cal. 2d 322, 329.) "Collusive assistance in the procurement of a judgment . . . constitutes a breach of the cooperation clause." (*Span, Inc. v. Associated Internat. Ins. Co.* (1991) 227 Cal. App. 3d 463, 483.)

7. Civil Code § 2860 Limits Disqualifying Conflicts Of Interest

Civil Code § 2860(b) provides in part: "a conflict of interest does not exist as to allegations or facts in the litigation for which the insurer denies coverage." Thus, an outright

denial of all coverage does not create a conflict of interest. This makes sense since when an insurer denies all coverage and does not hire dependent counsel, the lawyer has not conflict. The statute continues: "however, 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." Some dependent counsel and reserving insurers interpret this language to mean that if dependent counsel believes that there is not conflict of interest, then there is none. There are no reported California opinions embracing this interpretation. Also, the lawyer's belief must be reasonable - establishing an objective, not a subjective standard of reasonableness. Moreover, such a self-serving reading violates five of the six prongs of Rule 1.7, all six must be satisfied.

8. The Duty To Favor The Policyholder Solves Conflicts Of Interest

Some jurisdictions ruled that they will not assume that dependent counsel will behave unethically in the absence of proof. Therefore, reported opinions are satisfied that policyholders are adequately protected by dependent counsel's obligation to favor the policyholder over the insurer on coverage issues. Alabama, Hawaii, Michigan, Oregon, Washington, and West Virginia have all published opinion expressing this view. However, the Rules are prophylactic, not remedial, in nature. They are designed to prevent lawyers from accepting representation where dual clients have conflicting interests. It runs counter to the fundamental purpose of the Rules to allow dependent counsel to accept representation despite unresolved conflicts of interest with a view toward sorting out the damage later. "One of the principal obligations which bind an attorney is that of fidelity, the maintaining inviolate the confidence reposed in him by those who employ him, and at every peril to himself to preserve the secrets of his client. This obligation is a very high and stringent one. It is also an attorney's duty to protect his client in every possible way, and it is a violation of that duty for him to assume a position adverse or antagonistic to his client without the latter's free and intelligent consent given after full knowledge of all the facts and circumstances. By virtue of this rule an attorney is precluded from assuming any relation which would prevent him from devoting his entire energies to his client's interests. Nor does it matter that the intention and motives of the attorney are honest. The rule is designed not alone to prevent the dishonest practitioner from fraudulent conduct, but as well to preclude the honest practitioner from putting himself in a position where he may be required to choose between conflicting duties, or be led to an attempt to reconcile conflicting interests, rather than to enforce to their full extent the rights of the interest which he should alone represent." (citations omitted.) (*Anderson v. Eaton* (1930) 211 Cal. 113, 116.)

MEMORANDUM OF LAW

POLICYHOLDER POWER WHEN A LIABILITY INSURER AGREES TO DEFEND UNDER A RESERVATION OF RIGHTS AND HIRES PANEL COUNSEL

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Memorandum of Law

The Situation

You have a car accident and ask your liability insurer to take care of you by keeping its two primary promises: 1) hire a lawyer to guide you through the legal morass; and 2) swiftly fund a settlement or judgment.

But suppose the other driver was your spouse's lover who died and you are now accused of murder. If true, you will not be covered by your insurance, but no one can know for sure until a jury and judge find the truth. You might be an innocent victim, in which case you and the insurer both win and the plaintiff loses. You might be a negligent driver, in which case you and the plaintiff win, but the insurer loses. Or you might be a felon, in which case the plaintiff wins but may not collect, the insurer wins, and you lose.

In this situation, your insurer still has to keep its promise to hire an ethical lawyer to protect you, but it may not fund a settlement or judgment. The murder charge creates a conflict of interest between you and your insurer because each wants the other to pay, but the outcome will not be known until the case against you is over.

Your insurer must warn you in writing of this conflict of interest by what is called a "reservation of rights" letter. Because you and your insurer are at odds, the lawyers it regularly hires often may not ethically represent both you and your insurer without your informed written consent - implementing the Biblical stricture that no one can serve two masters. (Matthew 6:24.) Your interests are served by a lawyer who will prove you innocent and minimize the damage claim, but also protect you from your own insurer's threat to deny coverage. Your insurer's interests are served by a lawyer who proves that you are indeed a murderer!

Liability insurers issue reservations of rights hundreds of thousands of time per year across America. But in this situation, who gets to choose the lawyer? The universal answer is that the insurer must keep its promise to pay for an ethical lawyer, but you have the power to select and direct your own defense through a lawyer you choose.

Is the problem solved? No. Alas, in real world practice insurers and their chosen lawyers simply make a practice of disobeying the law (with exceptions, of course). This memorandum seeks to help you understand the law that controls in this situation.

Summary

Lawyers and insurers are highly regulated, each owing closely related duties to their policyholder/clients. Lawyer's Canons of Ethics and the State Bar Act impose on them duties of undivided loyalty, disclosure, and confidentiality. A liability policy makes two primary promises: 1) a very broad promise to pay for a lawyer to defend against claims; and 2) a much narrower promise to fund a settlement or adverse judgment. Liability insurers also owe duties to their policyholders rooted in contract, a duty of good faith, statutes, administrative regulations, and case law.

A liability insurer that wrongfully fails to defend its policyholder risks having to pay for all of the policyholder's losses even if the policy does not technically provide indemnity coverage. As a result, many insurers who are not certain that they will fund an adverse judgment will routinely issue a reservations of rights agreeing to defend a claim, but warning the policyholder that they may not indemnify.

All reservations of rights create some sort of conflict of interest between the insurer and its policyholder because each hopes to not be the one who must pay. This conflict always creates an ethical dilemma for lawyers regularly hired by insurers, often called panel counsel. While not all reservations of rights necessarily disqualify panel counsel from representing the policyholder, it is very important to decide whether the insurer's lawyer can or cannot ethically represent the policyholder before they start work.

The legal test to determine whethe r reservation of rights does or does not disqualify panel counsel is whether the reservation of rights involves any disputed issues of fact or law in common with the claim. The reserving insurer and panel counsel, not the policyholder bear the burden to do this analysis. Rules of Professional Conduct (Rule), Rule 1.7 lays out six different prongs, each of which must be satisfied in order for panel counsel to clear conflicts of interest.

The Attorney-Client Relationship

"The relation between attorney and client is a fiduciary relation of the very highest character, and binds the attorney to most conscientious fidelity." (*Cox v. Delmas* (1893) 99 Cal. 104, 123.) "The standards governing an attorney's ethical duties are conclusively established by the Rules of Professional Conduct." (*David Welch Co. v. Erskine & Tulley* (1988) 203 Cal.App.3d 884, 892.)

1. Lawyers Owe Fiduciary Duties To Their Clients

"(T)he dealings between practitioner and client frame a fiduciary relationship. The duty of a fiduciary embraces the obligation to render a full and fair disclosure to the beneficiary of all facts which materially affect his rights and interests. 'Where there is a duty to disclose, the disclosure must be full and complete, and any material concealment or misrepresentation will amount to fraud.'" (*Neel v. Magana, Olney, Levy, Cathcart & Gelfand* (1971) 6 Cal.3d 176, 188-89.) "An attorney's duty of loyalty to a client is not one that is capable of being divided, at least under circumstances where the ethical obligation to withdraw from further representation of one of the parties is mandatory, rather than subject to disclosure and client consent. (*Flatt v. Superior Court* (1994) 9 Cal.4th 275, 282.) "The fiduciary relationship existing between lawyer and client extends to preliminary consultations by a prospective client with a view to retention of the lawyer, although actual employment does not result. . . . An attorney represents a client - for purposes of a conflict of interest analysis - when the attorney knowingly obtains material confidential information from the client and renders legal advice or services as a result." (*People v. Speedee Oil Change Systems, Inc.* (1999) 86 Cal.Rptr.2d 816, 825.)

2. The Rules Of Professional Conduct Are Prophylactic

Panel counsel should not unthinkingly accept representation of a policyholder whose insurer has reserved its rights to deny coverage to the policyholder but should instead promptly determine wether a reservation of rights creates a disqualifying conflict of interest because the Rules of Professional Conduct are prophylactic. "The primary purpose of this prophylactic rule [now Rule 1.7] is to prevent situations in which an attorney might compromise his or her representation of the client in order to advance the attorney's own financial or personal interests." (*Santa Clara County Counsel Attorneys Assn. v. Woodside* (1994) 7 Cal.4th 525, 546; see also, *Gregori v. Bank of America* (1989) 207 Cal.App.3d 291, 308.) "[T]he purpose of a disqualification order must be prophylactic" (emphasis added).) "[T]he insurer has a prophylactic duty to defend the entire 'mixed' claim." (*Aerojet-General Corp. v. Transport Indemnity Co.* (1997) 17 Cal.4th 38, 60.)

3. The Duty Of Undivided Loyalty

"[T]he principle precluding representing an interest adverse to those of a current client is based . . . on the need to assure the attorney's undivided loyalty and commitment to the client." (*Flatt v. Superior Court* (1994) 9 Cal.4th 275, 288.) "Attorneys have a duty to maintain undivided loyalty to their clients to avoid undermining public confidence in the legal profession and the judicial process." (*People v. Speedee Oil Change Systems, Inc.* (1999) 86 Cal.Rptr.2d 816, 824.) "If this duty of undivided loyalty is violated, "public confidence in the legal profession and the judicial process" is undermined. (*Truck Ins. Exchange v. Fireman's Fund Ins. Co.* (1992) 6 Cal.App.4th 1050, 1057.)

A. Rule 1.7

Rule 1.7 is a source of the duty of undivided loyalty, which prohibits any lawyer from representing dual clients whose interests conflict in language that declares what lawyers shall not do and what they may do. (*Flatt v. Superior Court* (1994) 9 Cal.4th 275, 282, fn.2.) The Rule states in part:

"(a) A lawyer shall not, without informed written consent from each client and compliance with paragraph (d), represent a client if the representation is directly adverse to another client in the same or a separate matter.

"(b) A lawyer shall not, without informed written consent from each affected client and compliance with paragraph (d), represent a client if there is a significant risk the lawyer's representation of the client will be materially limited by the lawyer's responsibilities to or relationships with another client, a former client or a third person, or by the lawyer's own interests.

[(c) omitted.]

"(d) Representation is permitted under this rule only if the lawyer complies with paragraphs (a), (b), and (c), and:

"(1) the lawyer reasonably believes that the lawyer will be able to provide competent and

diligent representation to each affected client;
"(2) the representation is not prohibited by law; and
"(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal.
[(e) omitted.]"

B. The Rule Of Automatic Disqualification

Disqualification of a conflicted lawyer is almost automatic. "(I)n all but a few instances, the rule of disqualification in simultaneous representation cases is a per se or 'automatic' one. (Citation.) 'Where the [attorney-client] relationship is a continuing one, adverse representation is prima facie improper.'" (*Flatt v. Superior Court* (1994) 9 Cal.4th 275, 284-85.) Upon establishing a prima facie case, the burden of going forward and the burden or persuasion shifts the other party. (See, *Morgan v. Regents of the Univ. Of Cal.* (2000) 88 Cal.App.4th 52, 68.)

C. Panel Counsel Must Clear Conflicts Of Interest Before Starting Work

A liability insurer's duty to defend must be discharged immediately and entirely. "To defend meaningfully, [it] must defend immediately. [Citation.] To defend immediately, it must defend entirely. (*Buss v. Superior Court, supra*, 16 Cal.4th at pp. 48-49.)" (*Aerojet-General Corp. v. Transport Indemnity Co.* (1997) 17 Cal.4th 38, 59-60.) "Imposition of an immediate duty to defend is necessary to afford the insured what it is entitled to: the full protection of a defense on its behalf. (See *Signal Companies, Inc. v. Harbor Ins. Co.* (1980) 27 Cal.3d 359, 367.) ¶ The insured's desire to secure the right to call on the insurer's superior resources for the defense of third party claims is, in all likelihood, typically as significant a motive for the purchase of insurance as is the wish to obtain indemnity for possible liability. As a consequence, California courts have been consistently solicitous of insureds' expectations on this score." (*Montrose Chemical Corp. v. Superior Court* (1993) 6 Cal.4th 287, 295-96.)

