A PRIMER ON THE RIGHT TO INDEPENDENT COUNSEL

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RIGHT TO INDEPENDENT COUNSEL

One of the "hot" issues in insurance law these days is the "right" to independent counsel. In particular, questions arise as to whether the insurer or the insured gets to select counsel, who has to pay for independent counsel, and the appropriate rate to be paid by the insurer to independent counsel. Prior to addressing these independent counsel issues, however, this paper will provide some background on the so-called tripartite relationship between the insurer, the insured, and defense counsel as well as the use of captive counsel.

I.
<u>The Tripartite Relationship</u>

When an insurer assumes its insured's defense, generally it has the right to select defense counsel. Moreover, if no conflict of interest exists, the insurer may have exclusive control over the defense. When a conflict of interest exists (*e.g.*, when the outcome of a coverage issue can be affected by the manner in which the underlying action is defended), however, one must be cognizant of the relationship among the liability insurer, its insured, and the defense counsel selected by the liability insurer to defend the insured. The relationship among these parties is known as the "tripartite relationship."

A debate exists as to whether Texas is a "one client" or "two client" state. Essentially, the debate focuses on whether the insurer *also* is the client of defense counsel hired by the insurer to represent the insured. *See* Charles Silver, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 DUKE L.J. 255 (1995); Charles Silver & Michael Quinn, *Wrong Turns on the Three-Way Street: Dispelling Nonsense about Insurance Defense Lawyers*, COVERAGE, Nov.–Dec. 1995, at 1. Texas law is far from clear on this point. Texas law is clear, however, that defense counsel owes "unqualified loyalty" to the insured. *See State Farm Mut. Auto. Ins. Co. v. Traver,* 980 S.W.2d 625, 628 (Tex. 1998); *Employers Ins. Cas. Co. v. Tilley,* 496 S.W.2d 552, 558 (Tex. 1973). As the Supreme Court of Texas pointed out in *Traver*, "the lawyer must at all times protect the interests of the insured . . . ." *Traver,* 980 S.W.2d at 628. Despite the fact that defense counsel undeniably owes its unqualified loyalty to the insured, the fact remains that the "so-called tripartite relationship has been well documented as a source of unending ethical, legal, and economic tension." *Traver,* 980 S.W.2d at 633 (Gonzalez, J., concurring and dissenting). As Justice Gonzalez further noted:

> The duty to defend in a liability policy at times makes for an uneasy alliance. The insured wants the best defense possible. The insurance company, always looking at the bottom line, wants to provide a defense at the lowest possible cost. The lawyer the insurer retains to defend the insured is caught in the middle. There is a lot of wisdom in the old proverb: He who pays the piper calls the tune. The lawyer wants to provide a competent defense, yet knows who pays the bills and who is most likely to send new business.

Id.

The import of *Traver* and *Tilley* in the duty to defend context is that an insurer should not use the same counsel to review coverage that it does to defend the insured. *See Employers Cas. Co. v. Mireles,* 520 S.W.2d 516 (Tex. Civ. App.—San Antonio 1975, writ ref'd n.r.e.) (holding that the employment of separate firms to defend the insured and to address coverage issues eliminates conflicts of interest). Accordingly, when an insurer offers a qualified defense under a reservation of rights and proceeds by hiring defense counsel, the defense counsel should remain "independent." Likewise, when a qualified defense is provided, defense counsel should never communicate with the insurer with respect to "coverage" issues. *See Rhodes v. Chicago Ins. Co.,* 719 F.2d 116 (5th Cir. 1983).

II.
<u>The Use of Captive Firms</u>

Another issue that has come to the forefront as of late is the use of "captive firms" to defend insureds. A captive firm is a law office staffed by lawyers who actually are employees of the insurance company. The use of captive firms has increased over the past few years as insurers have searched for ways to be cost-effective. *See Traver,* 980 S.W.2d at 633 (Gonzalez, J., concurring and dissenting).

The Unauthorized Practice of Law Committee ("UPLC") has waged war against the use of so-called "captive firms" to defend insureds. According to the UPLC, the use of captive firms raises serious ethical issues. In particular, the UPLC questions whether captive lawyers truly will look out for the best interests of the insureds. The use of captive firms also has caught the attention of the Supreme Court of Texas. *See Traver,* 980 S.W.2d at 633 (Gonzalez, J., concurring and dissenting) (noting that "it is probably impossible for an attorney to provide the insured the unqualified loyalty that *Tilley* requires" where the insured is being represented by a captive firm).