Panel counsel hoping to conduct the policyholder's defense share a duty to resolve conflicts of interest promptly since they have little time to respond in court to the service of a summons on the policyholder. Whether or not panel counsel's investigation and analysis of potential conflicts of interest yields a conclusion that a reservation of rights creates a disqualifying conflict of interest, panel counsel should always seek: 1) the policyholder's informed written consent that the insurer's reservation of rights does not create a disqualifying conflict of interest; or 2) the policyholder's informed written consent to a conflicted representation although the insurer's reservation of rights does create a disqualifying conflict of interest; or 3) a judicial determination that the insurer's reservation of rights does or does not create a disqualifying conflict of interest. Because compliance with the Rules is prophylactic, resolution of conflict of interest questions

cannot be deferred until after panel counsel accepts the representation or violates duties of undivided loyalty, confidentiality, and disclosure.

Nor should panel counsel unethically accept representation of the policyholder with a view to reverse the violation of Rule 1.7 at a later time. The Rule is written in mandatory language that panel counsel "shall not, without informed written consent . . . represent a client if" - followed by the six prongs. Similarly, a reserving insurer may not cure a prior breach by subsequently changing its mind and deciding to start obeying the law. "[A] belated offer to pay the costs of defense may mitigate damages but will not cure the initial breach of duty." (*Shade Foods, Inc. v. Innovative Products Sales & Marketing, Inc.* (2000) 78 Cal.App.4th 847, 881.)

Panel counsel must comply with Rule 1.7 **before** they may ethically accept representation of the policyholder. If panel counsel fails to carry the burden to eliminate all six prongs of Rule 1.7 before accepting employment by the insurer to represent the policyholder, panel counsel are not qualified to represent the policyholder. A repeated phrase in subsections (a) and (b) is that panel counsel "shall not, without informed written consent . . . represent a" policyholder. "'Shall' is mandatory." (*In re Manzy W* (1997) 14 Cal.4th 1199, 1204.)

The manner in which a liability insurer must discharge its duty to defend must be determined at the outset of the third party liability dispute. (See, *Hartford Casualty Ins. Co. v. Swift Distribution, Inc.* (2014) 59 Cal.4th 277, 287.) Because the deadline for a policyholder to respond to a summons is 30 days (Code of Civ. Proc. § 412.20(a)(3)), panel counsel must act promptly to clear conflicts of interest.

D. The Policyholder May Consent To An Ethically Compromised Counsel

Rule 1.7 is clear that lawyers may represent clients with conflicting interests if a reservation of rights does not create a disqualifying conflict or if the clients give informed written consent. "(N)ot every reservation of rights entitles an insured to select Cumis counsel." (*Dynamic Concepts, Inc. v. Truck Ins. Exchange* (1998) 61 Cal.App.4th 999,1006.) The prohibitions of Rule 1.7 do not apply if the lawyer obtains each client's informed written consent.

4. The Duty Of Disclosure

Lawyers owe a duty of disclosure to their clients to equip the client to make informed decisions about their representation.

A. Rule 1.4

Rule 1.4 requires panel counsel to promptly and reasonably inform the policyholder of any decision or circumstance regarding the policyholder's informed consent, to reasonably consult with the policyholder to accomplish their objectives, keep the policyholder informed of significant developments, promptly comply with reasonable requests for information and documents, teach the policyholder, and advise the

policyholder about the lawyer's own limitations in accepting the representation so that the policyholder can make informed decisions regarding the representation.

B. Case Law

"Cases in which the defendant stands in a fiduciary relationship to the plaintiff are frequently treated as if they involved fraudulent concealment of the cause of action by the defendant. The theory is that although the defendant makes no active misrepresentation, this element 'is supplied by an affirmative obligation to make full disclosure, and the non-disclosure itself is a "fraud."'" (*Neel v. Magana, Olney, Levy, Cathcart & Gelfand* (1971) 6 Cal.3d 176, 189.) "[A] lawyer who, while purporting to continue to represent an insured and who devotes himself to the interests of the insurer without notification or disclosure to the insured, breaches his obligations to the insured and is guilty of negligence." (*Betts v. Allstate Ins. Co.* (1984) 154 Cal.App.3d 688, 716.)

5. The Duty Of Confidentiality

Lawyers owe a duty of confidentiality to their clients to protect them from the risk of any prejudice resulting from revealing the client's secrets.

A. Rule 1.6

Rule 1.6 prohibits panel counsel from violating the duty of confidentiality without the policyholder's informed consent. Panel counsel are prohibited from disclosing to any reserving insurer any confidential information obtained from the policyholder which could possibly impact coverage. Panel counsel cannot discharge this duty of confidentiality unless they have first investigated and analyzed coverage issues upon which the insurer has reserved its rights to later deny coverage to its policyholder. Bus. & Prof. Code § 6068(e)(1) provides that: "It is the duty of an attorney to . . . maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client."

B. Case Law

"One of the principal obligations which bind an attorney is that of fidelity, the maintaining inviolate the confidence reposed in him by those who employ him, and at every peril to himself to preserve the secrets of his client. This obligation is a very high and stringent one. It is also an attorney's duty to protect his client in every possible way, and it is a violation of that duty for him to assume a position adverse or antagonistic to his client without the latter's free and intelligent consent given after full knowledge of all the facts and circumstances. By virtue of this rule an attorney is precluded from assuming any relation which would prevent him from devoting his entire energies to his client's interests. Nor does it matter that the intention and motives of the attorney are honest. The rule is designed not alone to prevent the dishonest practitioner from fraudulent conduct, but as well to preclude the honest practitioner from putting himself in a position where he may be required to choose between conflicting duties, or be led to an attempt to reconcile

conflicting interests, rather than to enforce to their full extent the rights of the interest which he should alone represent." (*Anderson v. Eaton* (1930) 211 Cal. 113, 116 (citations omitted).)

6. The Duty To Investigate Potential Conflicts Of Interest

Common sense commands that lawyers cannot evaluate whether a reservation of rights creates a disqualifying conflict of interest without knowing the relevant facts and applicable law.

A. Rule 1.0.1

The phrases informed consent and informed written consent are defined in Rule 1.0.1(e) and (e-1). "'Informed consent' means a person's agreement to a proposed course of conduct after the lawyer has communicated and explained (i) the relevant circumstances and (ii) the material risks, including any actual and reasonably foreseeable adverse consequences of the proposed course of conduct. "'Informed written consent' means that the disclosures and the consent required by paragraph (e) must be in writing."

Logic dictates that a lawyer seeking to represent dual clients with conflicting interests must start the process of clearing conflicts of interest by investigating the applicable facts and law to determine at the very least whether informed consent or informed written consent are required. This investigation should address relevant circumstances, the material risks, and foreseeable adverse consequences of panel counsel accepting a representation. Rule definitions incorporate the disclosure obligations of Rule 1.4 in that the fruits of an investigation must be "communicated and explained" orally to the policyholder. In order to obtain informed written consent, both the disclosures by the lawyer to the policyholder and the policyholder's consent must be in writing. (Rule 1.0.1(e-1).)

B. Case Law

"No matter how honest the intentions, counsel cannot discharge inconsistent duties. . . . (Panel counsel) was bound to investigate all conceivable bases on which liability might attach. These investigations and client communications may provide information relating directly to the coverage issue. . . . As between counsel's two clients, there is no confidentiality regarding communications intended to promote common goals (Evid. Code, § 962). But confidentiality is essential where communication can affect coverage. Thus, the lawyer is forced to walk an ethical tightrope, and not communicate relevant information which is beneficial to one or the other of his clients." (*San Diego Navy Fed. Credit Union v. Cumis Ins. Society, Inc.* (1984) 162 Cal.App.3d 358, 366)

7. The Duty To Not Accept Compensation

Lawyers may not accept compensation from a liability insurer for representing a policyholder without informed written consent.

A. Rule 1.8.6 (ABA Rule 1.8)

California Rule 1.8.6 (ABA Rule 1.8) prohibits panel counsel from charging or accepting compensation from a liability insurer for representing a policyholder unless the insurer does not interfere with panel counsel's independent professional judgment, does not interfere with the lawyer-client relationship, protects confidential information, and the policyholder gives informed written consent. Panel counsel who fail to obtain a policyholder's informed written consent to a conflicted representation may not charge for nor accept compensation from some reserving insurer. The California Rule states in part: "A lawyer shall not enter into an agreement for, charge, or accept compensation for representing a client from one other than the client unless:

"(a) there is no interference with the lawyer's independent professional judgment or with the lawyer-client relationship;

"(b) information is protected as required by Business and Professions Code section 6068, subdivision (e)(1) and rule 1.6; and

"(c) the lawyer obtains the client's informed written consent at or before the time the lawyer has entered into the agreement for, charged, or accepted the compensation, or as soon thereafter as reasonably practicable. . . ."

Comment [3] of the Rule states: "This rule is not intended to abrogate existing relationships between insurers and insureds whereby the insurer has the contractual right to unilaterally select counsel for the insured, where there is no conflict of interest." The obverse of this comment is that where there is a conflict of interest between the insurer and the policyholder, the insurer may not unilaterally select counsel for the insured, and panel counsel must obtain the policyholder's informed written consent to be paid by the insurer.

B. Case Law

"The State Bar Rules of Professional Conduct, rule 3-310(F) [now Rule 1.8.6] recognize 'that there may be a conflict of interest where, [as here], a third party is paying for the attorney to represent another person or entity.' (Citation.) Such an attorney is disqualified from representation unless the client gives informed written consent to the arrangement." (*City of San Diego v. Hass* (2012) 207 Cal.App.4th 472, 502.) "(W)here the cost of the client's litigation is being borne by a third party, the client must provide informed written consent to this arrangement." (*Sharp v. Next Entertainment, Inc.* (2008) 163 Cal.App.4th 410, 430.)

8. Lawyers Must Resolve Conflicts Of Interest Before Accepting Representation

"In some limited circumstances, a lawyer might not be able to obtain client consent before the lawyer has entered into an agreement for, charged, or accepted compensation, as required by this rule. This might happen, for example, when a lawyer is retained or

paid by a family member on behalf of an incarcerated client or in certain commercial settings, such as when a lawyer is retained by a creditors' committee involved in a corporate debt restructuring and agrees to be compensated for any services to be provided to other similarly situated creditors who have not yet been identified. In such limited situations, paragraph (c) permits the lawyer to comply with this rule as soon thereafter as is reasonably practicable." (Rule 1.8.6 Comment [4].)

The Insurer-Policyholder Relationship

Liability insurers have a special relationship with their policyholders which is similar to the attorney-client relationship, but is based on contract law, good faith, and regulatory requirements rather than the State Bar Act and the Rules.

1. The Insurance Contract

"Insurance is a contract whereby one undertakes to indemnify another against . . . liability arising from a contingent or unknown event." (Ins. Code, § 22.) "An insurance policy is an indemnity contract." (*Safeco Ins. Co. Of Amer. v. Robert S.* (2001) 26 Cal.4th 758, 767.)