Even so, the UPLC has been unsuccessful in its prosecution of insurers that use captive firms. *See Unauthorized Practice of Law Committee v. Nationwide Mut. Ins. Co.,* 155 S.W.3d 590 (Tex. App.—San Antonio 2004, pet. filed); *American Home Assurance Co. v. Unauthorized Practice of Law Committee,* 121 S.W.3d 831(Tex. App.—Eastland 2003, pet. granted). Notably, both courts held that the use of staff counsel to represent insureds does not constitute the unauthorized practice of law. Interestingly, the Eastland Court of Appeals specifically held that a defense lawyer has two clients. *American Home,* 121 S.W.3d at 838 ("Reality and common sense dictate that the insurance company is also a client. The insurance company retains the attorney, controls the legal defense, decides if the case should be settled, and pays any judgment or settlement amount up to policy limits. It is a fiction to say that the insured is the only client in view of the contractual relationships."). Despite the result, no question exists that staff counsel still owe the insured unqualified loyalty. *See Nationwide Mut. Ins.,* 155 S.W.3d at 598; *American Home Assurance,* 121 S.W.3d at 838.

The use of staff counsel and the broader issue of whether Texas is a "one client" or "two client" state is a controversial issue. Oral argument took place in the *American Home Assurance* case on September 28, 2005. All of the briefing can be found on the Supreme Court's website at http://www.supreme.courts.state.tx.us/.

III.
The Right to Independent Counsel

Whether an insurer has the right to control the defense, which involves the right to select counsel, is a matter of contract. *See N. County Mut. Ins. Co. v. Davalos,* 140 S.W.3d 685, 688 (Tex. 2004); *see also Traver*, 980 S.W.2d at 627. Most policies vest this right in insurers. And, in fact, it may be a violation of the cooperation clause to refuse to allow an insurer to select counsel and control the defense when the insurer agrees to provide an unqualified defense. *See Burney v. Odyssey Re (London) Limited*, 2005 WL 81722 (N.D. Tex. Jan. 14, 2005). "Under certain circumstances, however, an insurer may not insist upon its contractual right to control the defense." *Davalos,* 140 S.W.3d at 688. In particular, an insurer must relinquish this right when a "conflict of interest" exists. *Traver,* 980 S.W.2d at 627. Even so, according to the Supreme Court of Texas, not every disagreement about how the defense should be conducted rises to the level of a conflict of interest. *See Davalos,* 140 S.W.3d at 689 (holding that a disagreement as to the proper venue for the defense of a third-party claim did not amount to a conflict of interest).

A big issue is whether the issuance of a reservation of rights constitutes a per se conflict of interest. To date, most courts that have addressed the issue have concluded that a reservation of rights does in fact create a sufficient conflict of interest that would warrant an insurer to relinquish its contractual right to control the defense. *See Rhodes v. Chicago Ins. Co.,* 719 F.2d 116, 120 (5th Cir. 1983) ("When a reservation of rights is made, however, the insured may propertly refuse the tender of defense and pursue his own defense" and the "insurer remains liable for attorneys' fees incurred by the insured and may not insist on conducting the defense."); *Arkwright-Boston Mfrs. Mut. Ins. Co. v. Aries Marine Corp.,* 932 F.2d 442, 445 (5th Cir. 1991) ("The insured, confronted by notice of the potential conflict [through a reservation of rights], may then choose to defend the suit personally."); *American Eagle Ins. Co. v. Nettleton,* 932 S.W.2d 169, 174 (Tex. App.—El Paso 1996, writ denied) ("Upon receiving notice of the reservation of rights, the insured may properlty refuse tender of defense and defend the suit personally."); *see also Britt v. Cambridge Mut. Fire Ins. Co.,* 717 S.W.2d 476, 481 (Tex. App.—San Antonio 1986, writ ref'd n.r.e.); *Steel Erection Co. v. Travelers Indem. Co.,* 392 S.W.2d 713 (Tex. App.—San Antonio 1965, writ ref'd n.r.e.).

One of the most recent opinions to address this issue was authored by Judge Lindsay from the Northern District. *See Hous. Auth. of City of Dallas v. Northland Ins. Co.,* 333 F. Supp. 2d 595 (N.D. Tex. 2004). In *Northland Ins. Co.*, Judge Lindsay noted as follows:

> Northland contends that despite that the facts in the [underlying lawsuit] are the same as those upon which coverage depends, there is no evidence that the facts could have been "steered" to exclude coverage. In other words, Northland contends that DHA has offered no evidence that the counsel it selected would have manipulated the facts of the case, thereby allowing it to avoid coverage.