The meaning of indemnity contracts is illuminated by the Civil Code. "[S]ection 2778, unchanged since 1872, sets forth general rules for the interpretation of indemnity contracts." (*Crawford v Weather Shield Mfg., Inc.* (2008) 44 Cal. 4th 541, 553.) The code states in part: "An indemnity against . . . liability . . . embraces the costs of defense against such . . . liability incurred in good faith, and in the exercise of reasonable discretion. The [insurer] is bound, on request of the [insured], to defend actions . . . brought against the [insured] in respect to the matters embraced by the indemnity, but the [insured] has the right to conduct such defenses, if he chooses to do so. If, after request, the [insurer] neglects to defend the [insured], a recovery against the [insured] suffered by him in good faith, is conclusive in his favor against the [insurer]."

A. The Promise To Defend

Liability policies typically include an express promise to defend. Typical policy language is: "We will have the right and duty to defend the insured against any 'suit' seeking those damages." The duty to defend is a primary obligation of a liability insurer. "(T)he policy sets forth the duty to defend as a primary one." (*Gray v. Zurich Insurance Co.* (1966) 65 Cal.2d 263, 268.) "[S]o far as the insured is concerned, the duty to defend may be as important as the duty to indemnify." (*Buss v. Superior Court* (1997) 16 Cal.4th 35, 48; *Montrose Chemical Corp. v. Superior Court* (1993) 6 Cal.4th 287, 295-296; see *also, Continental v. Zurich Ins. Co.* (1961) 57 Cal.2d 27, 45.) To satisfy the promise to defend, the insurer must defend immediately and entirely. "Implicit in this understanding of the duty to defend [a policyholder] . . . is that the duty arises immediately upon a proper tender of defense by [the policyholder], and thus before the litigation to be defended has determined whether indemnity is actually owed. This duty, as described in

the statute, therefore cannot depend on the outcome of that litigation." (*Crawford v Weather Shield Mfg., Inc.* (2008) 44 Cal. 4th 541, 558.) "Implicit in this rule is the principle that the duty to defend is broader than the duty to indemnify; an insurer may owe a duty to defend its insured in an action in which no damages ultimately are awarded." (*Montrose Chemical Corp. v. Superior Court* (1993) 6 Cal.4th 287, 295.)

B. The Promise To Indemnify

Liability insurance protects "against loss resulting from liability for injury, fatal or nonfatal, suffered by any natural person, or resulting from liability for damage to property, or property interests of others." (Ins. Code § 108(a).) While there is considerable variation in the language of liability insurance policies, typical language is: "This Company agrees to pay on behalf of the Insured all sums which the Insured shall become legally obligated to pay as damages because of bodily injury or property damage, to which this insurance applies, caused by an occurrence." (*State Farm Mut. Auto. Ins. Co. v. Partridge* 1973) 10 Cal.3d 94, 99, fn.5.) "We observe that other courts are in accord with our conclusion that the duty to indemnify is limited to money ordered by a court." (*Certain Underwriters at Lloyd's of London* (2001) 24 Cal.4th 945, 964.)

2. The Duty Of Good Faith And Fair Dealing

"There is an implied covenant of good faith and fair dealing in every contract that neither party will do anything which will injure the right of the other to receive the benefits of the agreement." (*Comunale v. Traders & General Ins. Co.* (1958) 50 Cal.2d 654, 658.) "[I]n every insurance contract there is an implied covenant of good faith and fair dealing." (*Gruenberg v. Aetna Ins. Co.* (1973) 9 Cal.3d 566, 575.) "[B]reach of the implied covenant requires unreasonable conduct or an action taken without proper cause." (*Campbell v. Superior Court* (1996) 44 Cal.App.4th 1308, 1321.) "[W]e consider the duty of an insurer to act in good faith and fairly in handling the claim of an insured, namely a duty not to withhold unreasonably payments due under a policy." (*Gruenberg v. Aetna Ins. Co.* (1973) 9 Cal.3d 566, 573.) Accordingly, when the insurer unreasonably and in bad faith withholds payment of the claim of its insured, it is subject to liability in tort." (*Gruenberg v. Aetna Ins. Co.* (1973) 9 Cal.3d 566, 575.)

"The insurer, in deciding whether a claim should be compromised, must take into account the interest of the insured and give it at least as much consideration as it does to its own interest." (*Comunale v. Traders & General Ins. Co.* (1958) 50 Cal.2d 654, 659.) "An insurer who denies coverage does so at its own risk, and, although its position may not have been entirely groundless, if the denial is found to be wrongful it is liable for the full amount which will compensate the insured for all the detriment caused by the insurer's breach of the express and implied obligations of the contract. . . . The insurer should not be permitted to profit by its own wrong." (*Comunale v. Traders & General Ins. Co.* (1958) 50 Cal.2d 654, 660.) "It follows from what we have said that an insurer,

who wrongfully declines to defend and who refuses to accept a reasonable settlement within the policy limits in violation of its duty to consider in good faith the interest of the insured in the settlement, is liable for the entire judgment against the insured even if it exceeds the policy limits." (*Comunale v. Traders & General Ins. Co.* (1958) 50 Cal.2d 654, 661.)

3. The Fiduciary-Like Relationship

"[A]n insurer and its insured have a 'special relationship'. Under this special relationship, an insurer's obligations are greater than those of a party to an ordinary commercial contract. . . . Cases have referred to the relationship between insurer and insured as a limited fiduciary relationship as 'akin to a fiduciary relationship'; or as one involving the 'qualities of decency and humanity inherent in the responsibility of a fiduciary'. ¶ The insurer-insured relationship, however, is not a true 'fiduciary relationship'. . . . This characteristic has led the courts to impose 'special and heightened' duties, but '[w]hile these "special" duties are akin to, and often resemble, duties which are also owed by fiduciaries, the fiduciary-like duties arise because of the unique nature of the insurance contract, not because the insurer is a fiduciary.'" (*Vu v. Prudential Prop. & Cas. Ins. Co.* (2001) 26 Cal.4th 1142, 1150-51 (citations omitted).)

"The insurance business is governmentally regulated to a substantial degree. It is affected with a public interest and offers services of a quasi-public nature. . . . To some extent the special relationship and duties of the insurer exist in recognition of the fact that the insured does not contract '... to obtain a commercial advantage but to protect [himself] against the risks of accidental losses, including the mental distress which might follow from the losses. Among the considerations in purchasing . . . insurance, as insurers are well aware, is the peace of mind and security it will provide in the event of an accidental loss . . . .' (Citation omitted.) . . . The very risks insured against presuppose that if and when a claim is made, the insured will be . . . in strait financial circumstances and, therefore, particularly vulnerable to oppressive tactics on the part of an economically powerful entity." (*Fletcher v. Western National Life Ins. Co.* (1970) 10 Cal.App.3d 376, 403-404.)

4. The Duty Of Disclosure

Liability insurers have a regulatory duty of disclosure. "Every insurer shall disclose to a [policyholder] all benefits, coverage, or other provisions of any insurance policy issued by that insurer that may apply to the claim presented by the [policyholder]. When additional benefits might reasonably be payable under an insured's policy, the insurer shall immediately communicate this fact to the insured and cooperate with and assist the insured in determining the extent of the insurer's additional liability." (Cal. Code Regs. § 2695.4 (ellipses omitted).)

"[T]he insurer's fiduciary obligations were consistent with those of the attorney

retained to represent the insured, and as a result the insurer should have informed the insured of the conflict of interest and of the opportunity to have independent counsel." (*State Farm Fire & Casualty Co. v. Superior Court (Durant)* (1989) 216 Cal.App.3d 1222, 1235; see also, *Manzanita Park v. Insurance Co. of North America* (9th Cir. 1988) 857 F.2d 549, 555.)

The Duty To Defend

The rules governing a liability insurer's duty to defend are well established in the law. While the policyholder has the initial right to control one's own defense, most policies confer on the insurer the right to control the defense of actions for which they agree to indemnify. The duty to defend is broader than the duty to indemnify and is triggered by the mere potential that an adverse judgment may be covered for indemnity. When conflicts of interest ethically disqualify panel counsel from representing the policyholder, the insurer must yield control of the defense back to the policyholder.

1. Policyholders Initially Control The Defense

As mentioned above, insurers are "bound, on request of the [policyholder], to defend actions or proceedings brought against [the policyholder] in respect to the matters embraced by the indemnity, but [the policyholder] has the right to conduct such defenses, if he chooses to do so." (Civ. Code § 2778(4).)

2. Insurers Often Have A Limited Contractual Right To Take Control Of The Defense

Most liability insurance policies express whether the insurer or the policyholder may control the policyholder's defense. Some policies describe two options for control of the defense. If the duty to defend option is selected, "the Company will have the right and duty to defend any Claim covered by a Liability Coverage, even if the allegations are groundless, false or fraudulent, including the right to select defense counsel with respect to such Claim." If the reimbursement option is selected, "the Company will have no duty to defend any Claim covered by a Liability Coverage. It will be the duty of the Insured to defend such Claims . . . . [U]pon written request, the Company will advance Defense Expenses with respect to such Claim."

However, when the insurer assumes control of the defense, the policyholder risks loss if the insurer mishandles the defense. "The assured is not in a position to exercise effective control over the lawsuit or to further his own interests by independent action, even when those interests appear in serious jeopardy. The assured may face the possibility of substantial loss which can be forestalled only by action of the carrier. Thus the assured may find himself and his goods in the position of a passenger on a voyage to an unknown destination on a vessel under the exclusive management of the crew." (*Merritt v. Reserve Ins. Co.* (1973) 34 Cal.App.3d 858, 870.)

3. Familiar Principles Governing The Duty to Defend

"We summarize familiar principles pertaining to an insurer's duty of defense. An insurer must defend its insured against claims that create a potential for indemnity under the policy. (*Montrose Chemical Corp. v. Superior Court* (1993) 6 Cal.4th 287, (Montrose); *Gray v. Zurich Insurance Co.* (1966) 65 Cal.2d 263, 275 (Gray).) The duty to defend is broader than the duty to indemnify, and it may apply even in an action where no damages are ultimately awarded. (*Horace Mann Ins. Co. v. Barbara B*. (1993) 4 Cal.4th 1076, 1081.)

"Determination of the duty to defend depends, in the first instance, on a comparison between the allegations of the complaint and the terms of the policy. (Montrose, supra, 6 Cal.4th 287, 295.) But the duty also exists where extrinsic facts known to the insurer suggest that the claim may be covered. (Ibid.) Moreover, that the precise causes of action pled by the third party complaint may fall outside policy coverage does not excuse the duty to defend where, under the facts alleged, reasonably inferable, or otherwise known, the complaint could fairly be amended to state a covered liability. (*Gray, supra*, 65 Cal.2d 263, 275-276; *CNA Casualty of California v. Seaboard Surety Co.* (1986) 176 Cal.App.3d 598, 610-611.)

"The defense duty arises upon tender of a potentially covered claim and lasts until the underlying lawsuit is concluded, or until it has been shown that there is no potential for coverage. (*Montrose, supra*, 6 Cal.4th 287, 295.) When the duty, having arisen, is extinguished by a showing that no claim can in fact be covered, 'it is extinguished only prospectively and not retroactively.' (*Buss v. Superior Court* (1997) 16 Cal.4th 35, 46 (Buss); see also *Aerojet-General Corp. v. Transport Indemnity Co.* (1997) 17 Cal.4th 38, 58 (Aerojet-General).)

"On the other hand, 'in an action wherein none of the claims is even potentially covered because it does not even possibly embrace any triggering harm of the specified sort within the policy period caused by an included occurrence, the insurer does not have a duty to defend. [Citation.] 'This freedom is implied in the policy's language. It rests on the fact that the insurer has not been paid premiums by the insured for [such] a defense. . . . [T]he duty to defend is contractual. 'The insurer has not contracted to pay defense costs' for claims that are not even potentially covered.' [Citation.]' (*Aerojet-General, supra*, 17 Cal.4th 38, 59, quoting *Buss, supra*, 16 Cal.4th 35, 47.)

"From these premises, the following may be stated: If any facts stated or fairly inferable in the complaint, or otherwise known or discovered by the insurer, suggest a claim potentially covered by the policy, the insurer's duty to defend arises and is not extinguished until the insurer negates all facts suggesting potential coverage. On the other hand, if, as a matter of law, neither the complaint nor the known extrinsic facts indicate any basis for potential coverage, the duty to defend does not arise in the first instance." (*Scottsdale Ins. Co. v. MV Transp.* (2005) 36 Cal.4th 643, 654-55.)

"'Unlike the obligation to indemnify, which is only determined when the insured's underlying liability is established, the duty to defend must be assessed at the very outset of a case. An insurer may have a duty to defend even when it ultimately has no obligation to indemnify, either because no damages are awarded in the underlying action against the insured, or because the actual judgment is for damages not covered under the policy.' (*Ringler Associates Inc. v. Maryland Casualty Co.* (2000) 80 Cal.App.4th 1165, 1185.)" (*Hartford Casualty Ins. Co. v. Swift Distribution, Inc.* (2014) 59 Cal.4th 277, 287.) "Any doubt as to whether the facts establish the existence of the defense duty must be resolved in the insured's favor." (*Montrose Chemical Corp. v. Superior Court* (1993) 6 Cal.4th 287, 295, 299-300.) "An insurer who denies coverage does so at its own risk." (*Johansen v. California State Auto. Assn. Inter-Ins. Bureau* (1975) 15 Cal.3d 9, 15-16 (citations and ellipses omitted).

4. A Failure To Defend Risks Paying Regardless Of Coverage Defenses

A liability insurer which wrongfully fails to defend its policyholder against a third party liability dispute may be required to pay the judgment or settlement entered in good faith without regard to contractual policy defenses. (Civ. Code § 2778(5), see text above.)

An insurer's wrongful failure to defend its policyholder may be liable to pay a judgment for which the insurer would have had no contractual duty to indemnify. "Otherwise, an insurance carrier could refuse to defend its insured on the slightest provocation and then resort to hindsight for justification." (*Mullen v. Glens Falls Ins. Co.* (1977) 73 Cal.App.3d 163, 173.) "It is no defense that the ultimate judgment against the insured is not rendered on a theory within the coverage of the policy." (*Pershing Park Villas Homeowners Ass'n v. United Pac. Ins. Co.* (9th Cir. 2000) 219 F.3d 895, 901 (applying Calif. law).) The policyholder need not prove that the judgment would have been smaller, or would not have occurred, but for the insurer's wrongful failure to defend: "Such a theory . . . would impose upon the insured the impossible burden of proving the extent of the loss caused by the insurer's breach." (*Id.* at 901-902.) "The rationale for this rule prevents the insurer from relying on hindsight to justify its failure to defend. A judgment raises a conclusive presumption that the policyholder is legally liable to the plaintiff for the full amount of the damages together with "all material findings of fact essential to the judgment." (*Hogan v. Midland National Ins. Co.* (1970) 3 Cal.3d 553, 564.) "[T]he law is well settled that, where one is bound either by law or agreement to protect another from liability, he is bound by the result of a litigation to which such other is a party, provided he had notice of the suit and an opportunity to control and manage it." (*Kershaw v. Maryland Casualty Co.* (1959) 172 Cal.App.2d 248, 257.)

A wrongful failure to defend its policyholder may be liable to pay any reasonable, non-collusive settlement for which the insurer would have had no contractual duty to indemnify. An insurer which fails to defend must reimburse the policyholder for "all sums reasonably paid to the injured party . . . pursuant to a . . . reasonable settlement negotiated

by the insured." (*Rankin v. Curtis* (1986) 183 Cal.App.3d 939, 946; *Smith v. State Farm Mut. Auto. Ins. Co.* (1992) 5 Cal.App.4th 1104, 1110.) In *Gray v. Zurich Insurance Co.* (1966) 65 Cal.2d 263, 279-80, the Supreme Court held that an insurer that wrongfully failed to defend its policyholder was liable for the costs of defense and a judgment that was not covered by the policy, reasoning that holding otherwise "would impose upon the insured 'the impossible burden' of proving the extent of the loss caused by the insurer's breach (of the duty to defend and would) encourage insurance companies to similar disavowals of responsibility with everything to gain and nothing to lose."

5. The Reservation Of Rights

A liability insurer that agrees to defend its policyholder against the third party liability dispute but fails to promptly issue an adequate reservation of rights forfeits the right to later refuse to indemnity its policyholder. "The general rule supported by the great weight of authority is that if a liability insurer, with knowledge of a ground of forfeiture or noncoverage under the policy, assumes and conducts the defense of an action brought against the insured, without disclaiming liability and giving notice of its reservation of rights, it is thereafter precluded in an action upon the policy from setting up such ground of forfeiture or noncoverage. In other words, the insurer's unconditional defense of an action brought against its insured constitutes a waiver of the terms of the policy and an estoppel of the insurer to assert such grounds." (*Miller v. Elite Ins. Co.* (1980) 100 Cal.App.3d 739, 754.)

A liability insurer may specify certain grounds upon which it reserves the right to later deny coverage and omit other grounds from its reservation. A ground to deny coverage that could have been reserved but was not, results in the forfeiture of the insurer's right to later raise an unreserved ground as a basis to deny coverage. One insurer "never raised [a particular] exclusion in its reservation of rights letter . . . thereby precluding any actual conflict during the pendency of the underlying action. The existence of a conflict would have estopped [the insurer] from later raising the provision. (*Tomerlin v. Canadian Indemnity Co., supra*, 61 Cal.2d 638.)" (*Dynamic Concepts, Inc. v. Truck Ins. Exchange* (1998) 61 Cal.App.4th 999, 1010, fn.10.)

A. All Reservations of Rights Create Some Conflicts Of Interest

"[W]hen coverage is disputed, the interests of the insured and the insurer are always divergent. The attorney should not be placed in the position of divided loyalties. Such an arrangement would be adverse to the best interests of the insured, the insurer, the attorney, and the profession." (*San Diego Navy Fed. Credit Union v. Cumis Ins. Society, Inc.* (1984) 162 Cal.App.3d 358, 375 .) "[W]here the carrier questions the availability of coverage and provides a defense in the third party action subject to a reservation of rights, a conflict exists - because the insured's goal is coverage, which flies in the face of the insurer's desire to avoid its duty to indemnify. (*Cumis supra*, at pp. 364-365.) Since it is unavoidable that, in the course of investigating and preparing the insured's defense in the

third party action, the insured's attorney will come upon information relevant to a coverage issue, it is impossible for the carrier's attorney to represent the insured (unless, of course, the insured consents) and the insured is entitled to independent counsel. (Civ. Code, § 2860, subds. (a), (b).)" (*Rockwell Internat. Corp. v. Superior Court* (1994) 26 Cal.App.4th 1255, 1263-64.)

By its nature, a reservation of rights is an expression by the insurer that it may later deny coverage to its policyholder which constitutes an adverse assertion by the insurer against its policyholder that the policyholder unsually opposes because the policyholder wants the insurer to pay and vice versa.

A reservation of rights may create two separate but closely related conflicts of interest among the insurer, the policyholder, and their shared lawyer. First, the policyholder and reserving insurer are adverse regarding coverage for a third party liability dispute. This insurer-insured conflict of interest is principally governed by contract law, the outcome of which is often determined by the precise language of the policy. Second, dependent counsel cannot represent dual clients whose interests conflict without their informed written consent. This attorney-client conflict of interest is principally governed by the State Bar Act and the Canons of Ethics (particularly Rule 1.7), and applicable case law. Both the insurer and its dependent counsel may be liable for breach of their duties to the policyholder unless both the insurer and its dependent counsel faithfully perform their respective duties.

Under California law some reservations of rights create a disqualifying conflict of interest for dependent counsel while others do not: "(N)ot every reservation of rights entitles an insured to select Cumis counsel." (*Dynamic Concepts, Inc. v. Truck Ins. Exchange* (1998) 61 Cal.App.4th 999*,*1006.) The distinction between reservations of rights that do or do not create a disqualifying conflict of interest is determined by the Cumis Test, discussed below.

Insurance policy contracts are highly structured, including Conditions and Exclusion. Conditions describe duties owed by the policyholder to the insurer such as paying the premium and notifying the insurer of a claim. Insurers frequently reserves their rights because the policyholder may violate a condition, but these rarely created a disqualifying conflict of interest. An example of a reservation of rights that does not create a disqualifying conflict of interest is an insurer that reserves its right to deny indemnity coverage to its policyholder because of a failure to pay the premium. The insurer would be justified in denying coverage if the policyholder did not pay for the policy. But the issue of payment of premium simply will not be litigated in a third party liability dispute. Therefore, neither the insurer not its dependent counsel would possibly do anything to prejudice the policyholder by the manner in which the defense is conducted. Accordingly, dependent counsel has no disqualifying conflict of interest and the insurer is not obligated to pay for independent counsel.

In contrast, exclusions limit the insurer's obligation to pay for certain types of liability or damages that may be awarded by an adverse judgment in the liability dispute. A reservation of rights based upon an exclusion frequently creates a disqualifying conflict of interest because the applicability of the exclusion can often be determined by the conduct of the policyholder's defense. For example, if the policyholder is found guilty of intentional conduct, the policyholder will be liable to the injured plaintiff, but insurer may not be obligated to pay the judgment because of a willful acts exclusion.

As discussed below, the legal test to distinguish reservations of rights that do or do not create a disqualifying conflict of interest focuses upon whether any disputed issues of fact or law are common to both the liability dispute and the coverage challenge.

B. A Reservation Of Rights Warns The Policyholder Of Adversity

A reservation of rights is like a slap in the face, by which the insurer makes it clear that the insurer is no friend of the policyholder in the coverage dispute and that the policyholder should respond by taking steps to protect oneself from the reserving insurer. "Through reservation, the insurer gives the insured notice of how it will, or at least may, proceed and thereby provides it an opportunity to take any steps that it may deem reasonable or necessary in response - including whether to accept defense at the insurer's hands and under the insurer's control (citation) or, instead, to defend itself as it chooses." (*Buss v. Superior Court* (1997) 16 Cal.4th 35, 61, fn. 27.)

C. Reservations Of Rights Have Three Primary Purposes

A primary purpose of a reservation of rights is to preserve policy defenses to coverage by operation of law through forfeiture, waiver or estoppel. The insurer's "failure to reserve its right to contest coverage under the policy's exclusions of coverage for willful acts or trademark infringement waived its right to assert those exclusions as a basis for denying coverage in the federal action. (*Foremost Ins. Co. v. Wilks* (1988) 206 Cal.App.3d 251, 258; *Insurance Co. of the West v. Haralambos Beverage Co.* (1987) 195 Cal.App.3d 1308, 1319; *Miller v. Elite Ins. Co., supra*, 100 Cal.App.3d at p. 754 [if a carrier assumes the defense of its insured without giving notice of a reservation of rights, 'it is thereafter precluded in an action upon the policy from setting up such ground of forfeiture or noncoverage']; *Tomerlin v. Canadian Indemnity Co.* (1964) 61 Cal.2d 638, 648 [although a carrier may not insure against willful misconduct, coverage is available when it is based not on the willful conduct itself but rather on an estoppel occurring after the misconduct].)" (*Canadian Ins. Co. v. Rusty's Island Chip Co.* (1995) 36 Cal.App.4th 491, 498.)

A second reason to assert a reservation of rights is to pressure the policyholder to contribute toward a settlement under the threat of no coverage if it turns out that the insurer's coverage denial is correct. However, the insurer should pay to have independent counsel participate in such settlement negotiations at the insurer's expense. (See, 3.G. Independent Counsel May Participate In Settlement Negotiations, below.)