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> Northland next contends that regardless of whether the reservation of rights letter created a potential conflict of interest, DHA's only opposition at the time it tendered a defense was the slow progress of DHA's cases . . . which, it contends, is insufficient to create a disqualifying conflict of interest. It is true that the record establishes that the slow progress of its cases . . . was DHA's only concern, and that the conflict of interest matter seemingly just fell into DHA's lap; however, the facts are what they are and necessarily establish or create a disqualifying conflict of interest. Specifically, Northland issued a reservation of rights letter, which created a potential conflict of interest. . . . As previously stated, Northland acknowledged that the liability facts and coverage facts are the same, or at a minimum, did not dispute that the facts were the same, although it had the opportunity to do so. The court, therefore, determines that because the liability facts and coverage facts were the same and because a potential conflict of interest was created by the issuance of the reservation of rights letter, a disqualifying conflict existed; therefore Northland could not conduct the defense of the *Bell* lawsuit. Under these circumstances, DHA properly refused Northland's qualified tender of defense and defended the *Bell* lawsuit on its own.

Northland Ins. Co., 333 F. Supp.2d at 601-02 (internal quotations and citations omitted). *Northland Ins Co.* stands for the proposition that a reservation of rights creates a disqualifying conflict so long as the facts to be developed in the underlying lawsuit are the same facts upon which coverage depends. *See id.*

Judge Rosenthal recently issued an opinion that addresses this issue:

> Not every reservation of rights creates a conflict of interest allowing an insured to select independent counsel. Rather, the existence of a conflict depends on the nature of the coverage issue as it relates to the underlying case. If the insurance policy (like the policy in this case) gives the insurer the right to control the defense of a case the insurer is defending on the insured's behalf, the insured cannot choose independent counsel and require the insurer to reimburse the expense unless "the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends."

RX. Com, Inc. v. Hartford Fire Ins. Co., 2006 WL 801133 (S.D. Tex. March 29, 2006) (citing *Davalos,* 140 S.W.3d at 689). In other words, according to the *RX.Com* case, "[a] conflict of interest does not arise does not arise unless the outcome of the coverage issue can be controlled by counsel retained by the insurer for the defense of the underlying claim." *Id* at *13.

Even when the right to independent counsel is recognized, a big fight oftentimes ensues as to "how much" the insurer must pay independent counsel. In particular, if independent counsel normally charges $250 per hour whereas the counsel selected by the insurer charges $165 per hour, can the insurer insist on paying the lower rate? Very little guidance is provided by the Texas courts on this issue. The most rationale answer is that the insurer should be forced to pay what is reasonable and customary for the type and sophistication of the particular case. Notably, defense counsel that receive a large volume of work from a particular insurer oftentimes discount their rates. Independent counsel, who may or may not ever have another case involving the insurer, should not be forced to accept the discounted rate. For example, after deciding that Northland had breached its duty to defend in the *Northland Ins. Co.* case, Judge Lindsay issued a subsequent opinion in which he concluded that the fees charged by the lawyers DHA retained to represent it after refusing to accept the insurer's qualified defense were "on the low end of reasonableness" despite the fact that they were significantly higher than the rates that would have been charged by the insurer's selected counsel. *See Hous. Auth. of City of Dallas v. Northland Ins. Co.*, *Civil Action No. 3:03-CV-385-L, In the United States District Court for the Northern District of Texas, Order dated January 27, 2005.*

Another fight centers on whether independent counsel must follow litigation/billing guidelines. Again, very little guidance is provided by the Texas courts on this issue. A Texas Ethics Opinion, however, does provide some insight. *See* STATE BAR ETHICS OPINION NO. 533 (2000) ("It's impermissible under the Texas Disciplinary Rules of Professional Conduct for a lawyer to agree with an insurance company to restrictions which interfere with the lawyer's exercise of his or her independent professional judgment in renders such legal services the insured/client."). Ethics Opinion 533 basically stands for the proposition that a defense lawyer can follow billing/litigation guidelines so long as such guidelines do not interfere with the defense counsel's professional judgment. *Id.* In addition, in *Traver*, the Supreme Court recognized that "the lawyer must at all times protect the interests of the insured if those interests would be compromised by the insurer's instructions." *Traver*, 980 S.W.2d at 628. In other words, while a prohibition on block billing may be permissible, it likely would not be permissible for an insurer to restrict research, discovery or other matters that fall within the professional judgment of the defense counsel.

V.
Conclusions

Issues surrounding the tripartite relationship, the use of captive counsel, and the selection and control of defense counsel are extremely prevalent. To date, the Texas courts have provided little guidance in resolving these issues. It is expected that at least some of the issues discussed above will be resolved by the Supreme Court of Texas in the near future. Other issues, such as reasonable rates to be paid to independent counsel and the application of litigation/billing guidelines, simply may need to be decided on a case-by-case basis.