A third reason to assert a reservation of rights is to pressure the injured plaintiff to accept less in settlement under the same threat of no coverage if it turns out that the insurer's coverage denial is correct.

The Coalescence Of Insurer And Attorney Duties In The Duty To Defend

While a liability insurer promises to defend its policyholder against liability claims, it cannot discharge this promise by itself, since it is not licensed to practice law. Typically in conducting the defense, the policyholder, the insurer, and their common lawyer work together against the injured plaintiff. This relationship is harmonious so long as the three do not have any conflicts of interest, but it may turn dissonant when conflicts arise among them. If a reservation of rights creates a disqualifying conflict of interest, only ethical counsel may do the work of conducting the policyholder's defense. In this situation, the insurer is required to keep its promise to defend by paying for independent counsel selected and directed by the policyholder, who has no attorney-client relationship with the insurer and owes it few duties.

1. The Insurer Is Not Licensed To Practice Law

"By its very nature the duty assumed by [the insurer] to defend its assured against suits must necessarily be classified as a delegable duty, understood by all parties as such, for [the insurer] had no authority to perform that duty itself and, in fact, was prohibited from appearing in the California courts. (Bus. & Prof. Code, § 6126.) Since a carrier is not authorized to practice law (*People ex rel. Los Angeles Bar Assn. v. California Protective Corp*., 76 Cal.App. 354 [244 P. 1089]; Bus. & Prof. Code, §§ 6125 and 6127.5), it must rely on independent counsel for the conduct of the litigation." (*Merritt v. Reserve Ins. Co.* (1973) 34 Cal.App.3d 858, 880-881.)

2. The Harmonious Tripartite Relationship

In opposing an injured plaintiff's liability claim, three team members often harmoniously coalesce to defeat or minimize the claim: 1) the policyholder as witness; 2) the insurer as financier; and 3) dependent counsel as warrior for both. "In the insured -insurer relationship, the attorney characteristically is engaged and paid by the carrier to defend the insured. The insured and the insurer have certain obligations each to the other ... arising from the insurance contract. Both the insured and the carrier have a common interest in defeating or settling the third party's claim. If the matter reaches litigation, the attorney appears of record for the insured and at all times represents him in terms measured by the extent of his employment. [¶] In such a situation, the attorney has two clients whose primary, overlapping and common interest is the speedy and successful resolution of the claim and litigation. Conceptually, each member of the trio, attorney, client-insured, and client-insurer has corresponding rights and obligations founded largely on contract, and as to the attorney, by the Rules of Professional Conduct as well. The three parties may be viewed as a loose partnership, coalition or alliance directed toward a common goal, sharing a common purpose which lasts during the pendency of the claim or

litigation against the insured. Communications are routinely exchanged between them relating to the joint and common purpose - the successful defense and resolution of the claim. Insured, carrier, and attorney, together form an entity - the defense team - arising from the obligations to defend and to cooperate, imposed by contract and professional duty. This entity may be conceived as comprising a unitary whole with intramural relationships and reciprocal obligations and duties each to the other quite separate and apart from the extramural relations with third parties or with the world at large. Together, the team occupies one side of the litigating arena." (*Gafcon, Inc. v. Ponsor & Associates* (2002) 98 Cal.App.4th 1388, 1407, quoting *American Mut. Liab. Ins. Co. v. Superior Court* (1974) 38 Cal.App.3d 579, 591-592.)

3. The Dissonant Tripartite Relationship

However, this harmonious tripartite relationship may turn to dissonance if a conflict of interest divides them. "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. 'So long as the interests of the insurer and the insured **coincide**, they are both the clients of the defense attorney and the defense attorney's fiduciary duty runs to both the insurer and the insured.'. . . In certain circumstances a conflict of interest between insurer and insured will trigger the insured's right to retain independent counsel at the insurer's expense." (*Gafcon, Inc. v. Ponsor & Associates* (2002) 98 Cal.App.4th 1388, 1406-07 (citations and ellipses omitted, emphasis added).)

4. Only Ethical Defense Counsel May Keep The Promise To Defend

The landmark Cumis case, held: "Canons of Ethics impose upon lawyers hired by the insurer an obligation to explain to the insured and the insurer the full implications of joint representation in situations where the insurer has reserved its rights to deny coverage." "The Cumis opinion was based heavily on the canons of ethics." (*Blanchard v. State Farm Fire & Casualty Co.* (1991) 2 Cal.App.4th 345, 350; see also, *Mosier v. S. Cal. Physicians Ins. Exch.* (1998) 63 Cal. App. 4th 1022, 1042 ("Cumis is based on ethical standards, not on insurance concepts"); *Golden Eagle Ins. Co. v. Foremost Ins. Co.* (1993) 20 Cal. App. 4th 1372, 1394 ("[T]he Cumis rule is not based on insurance law but on the ethical duty of an attorney to avoid representing conflicting interests"); *United Pac. Ins. Co. v. Hall* (1988) 199 Cal. App. 3d 551, 556 ("The obligation of an insurer to provide independent Cumis counsel for an insured is premised on the ethical inability of an attorney to represent conflicting interests.")

The Cumis Rule - Canons Of Ethics Control
Who Reserving Insurers Must Pay To Defend

If a reservation of rights creates a disqualifying conflict of interest, dependent counsel may comply with the Rules by seeking the policyholder's informed written consent to representation before accepting the assignment from the insurer. However,

"(i)f the insured does not give an informed consent . . . , counsel must cease to represent both." (*San Diego Navy Fed. Credit Union v. Cumis Ins. Society, Inc.* (1984) 162 Cal.App.3d 358, 375.) The conflict of interest does not relieve the insurer of its promise to defend. Instead, "where there are divergent interests brought about by the insurer's reservation of rights, . . . the insurer must pay the reasonable cost for hiring independent counsel by the insured. The insurer may not compel the insured to surrender control of the litigation." (*Ibid.*)

1. The Cumis Protocol

As explained above, the duties by the insurer and its dependent counsel coalescence in discharging the duty to defend. Regulations of insurers and lawyers require a reserving insurer to investigate and explain its coverage position so that the policyholder may be adequately forewarned of the risk that the insurer will disclaim coverage so that the policyholder may take appropriate steps to protect one's own interests against the reserving insurer. Similarly, dependent counsel must independently investigate and analyze potential conflicts of interest.

A. The Duty To Investigate Conflicts Of Interest

Insurance statutes and regulations also compel a reserving insurer to investigate and analyze potential conflicts of interest. It constitutes an unfair business practice for a reserving insurer to fail "to adopt and implement reasonable standards for the prompt investigation and processing of claims." (Ins. Code § 790.03(h).) "Every insurer shall adopt . . . written standards for the prompt investigation and processing of claims." (Cal. Code Regs. § 2695.6(a).) "(E)very insurer shall immediately, but in no event more than fifteen (15) calendar days later . . . begin any necessary investigation of the claim." (Cal. Code Regs. § 2695.5(e)(2)(3).)

While diligent research has not revealed a similar explicit duty by lawyers to "investigate" the facts and law upon which an adequate conflict of interest analysis may be made, Rules 1.0.1 (definitions), 1.4 (communication), and 1.7 (duty of undivided loyalty) do imply that lawyers must thoroughly investigate the facts and law in order to do an adequate conflict of interest analysis.

Rule 1.0.1(e) defines "informed consent' to means a policyholder's agreement "after the lawyer has communicated and explained (i) the relevant circumstances and (ii) the material risks, including any actual and reasonably foreseeable adverse consequences of the proposed course of conduct." Rule 1.0.1(e-1) specifies that "informed consent" "must be in writing." Rule 1.4 requires dependent counsel to explain significant developments and the circumstance requiring informed consent to permit the policyholder to make informed decisions and to achieve their objectives, and to respond to requests for information. Rule 1.7 forbids dependent counsel from accepting representation of a policyholder without satisfying all six prongs of the Rule (discussed below) and obtaining informed written consent. Taken together, these Rules impose on dependent counsel a

duty to investigate potential conflicts of interest to at least determine whether any give reservation of rights creates a disqualifying conflict of interest.

B. The Duty To Analyze Conflicts Of Interest

The Unfair Insurance Practices Act (UIPA) defines unfair and deceptive acts or practices in the business of insurance. Insurers may not deceive their policyholders, by false statement or by omission, must communicate truthfully with their policyholders, must thoroughly investigate claims, promptly analyze coverage, and seek prompt resolution of conflict of interest disputes, including the insurer's obligation to pay for independent counsel. "Knowingly committing or performing with such frequency as to indicate a general business practice any of the following unfair claims settlement practices: (1) Misrepresenting to [policyholder]s pertinent facts or insurance policy provisions relating to any coverages at issue. (2) Failing to acknowledge and act reasonably promptly upon communications with respect to claims arising under insurance policies. (3) Failing to adopt and implement reasonable standards for the prompt investigation and processing of claims arising under insurance policies. (4) Failing to affirm or deny coverage of claims within a reasonable time after proof of loss requirements have been completed and submitted by the insured. (5) Not attempting in good faith to effectuate prompt, fair, and equitable settlements of claims in which liability has become reasonably clear. (Ins. Code § 790.03(h).)

An insurer's investigation means "all activities of an insurer or its claims agent related to the determination of coverage, liabilities, or nature and extent of damages afforded by an insurance policy, ... and other obligations or duties arising from an insurance policy." (Code of Regs. § 2695.2(k).) "Upon receiving notice of claim, every insurer shall immediately, but in no event more than fifteen (15) calendar days . . . begin any necessary investigation of the claim." (Cal. Code Regs. § 2695.5(e)(3).) "Every insurer shall adopt and communicate to all its claims agents written standards for the prompt investigation and processing of claims." (Cal. Code Regs. § 2695.6(a).)

A lawyer's duty to analyze conflicts of interest is discussed at length below in a description of the Cumis Test.

A proper conflict of interest analysis should include consideration of the exact nature of the claims asserted, reserved coverage defenses, the logically relationship between the coverage defenses and the issues asserted in the liability dispute, unresolved factual questions, the nature of the available evidence, prejudice to the policyholder from discovery, and threats to breaches of confidentiality. (See, *Haskel, Inc. v. Superior Court* (1995) 33 Cal.App.4th 963, 980 (see text below).)

C. The Duty To Disclose The Conflict Of Interest Analysis

Liability insurers are required to disclose to policyholders all policy benefits that may apply to a policyholder's request for a defense, including the right to independent counsel. Liability insurers must disclose to policyholders "all benefits, coverage, . . . or

other provisions . . . that may apply to the claim" and "additional benefits might reasonably be payable" and "immediately communicate this fact to the insured and cooperate with and assist the insured in determining the extent of the insurer's additional liability." (Cal. Code Regs. § 2695.4(a) (see full text above).) The regulations define claimant to include a policyholder's request for a defense, and proof of claim to include any documentation submitted to the insurer evidencing and supporting a claimed loss. (Cal. Code Regs. § 2695.2(c)(s).)

Liability insurers are required to promptly respond to requests for information by a policyholder. "Upon receiving any communication from a [policyholder], regarding a claim, that reasonably suggests that a response is expected, every [insurer] shall immediately, but in no event more than fifteen (15) calendar days after receipt of that communication, furnish the [policyholder] with a complete response based on the facts as then known by the [insurer]." (Cal. Code Regs. § 2695.5(b).)

Liability insurers are required to initiate disclosure to policyholders of all policy benefits that may apply. "Upon receiving notice of claim, every insurer shall immediately, but in no event more than fifteen (15) calendar days later, do the following . . . provide to the [policyholder] necessary . . . instructions, and reasonable assistance, including but not limited to, specifying the information the [policyholder] must provide for proof of claim [and] begin any necessary investigation of the claim." (Cal. Code Regs. § 2695.5(e)(2-3).) A notice of claim is defined any notification that reasonably apprises the insurer that the policyholder wishes to make a claim. (Cal. Code Regs. § 2695.2(n).) A proof of claim is defined as any document submitted to the insurer which provides any evidence of the claim and that supports the magnitude or the amount of the claimed loss. (Cal. Code Regs. § 2695.2(s).) "Every insurer shall adopt . . . written standards for the prompt investigation and processing of claims." (Cal. Code Regs. § 2695.6(a).) "Upon receiving proof of claim, every insurer . . . shall immediately, but in no event more than forty (40) calendar days later, accept or deny the claim, in whole or in part. . . . Where an insurer denies or rejects a first party claim, in whole or in part, it shall do so in writing and shall provide to the [policyholder] a statement listing all bases for such rejection or denial and the factual and legal bases for each reason given for such rejection or denial which is then within the insurer's knowledge. Where an insurer's denial of a first party claim, in whole or in part, is based on a specific policy provision, condition or exclusion, the written denial shall include reference thereto and provide an explanation of the application of the provision, condition or exclusion to the claim." (Cal. Code Regs. § 2695.7(b)(1).)

Rule 1.4 describes a lawyer's duty to disclose a conflict of interest analysis. "(a) A lawyer shall: (1) promptly inform the client of any decision or circumstance with respect to which disclosure or the client's informed consent is required by these rule. . . . (2) reasonably consult with the client about the means by which to accomplish the client's objectives in the representation; (3) keep the client reasonably informed about significant

developments relating to the representation, including promptly complying with reasonable requests for information and copies of significant documents when necessary to keep the client so informed; and (4) advise the client about any relevant limitation on the lawyer's conduct. . . . (b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."

While lawyers are not required to always disclose their conflict of interest analysis in writing to the policyholder, insurers are. Thus, through the coalescence of duties in discharging the duty to defend, the policyholder is always entitled to receive written confirmation of a conflict of interest analysis.

2. The Two Part Cumis Rule

The Cumis Rule has two parts: one recognizing ethical obligations of dependent counsel asked to defend under a reservation of rights; and one requiring a reserving insurer to pay for independent counsel if dependent counsel is ethically disqualified. "If the insured does not give an informed consent to continued representation, counsel must cease to represent both. Moreover, in the absence of such consent, where there are divergent interests of the insured and the insurer brought about by the insurer's reservation of rights based on possible noncoverage under the insurance policy, the insurer must pay the reasonable cost for hiring independent counsel by the insured. The insurer may not compel the insured to surrender control of the litigation (*Tomerlin v. Canadian Indemnity Co., supra*., 61 Cal.2d 638, 648; and see *Nike, Inc. v. Atlantic Mut. Ins. Co.* (N.D.Cal. 1983) 578 F.Supp. 948, 949). Disregarding the common interests of both insured and insurer in finding total nonliability in the third party action, the remaining interests of the two diverge to such an extent as to create an actual, ethical, conflict of interest warranting payment for the insureds' independent counsel." (*San Diego Navy Fed. Credit Union v. Cumis Ins. Society, Inc.* (1984) 162 Cal.App.3d 358, 375.)

"[T]he governing principle underlying Cumis and section 2860 is the attorney's ethical duty to the clients. Thus, an attorney representing the interests of the insurer and the insured is subject to the rule a '[c]onflict of interest between jointly represented clients occurs whenever their common lawyer's representation of the one is rendered less effective by reason of his representation of the other.' (*Spindle v. Chubb/Pacific Indemnity Group* (1979) 89 Cal.App.3d 706, 713.)" (*Golden Eagle Ins. Co. v. Foremost Ins. Co.* (1993) 20 Cal.App.4th 1372, 1396.)

A. Some Reserving Insurers Must Pay Independent Counsel

Because all reservations of rights do not necessarily create a disqualifying conflict of interest, in some jurisdictions (see, Cumis Test below), it is important for dependent counsel to determine whether a reservation of rights requires the lawyer to obtain the policyholder's informed written consent to representation before accepting an assignment from a reserving insurer.

1). Dependent Counsel Who Are Not Ethically Disqualified May Represent The Policyholder

No one can know whether a reservation of rights does or does not create a disqualifying conflict of interest until a reserving insurer and its dependent counsel complete their thorough investigation and analysis. Although Rule 1.7 does not always require written disclosure nor written informed consent, Rule 1.4 does require disclosure of the analysis. Also, insurance regulations require the reserving insurer to make written disclosure of its analysis. Even if dependent counsel do not make written disclosure of their conflict of interest analysis to the policyholder, then the insurer will have to do so in order to comply with insurance regulations. Dependent counsel may perform this task for the reserving insurer. In either case, the policyholder is entitled to written disclosure of a conflict of interest analysis. Better practice will be for dependent counsel to make its disclosure to the policyholder/client of its conflict of interest analysis in writing.

2). Dependent Counsel Who Are Ethically Disqualified May Not Represent The Policyholder Without Informed Written Consent

While Rule 1.7 requires dependent counsel to investigate and analyze potential conflicts of interest and to obtain informed written consent to conflicted representation before the lawyer may ethically represent a policyholder, it does not require written disclosure nor informed written consent if a reservation of rights does not create a disqualifying conflict of interest. This situation raises the old idiom about putting the cart before the horse. In what temporal order should dependent counsel resolve questions about ethical representation? Because ethical compliance is prophylactic, conflict of interest issues must be resolved before dependent counsel accepts representation. To do otherwise will simply invite protracted, complex and expensive litigation in which a judge and jury may face an impossible task of trying to unwind the outcome of the liability dispute. Doing so is likely to be as challenging as trying to reconstitute a whole viable egg from a baked cake. Therefore, a question whether a reservation of rights creates a disqualifying conflict of interest should be conclusively resolved before dependent counsel may accept representation of any policyholder being defended by any liability insurer under a reservation of rights.

3). Ethical Disputes Should Be Resolved Before Dependent Counsel Accepts Representation

Absent the policyholder's informed written consent, a reserving insurer and its dependent counsel may control the policyholder's defense only if the insurer's reservation of rights does not create a disqualifying conflict of interest. Such a determination may be made by a motion before the court presiding over the liability dispute to disqualify dependent counsel, by an independent declaratory relief action, by contractual arbitration, or any other manner agreed upon by the parties.

Regardless of how conflict of interest disputes are solved, dependent counsel must

not accept representation of a policyholder being defended under a reservation of rights until conflicts of interest are cleared.(Rules 1.4, 1.7.)

B. The Distinction Between Independent And Dependent Counsel

The difference between dependent counsel and independent counsel is that dependent counsel is selected and directed by the insurer while independent counsel is selected and directed by the policyholder.

"The defense counsel-insurer relationship is unique. . . . the attorney has a dual attorney-client relationship with both insurer and insured. (*Unigard Ins. Group v. O'Flaherty & Belgum* (1995) 38 Cal.App.4th 1229, 1236-37.)

In contrast, "there is no attorney-client relationship between Cumis counsel and the insurer." (*Assurance Co. of America v. Haven* (1995) 32 Cal.App.4th 78, 90.) "[T]he Cumis doctrine 'intended to eliminate the ethical dilemmas and temptations that arise along with conflict in joint representations ... through mandating the insured's right to Cumis counsel that represent[s] only the insured.'" (*Id*. at 88 quoting *Employers Ins. of Wausau v. Albert D. Seeno Const.* (N.D.Cal. 1988) 692 F.Supp. 1150, 1157.) "'[T]he Cumis rule requires complete independence of counsel when an insurance company interposes a reservation of rights, the basis of which creates a conflict of interest.' (*State Farm Fire & Casualty Co. v. Superior Court* (1989) 216 Cal.App.3d 1222, 1226.)" (*Assurance Co. of America v. Haven* (1995) 32 Cal.App.4th 78, 87).)

The succinct moniker "**de**pendent counsel" describes and differentiates their counterpart, "**in**dependent counsel." This phrase acknowledges that "[a]s a practical matter . . . in reality, the insurer's attorneys may have closer ties with the insurer and a more compelling interest in protecting the insurer's position, whether or not it coincides with what is best for the insured" (*Purdy v. Pacific Automobile Ins. Co.*(1984) 157 Cal.App.3d 59, 76), "[i]nsurance companies hire relatively few lawyers and concentrate their business. A lawyer who does not look out for the Carrier's best interest might soon find himself out of work" (*San Diego Navy Fed. Credit Union v. Cumis Ins. Society, Inc.* (1984) 162 Cal.App.3d 358, 364), and "defense counsel and the insurer frequently have a longstanding, if not collegial, relationship" (*Gulf Ins. Co. v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone* (2000) 79 Cal.App.4th 114, 131; *Unigard Ins. Group v. O'Flaherty & Belgum* (1995) 38 Cal.App.4th 1229, 1236-37). "In California, an attorney may usually, under minimum standards of professional ethics, represent dual interests as long as full consent and full disclosure occur." (*Lysick v. Walcom* (1968) 258 Cal.App.2d 136, 147; See, also *Ishmael v. Millington* (1966) 241 Cal.App.2d 520, 528; *Industrial Indem. Co. v. Great American Ins. Co.* (1977) 73 Cal.App. 3d 529, 537.)

C. Civil Code Section 2860 Codifies The Cumis Rule

"Civil Code section 2860 is the Legislature's codification of the decision in San Diego Federal Credit Union v. Cumis Ins. Society, Inc. (1984) 162 Cal.App.3d 358, 375." (*Western Polymer Technology, Inc. v. Reliance Ins. Co.* (1995) 32 Cal.App.4th 14, 21.)

"In 1987 the Legislature enacted section 2860 of the Civil Code, which codified the Cumis rule." (*Golden Eagle Ins. Co. v. Foremost Ins. Co.* (1993) 20 Cal.App.4th 1372, 1394.) "Civil Code, section 2860 codifies (with clarifications and limitations) the holding in" Cumis. (*Seltzer v. Barnes* (2010) 182 Cal.App.4th 953, 966; see also, *Novak v. Low, Ball & Lynch* (1999) 77 Cal.App.4th 278, 282 ("Section 2860 codifies this holding.")) "Recognizing reasonable minds may differ concerning the premise of Cumis that for the attorney hired by the insurer, as distinguished from the insurer itself, in certain circumstances involving coverage questions there is a conflict of interest based on considerations of professional ethics, we find no flaw in the Cumis reasoning that would support disregarding its precedential value. Moreover, more recent appellate court decisions and the Legislature's enactment of Civil Code, section 2860, effective January 1, 1988, refining portions of Cumis, furnish an affirmative basis for following the decision." (*United States Fid. & Guar. Co. v. Superior Court* (1988) 204 Cal.App.3d 1513, 1516.)

The holding of Cumis remains controlling California law. Some reported opinions drop a footnote that the Cumis case has been superceded by Civil Code § 2860, but offer no reasoning nor analysis. The Cumis case was decided in 1984 and Civil Code § 2860 was enacted in 1988. All eight of the following California Supreme Court opinions post date the statute and refer to the Cumis case with approval. (*J. C. Penney Casualty Ins. Co. v. M. K.* (1991) 52 Cal.3d 1009; *Montrose Chemical Corp. v. Superior Court* (1993) 6 Cal.4th 287; *Waller v. Truck Ins. Exchange, Inc.* (1995) 11 Cal.4th 1; *Buss v. Superior Court* (1997) 16 Cal.4th 35; *Vandenberg v. Superior Court* (1999) 21 Cal.4th 815; *Musser v. Provencher* (2002) 28 Cal.4th 274; *Simmons v. Ghaderi* (2008) 44 Cal.4th 570; *Hartford Cas. Ins. Co. v. J.R. Marketing* (2015) 61 Cal.4th 988.) Most of the other cases cited in this memorandum also post date the statute and none of them hold nor imply that the statute limits a lawyer's ethical obligations to the client.

3. The Cumis Test - Some Dependent Counsel Are Ethically Disqualified From Representing Policyholders Whose Insurers Have Reserved Rights

The Cumis Test describes a body of law that distinguishes between reservations of rights that do or do not create a disqualifying conflict of interest for dependent counsel. A liability insurer that does not promptly and expressly accept full coverage for a third party liability dispute asserted against its policyholder must pay for independent counsel to conduct the policyholder's defense if there is any possibility that any single ground upon which the insurer reserves its rights to later deny coverage involves any disputed issue of fact or law, resolution of which could conceivably be influenced by the conduct of the policyholder's defense.

A. Conflicts Of Interest May Arise In Many Ways

Reservations of rights are not the only means by which a disqualifying conflict of interest may arise. "Conflicts [of interest] come in all shapes and sizes. The following list,

by no means exhaustive, illustrates circumstances giving rise to a conflict: ¶ (1) counsel has divided loyalty between current client and former clients; ¶ (2) counsel has acquired a pecuniary interest which is adverse to the interests of the client; ¶ (3) unpaid fees to counsel may result in the sacrifice of important client rights; . . . ¶ (5) there is a conflict between the interest of the insurer and the insured which in turn creates a conflict for counsel hired by the insurer to represent the insured; . . . ¶ (7) there has been an irreparable breakdown of the working relationship between counsel and client; ¶ (8) counsel plans to take on the role as a witness; ¶ (9) there have been settlement negotiations in which attorney's fees are recoverable apart from the amount sought for damages." (*Manfredi & Levine v. Superior Court (Barles)* (1998) 66 Cal.App.4th 1128, 1134-35 (citations, quotation marks, and ellipses omitted).) "Some of the circumstances that may create a conflict of interest requiring the insurer to provide independent counsel include: (1) where the insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by the insurer's retained counsel (§ 2860, subd. (b); *Golden Eagle, supra*, 20 Cal.App.4th at pp. 1394-1395); (2) where the insurer insures both the plaintiff and the defendant (*O'Morrow v. Borad* (1946) 27 Cal.2d 794, 800 [167 P.2d 483, 163 A.L.R. 894]); (3) where the insurer has filed suit against the insured, whether or not the suit is related to the lawsuit the insurer is obligated to defend (*Truck Ins. Exchange v. Fireman's Fund Ins. Co.* (1992) 6 Cal.App.4th 1050 [8 Cal.Rptr.2d 228]); (4) where the insurer pursues settlement in excess of policy limits without the insured's consent and leaving the insured exposed to claims by third parties (*Golden Eagle, supra*, 20 Cal.App.4th at 1396); and (5) any other situation where an attorney who represents the interests of both the insurer and the insured finds that his or her "representation of the one is rendered less effective by reason of his [or her] representation of the other." (*Spindle, supra*, 89 Cal.App.3d at 713; *Golden Eagle, supra*, 20 Cal.App.4th at 1396.)" (*James 3 Corp. v. Truck Ins. Exchange* (2001) 91 Cal.App.4th 1093, 1101-1102.)

B. Reserving Insurers And Their Dependent Counsel Bear The Burden Of Conflicts Of Interest Resolution

In order to clear conflicts of interest, dependent counsel has the burden of establishing that none of six prongs of Rule 1.7 applies (discussed below). A liability insurer that hires dependent counsel who fail to timely comply with Rule 1.7 may breach the duty to defend by providing lawyers who cannot ethically accept the representation. Thus, the liability insurer shares dependent counsel's burden to comply with Rule 1.7.

In contrast, the policyholder has no burden to resolve conflicts of interest. Liability insurers and their dependent counsel may not delegate to the policyholder the burden of conflict of interest resolution. "The rationale is that, as between the lay client and the attorney, the latter is more qualified to recognize and analyze the client's legal needs." (*Nichols v. Keller* (1993) 15 Cal.App.4th 1672, 1685.) It is no excuse for liability insurers

or their dependent counsel that a policyholder did not take the initiative to prove nor disprove that a disqualifying conflict of interest exists.

C. Conflict Of Interest Analysis Must Be Tailored And Thorough

Conflicts of interest must be assessed based on the particular facts and applicable law of each reservation of rights. "There is no talismanic rule that allows a facile determination of whether a disqualifying conflict of interest exists. Instead, '[t]he potential for conflict requires a careful analysis of the parties' respective interests to determine whether they can be reconciled ... or whether an actual conflict of interest precludes insurer-appointed defense counsel from presenting a quality defense for the insured.'" (*Gulf Ins. Co. v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone* (2000) 79 Cal.App.4th 114, 131, quoting *Dynamic Concepts, Inc. v. Truck Ins. Exchange* (1998) 61 Cal.App.4th 999, 1007-1008.) "The question of the existence of a conflict is a question of law unless there is a dispute over an underlying fact." (*Clarendon Nat'l Ins. Co. v. Insurance Co. of the West*, 442 F. Supp. 2d 914, 943 (E.D. Cal. 2006.)

"In the absence of dispute over some underlying fact, the existence of a conflict is a question of law for the trial judge to decide, not a jury question." (*Blanchard v. State Farm Fire & Casualty Co.* (1991) 2 Cal.App.4th 345, 350.) Courts have attempted to systematize what a proper conflict of interest analysis should include as follows: "(1) what is the exact nature of the claims asserted in the underlying action, (2) what defenses to coverage are asserted by the insurers, and to what extent, if at all, are they logically related to the liability issues raised in the underlying action, (3) what factual questions have to be resolved in order to sustain or defeat such defenses, (4) what is the likely nature of the available evidence, (5) to what extent, if at all, will [the policyholder] suffer prejudice by the enforced discovery of the evidence which tends to support or defeat its claim of coverage or the defenses raised by the insurers and (6) to what extent, if at all, will a confidentiality order realistically protect [the policyholder] from prejudicial disclosure." (*Haskel, Inc. v. Superior Court* (1995) 33 Cal.App.4th 963, 980.)

Dependent counsel may not simply ignore potential conflicts of interest. "It seems doubtful that the conflict of interest can be avoided merely by the insurer's instructing defense counsel to ignore coverage defenses. . . . Moreover, the notion that defense counsel can ignore coverage issues in defending the insured seems inconsistent with Ca Civil § 2860, which requires appointment of independent counsel whenever the outcome of the coverage dispute 'can be controlled' (i.e., a potential for control) by the handling of the defense." (Croskey et al., Cal. Practice Guide: Insurance Litigation (The Rutter Group 2019) ¶ 7:788.)

D. The Six Prongs Of Rule 1.7

As discussed above, Rule 1.7 lays the foundation for an attorney's duty of undivided loyalty and prohibits the representation of dual clients whose interests conflict in specified situations. The Rule is written in the conjunctive, establishing six different

prongs, each of which must be satisfied for ethical counsel to represent conflicted clients. Rule 1.7(a) and (b) are prohibitory, providing that a "lawyer shall not, without informed written consent . . . represent a client" violate a series of standards. Rule 1.7(d) permits representation if identified prohibitions are not present.

1). Insurer And Policyholder Are Directly Adverse

Rule 1.7(a) prohibits a lawyer from representing "a client if the representation is directly adverse to another client in the same or a separate matter."

2). Significant Risk Of Limitation From Responsibilities To Insurer

Rule 1.7(b) prohibits a lawyer from representing "a client if there is a significant risk the lawyer's representation of the client will be materially limited by the lawyer's responsibilities to or relationships with another client, a former client or a **third person**." (Emphasis added.)

3). Significant Risk Of Limitation From Lawyer's Own Interests

Separately, Rule 1.7(b) also prohibits a lawyer from representing "a client if there is a significant risk the lawyer's representation of the client will be materially limited by . . . the lawyer's own interests."

4). Reasonable Belief Of Competent, Diligent Representation

Rule 1.7(d)(1) permits representation "only if the lawyer complies with paragraphs (a), (b), and (c), and: (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client."

5). Not prohibited By Law

Rule 1.7(d)(2) also permits representation "only if the lawyer complies with paragraphs (a), (b), and (c), and: . . . (2) the representation is not prohibited by law."

6). Coverage Claim By Insurer Against Policyholder Is Not Involved

Rule 1.7(d)(3) also permits representation "only if the lawyer complies with paragraphs (a), (b), and (c), and: . . . (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal."

Because each of these six prongs is written in the conjunctive, dependent counsel must investigate and analyze all six prongs, and make disclosure to the policyholder of the analysis as to each of the six prongs in order to comply with Rule 1.7.

E. Dependent Counsel Always Represents The Insurer

Some insurers seek to circumvent Rule 1.7 by claiming that they are not a "client" of their dependent counsel because the insurer is typically not a party to a third party liability dispute. This assertion is contrary to California law. Rule 1.7(b) prohibits a lawyer from representing a policyholder if there is a significant risk that a representation will be materially limited by the lawyer's responsibilities to or relationships with a **third person**, such as a reserving insurer whether that third person is technically a client or not. California is a two client state so that the word "client" in Rule 1.7 means any liability

insurer that hires the lawyer to represent a policyholder. (See, *Gulf Ins. Co. v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone* (2000) 79 Cal.App.4th 114, 127.)

"Even the most optimistic view of human nature requires us to realize that an attorney employed by an insurance company will slant his efforts, perhaps unconsciously, in the interests of his real client - the one who is paying his fee and from whom he hopes to receive future business - the insurance company. Matthew 6:24 retains a particular relevancy, 'No man can serve two masters'. . . . [T]he conflict situation cannot be eliminated so long as the insurance company selects the counsel. It is simply a matter of human nature." (*Union Ins. Co. v. Knife Co., Inc.* 902 F. Supp. 877, 881 (W.D. Ark. 1995) (citations, quotation marks, and ellipses omitted).)

Under California law, dependent counsel always have an attorney-client relationship with both a liability insurer that regularly select and direct them and its policyholder they agree to represent as a party to the third party liability dispute. "Excepting Cumis counsel, an attorney hired by a liability insurer to defend an action against one of its insureds owes duties to both insurer and insured under tort law (duty to represent their interests with due care) and the Rules of Professional Conduct: 'In the absence of a conflict of interest between the insurer and the insured that would preclude an attorney from representing both, the attorney has a dual attorney-client relationship with insurer and insured.' [*State Farm Mut. Auto. Ins. Co. v. Federal Ins. Co.* (1999) 72 CA4th 1422, 1429; *Lysick v. Walcom* (1968) 258 CA2d 136, 146]." (Croskey, Heeseman, Ehrlich & Klee, Cal. Prac. Guide: Insurance Litigation (The Rutter Group 2019) § 7:840, italics omitted.) "The signed defense guidelines, with the negotiated hourly rate, and subsequent correspondence, along with the subsequent dealings between the [dependent counsel and the insurer], reflected an agreement between them and an attorney-client relationship as a matter of law." (*Gulf Ins. Co. v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone* (2000) 79 Cal.App.4th 114, 127.) Liability insurers always hire dependent counsel to protect the financial interests of the liability insurer in defending the lawsuit. Dependent counsel rely upon liability insurers for much of their income. "Insurance companies hire relatively few lawyers and concentrate their business.

Dependent counsel risk liability to the policyholder and a reserving insurer risks loss of coverage defenses reserved when dependent counsel violate their ethical obligations to the policyholder. "'Had [dependent counsel] so misbehaved, they would have been exposed to malpractice liability, disciplinary actions and possible loss of coverage defense by [the insurer].'" (*Midiman v. Farmers Ins. Exchange* (1999) 76 Cal.App.4th 102, 122 quoting *Dynamic Concepts, Inc. v. Truck Ins. Exchange* (1998) 61 Cal.App.4th 999, 1008.)

F. Oddly, There Are Variations Of The Cumis Test Among Fifty American Jurisdictions

Some jurisdictions hold that dependent counsel do not represent the insurer.

However, the wisdom of these decisions is suspect because both ABA and California Rule 1.7 specifically requires compliance if "there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to . . . a **third person**" whether or not designated technically as a "client". This Rule makes sense since a liability insurer is always a potential indemnitor of an adverse judgment against its policyholder with a right to have its interests protected by counsel in the defense of claim.

Since most American jurisdictions adopt the Model ABA Rules of Professional Conduct and California's unique expression of the Rules mirrors the ABA Rules, one might expect that application of more or less uniform rules would lead to a more or less uniform body of law, but it does not. A close reading of all of the cases suggests that variations among the jurisdictions is the result of how policyholder lawyers have framed legal issues and succeeded or failed to prove that disqualifying conflicts of interest existed. Many courts remain confused regarding the Cumis Law. "[T]he professional obligations of counsel who represents a liability insurer as well as its insured -- needs clarification." (*Industrial Indem. Co. v. Great American Ins. Co.* (1977) 73 Cal.App.3d 529, 531.)

Most American jurisdictions have addressed the subject matter, but have chosen solutions across a broad spectrum, which can be put into three imprecise categories. About a third of the states adopt a "per se" rule by which all reservations of rights disqualify dependent counsel from representing the policyholder without informed written consent. California, the Restatement of Liability Insurance, and many recent, thoughtful published opinions from sister states adopt a modified "per se" rule that only reservations of rights that create a disqualifying conflict of interest compel dependent counsel to withdraw and the insurer to pay independent counsel instead. A few states have adopted an "enhanced duties" rule, which imposes on reserving insurers and their dependent counsel duties to the policyholder that are higher than lawyers' Canons of Ethics and insurers' duty of good faith and fair dealing - especially since these duties are already described by many courts as being duties of the highest magnitude. (See, *Anderson v. Eaton* (1930) 211 Cal. 113, 116.)

1). The Per Se Rule

Most American jurisdictions have ruled that all reservations of rights create a conflict of interest between the insurer and its policyholder, which alone requires that the insurer pay for independent counsel. However, many of the opinions published in the jurisdictions that so hold are not particularly thoughtful - in a sentence of two, the court simply announces the rule. Interestingly, none of these jurisdictions acknowledge that they are adopting a "per se" rule. Instead, other jurisdictions that reject the "per se" rule attribute this moniker to those other jurisdictions.

2). The California And Restatement Rule

The prestigious and independent American Law Institute thoroughly researches and publishes "Restatements of the Law" which articulate the principles or rules for specific areas of law to clarify the law and help courts understand and interpret the current common law by synthesizing and restating existing case law and statutes from various jurisdictions. The Restatement of Liability Insurance has adopted California's Cumis Test: "When an insurer with the duty to defend provides the insured notice of a ground for contesting coverage under § 15 and there are facts at issue that are common to the legal action for which the defense is due and to the coverage dispute, such that the action could be defended in a manner that would benefit the insurer at the expense of the insured, the insurer must provide an independent defense of the action." (Restatement of Law, Liability Insurance § 16 (2019).)

Many California courts have clearly, but variously, enunciated this legal standard to determine whether a reservation of rights creates a disqualifying conflict of interest which prohibits dependent counsel from representing a policyholder without informed written consent and requires the insurer to pay for independent counsel. Fourteen published California opinions and Civil Code § 2860 illuminate the Cumis Test.

A liability insurer that does not promptly and expressly accept full coverage for a lawsuit filed against its policyholder must pay for independent counsel to conduct the policyholder's defense if any single ground upon which the insurer reserves its rights to later deny coverage involves any disputed issue of fact or law, resolution of which could be influenced by the conduct of the policyholder's defense. California courts have expressed the Cumis Test both negatively and positively.

Expressed negatively, insurer selected counsel has no disqualifying conflict of interest and the liability insurer that reserves its rights is not required to pay for independent counsel if each ground upon which the insurer may later deny coverage:
1) has "nothing to do with the issues being litigated in the underlying action" (*Long v. Century Indemnity Co.* (2008) 163 Cal.App.4th 1460, 1470 (citation and ellipsis omitted);
2) "is logically unrelated to the issues of consequence in the underlying case" (*Montrose Chemical Corp. v. Superior Court* (1993) 6 Cal.4th 287, 302;
3) "is independent of the issues in the underlying case;" (*Blanchard v. State Farm Fire & Casualty Co.* (1991) 2 Cal.App.4th 345, 350; see also, *Gafcon, Inc. v. Ponsor & Associates* (2002) 98 Cal.App.4th 1388, 1422); or
4) "is extrinsic to the issues in the underlying action." (*Gafcon, Inc. v. Ponsor & Associates* (2002) 98 Cal.App.4th 1388, 1422.)

Expressed positively, insurer selected counsel has no disqualifying conflict of interest and the liability insurer that reserves its rights is required to pay for independent counsel:
1) "whenever [the insurer's and policyholder's] common lawyer's representation of the

one is rendered less effective" (*Spindle v. Chubb/Pacific Indemnity Group* (1979) 89 Cal.App.3d 706, 713);
2) if coverage issues "overlap" issues in the third party liability action (*United Enterprises, Inc. v. Superior Court* (2010) 183 Cal.App.4th 1004, 1010);
3) if any coverage question depends "upon the insured's own conduct" (*Foremost Ins. Co. v. Wilks* (1988) 206 Cal.App.3d 251, 261);
4) if "[i]nsurance counsel had [an] incentive to attach liability to [the insured]" (*Gulf Ins. Co. v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone* (2000) 79 Cal.App.4th 114, 131;
5) if "the ground of noncoverage was based on the nature of the insured's conduct" (*McGee v. Superior Court* (1985) 176 Cal.App.3d 221, 226);
6) if "the outcome of the coverage issue can be controlled by the way counsel defends the case" (*Novak v. Low, Ball & Lynch* (1999) 77 Cal.App.4th 278, 282; Civ. Code § 2860(a));
7) "can be controlled by counsel first retained by the insurer for the defense of the claim" (Civ. Code § 2860(b));
8) "the way counsel retained by the insurance company defends the action will affect an underlying coverage dispute between the insurer and the insured" (*James 3 Corp. v. Truck Ins. Exchange* (2001) 91 Cal.App.4th 1093, 1108);
9) "the basis for the reservation of rights is such as to cause assertion of factual or legal theories which undermine the positions to be asserted in the liability case" (*State Farm Fire & Cas. Co. v. Superior Court* (1989) 216 Cal.App.3d 1222, 1226, fn.3.) and;
10) "where the issue creating the conflict is one which must be decided in the underlying action." (*Truck Ins. Exchange v. Superior Court* (1996) 51 Cal.App.4th 985, 994; see also, *Golden Eagle Ins. Co. v. Foremost Ins. Co.* (1993) 20 Cal.App.4th 1372, 1395-1396.)

The recent trend among other jurisdictions is to follow California law. Nevada and Indiana have published thoughtful analyses that adopt the California and Restatement view. (See, *State Farm Mut. Auto. Ins. Co. v. Hansen*, 131 Nev. Adv. Op. 74 (2015) and *Auto-Owners Ins. Co. v. Lake Erie Land Co.* 2:12-CV-184 JD (N.D. Ind. 2013).

3). The Enhanced Duties Rule

In *Tank v. State Farm Fire & Cas. Co.* (1986) 105 Wash.2d 381, 387-91, Washington imposed "enhanced duties" on both reserving insurers and their dependent counsel which "mandate an even higher standard" than the duty of good faith and fair dealing or the Canons of Ethics and threaten both with civil liability for a failure to adhere to this higher standard. The court specified that a reserving insurer must: 1) thoroughly investigate; 2) retain competent defense who represents only the insured as the client; 3) fully inform the policyholder, especially regarding settlement offers; and 4) refrain from favoring its monetary interest over the policyholder's financial risk. The court also

specified that defense counsel must: 1) not allow the insurer to influence his or her professional judgment; 2) make full and ongoing disclosure to the insured, including A) that potential conflicts of interest must be fully disclosed and resolved in favor of the insured; B) all information relevant to the defense must be disclosed; and C) all offers of settlement must be disclosed.

Three consistent features of jurisdictions adopting the "enhanced duties" rule are that the policyholder: 1) failed to sue the lawyers; 2) failed to prove the existence of a disqualifying conflict of interest; and 3) failed to prove any violation of the criteria describing the "enhanced duties".

G. Independent Counsel May Participate In Settlement Negotiations

Some jurisdictions recognize that conflicts of interest are likely to arise regarding settlement. Rule 1.4.1 requires lawyers to communicate of settlement offers "all amounts, terms, and conditions of any written offer of settlement made" to the client and "a person who possesses the authority to accept an offer of settlement", such as a liability insurer.

Conflicts of interest commonly arise "in two situations: where coverage under the policy is disputed . . . and where the claim against the insured is likely to result in a recovery in excess of the policy limits unless the insurer accepts a settlement offer within the policy limits." (*Bogard v. Employers Casualty Co.* (1985) 164 Cal.App.3d 602, 609) Because the insurer and the policyholder each want the other to pay, "it will always be to the insured's advantage to have settlement effected within policy limits." (*Barney v. Aetna Casualty & Surety Co.* (1986) 185 Cal.App.3d 966, 976.) "Where a conflict of interests emerges, the carrier has the obligation of protecting the interests of the insured equally with his own. . . . The insurer . . . must advise the insured of the offer and the company's assessment of that offer." (*Miller v. Elite Ins. Co.* (1980) 100 Cal.App.3d 739, 756.)

As a result, policyholders are often entitled to have independent counsel participate in settlement negotiations at the insurer's expense. "Under these circumstances, we hold the [policyholder] were entitled to independent counsel at the insurers' expense to represent them in the settlement negotiations." (*Golden Eagle Ins. Co. v. Foremost Ins. Co.* (1993) 20 Cal.App.4th 1372*,* 1396.)

H. Does A Defense By Disqualified Dependent Counsel Deprive The Policyholder Of Procedural Due Process Of Law?

A policyholder is "deprive[d] . . . of . . . property, without due process of law" in violation of the U.S. Constitution, 14th Amendment (and Cal. Const., art. I, § 7, subd. (a)) if the advocate purporting to represent the policyholder was actually advocating a judgment with a non-covered outcome. "Adjudicative governmental actions that implicate significant or substantial property deprivation generally require the procedural due process protections of reasonable notice and an opportunity to be heard. (*Venice Coalition*

to Preserve Unique Community Character v. City of Los Angeles (2019) 31 Cal.App.5th 42, 49 (citations omitted).) An insurer that hires dependent counsel who are not ethically qualified to conduct the policyholder's defense cannot properly be said to fulfill the insurer's duty to defend. A policyholder who is unwittingly represented by ethically compromised counsel who shepherds a civil action to a non-covered result deprives the policyholder of procedural due process of law in a fashion that is analogous to a criminal defendant who is deprived of the right to the effective assistance of counsel. (See, *Strickland v. Washington* 466 U.S. 668 (1984). The duty to defend is a duty to pay for ethically qualified counsel which right should be triggered by the possibility that a reservation of rights creates a disqualifying conflict of interest.

A judgment rendered through disqualified dependent counsel may also be void. "A conflict of interest was manifested where defense counsel told the jury he believed his client (the insured) was testifying falsely in order to help the plaintiff ('I think my client has been less than candid with us ... '). It was misconduct for defense counsel to attack the insured's credibility in order to protect the insurance company's interests. Such misconduct prevented a fair trial, so that the court was required to grant a new trial." (*Price v. Giles* (1987) 196 Cal.App.3d 1469, 1473.)