Conflicts of Interest in Insurance Defense

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I. Introduction

Standard liability insurance policies grant the insurance company the right to defend a lawsuit against an insured in addition to imposing on the insurer the duty to defend the insured. The insurer's duty to defend the insured and its right to do so go hand-in-hand.

An insurer's right to defend its insured entitles it to control the insured's defense, including the right to select defense counsel for the insured. *DePasquale Steel Erectors Inc. v. Gemini Ins. Co.*, 249 F. Supp. 3d 899, 902 (N.D. Ill. 2017) (applying Illinois law); *Moeller v. Am. Guarantee & Liab. Ins. Co.*, 707 So. 2d 1062, 1068 (Miss. 1996); *In re Farmers Tex. Cnty. Mut. Ins. Co.*, 621 S.W.3d 261, 269 (Tex. 2021). Unfortunately, the language in standard liability insurance policies that generally vests control of the insured's defense in the insurer and empowers the insurer to appoint defense counsel for the has long fostered concern about conflicts of interest between insureds and the defense lawyers appointed by insurers. The essential concern has always been that because insurance defense attorneys normally enjoy on-going relationships with the insurers that engage them but seldom have continuing relationships with the insureds they are hired to represent, they are predisposed to favor the insurer over the insured in any case where their interests diverge. In fact, it is a rare case in which the insurer's and insured's interests in a lawsuit against the insured are not aligned. Third-party claims against insureds typically are within policy limits, do not spawn coverage issues, and do not involve a situation where the insured has an independent, non-economic interest at stake in the litigation. It is also wrong to presume that a lawyer hired by an insurer to defend an insured will somehow favor the insurer's interests over the insured's interests because of her business relationship with the insurer. Nonetheless, conflicts of interest occasionally arise in insurance defense just as they do in other litigation practice areas.

II. Recurring Conflict of Interest Scenarios

Although conflicts of interest arise in various circumstances, conflicts are most often alleged to arise in cases where (a) the insurer is defending under a reservation of rights; (b) the plaintiff's claimed damages exceed the liability limits of the insured's policy; (c) the plaintiff seeks punitive damages; (d) the defense lawyer represents multiple insureds; (e) the insured shares confidential information with defense counsel that it does want the lawyer to share with the insurer, such as information affecting coverage; (f) the insurer and insured disagree over litigation strategy; and (g) the insurer declines to fund the pursuit of an insured's affirmative claim for relief. Whether there is, in fact, a conflict of interest that entitles the insured to representation by independent counsel must be determined on a case-by-case analysis.

A. A Defense Under a Reservation of Rights

In theory, an insurer's reservation of rights presents a conflict of interest because the insurer may be more concerned with developing facts defeating coverage than facts defeating liability. *State ex rel. Rimco, Inc. v. Dowd*, 858 S.W.2d 307, 308 (Mo. Ct. App. 1993). Yet, an insurer's interest in defeating coverage does not alone create a conflict of interest. *Flexi-Van Leasing, Inc. v. Travelers Indem. Co.*, 837 F. App'x 141, 147 (4th Cir. 2020); *Nat'l Cas. Co. v. Forge Indus. Staffing, Inc.*, 567 F.3d 871, 874 (7th Cir. 2009).

Under the majority approach, courts correctly reason that not every reservation of rights creates a conflict of interest requiring the insurer to provide its insured with independent counsel. *Centex Homes v. St. Paul Fire & Marine Ins. Co.*, 187 Cal. Rptr. 3d 542, 548 (Ct. App. 2015); *Fed. Ins. Co. v. MBL, Inc.*, 160 Cal. Rptr. 3d 910, 920 (Ct. App. 2013); *State Farm Mut. Auto. Ins. Co. v. Hansen*, 357 P.3d 338, 343 (Nev. 2015). Rather, an insurer must provide its insured with independent counsel only when the outcome of a coverage issue can be affected by the defense of the third-party action. *Downhole Navigator, L.L.C. v. Nautilus Ins. Co.*, 686 F.3d 325, 328–29 (5th Cir. 2012) (applying Texas law); *Centex Homes*, 187 Cal. Rptr. 3d at 548; *Fed. Ins. Co.*, 160 Cal. Rptr. 3d at 920; *Nisson v. Am. Home Assur. Co.*, 917 P.2d 488, 490 (Okla. Ct. App. 1996). Phrased another way, a conflict of interest exists when the insurer defends under a reservation of rights and the facts on which liability will be adjudicated are the same facts on which coverage depends. *Graper v. Mid-Continent Cas. Co.*, 756 F.3d 388, 392 (5th Cir. 2014); *Allstate Cnty. Mut. Ins. Co. v. Wootton*, 494 S.W.3d 825, 837 (Tex. App. 2016).

So, in what circumstances might the conduct of the defense be able to affect coverage? One example is a case in which the insurer is defending under a reservation of rights because the insured's alleged conduct may have been intentional. In that scenario, if the insured can be shown to have intentionally injured the plaintiff rather than having acted negligently, there will have been no "occurrence" within the meaning of the policy's insuring agreement and the policy's exclusion for expected or intended injury will additionally foreclose coverage. To be sure, the insurer and the insured share a common interest in defeating the plaintiff's claims, but if the insured is found to be liable, their interests diverge in establishing the basis for liability. Accordingly, the insured is owed a defense by independent counsel. *Select Comfort Corp. v. Arrowood Indem. Co.*, 2014 WL 4232334, at *6–7 (D. Minn. Aug. 26, 2014) (applying Minnesota law); *Auto-Owners Ins. Co. v. Lake Erie Land Co.*, 2013 WL 4401834, at *6–7 (N.D. Ind. Aug. 13, 2013).

A defense lawyer also may be able to affect coverage in a mixed action, that is, a case in which the plaintiff pleads multiple claims against the insured but only some are covered. The archetypal mixed action creating a conflict of interest is one where some causes of action allege negligence and others allege intentional torts. *Roussos v. Allstate Ins. Co.*, 655 A.2d 40, 44 (Md. Ct. Spec. App. 1995); *see, e.g.*, *Aquino v. State Farm Ins. Cos.*, 793 A.2d 824, 830 (N.J. Super. Ct. App. Div. 2002); *State Farm Mut. Auto. Ins. Co. v. Van Dyke*, 668 N.Y.S.2d 821, 822–23 (App. Div. 1998). The concern there is that a defense lawyer could through discovery steer the case out of coverage, successfully move for summary judgment on covered claims and leave the insured exposed to liability on uncovered causes of action, or submit special interrogatories or a special verdict form to enable the jury to allocate damages between covered and uncovered claims.

Conversely, there is no conflict of interest, and an insurer consequently has no duty to provide independent counsel for the insured when the manner in which the third-party action is defended cannot affect coverage. The essential conflict of interest inquiry in all cases, of course, is not whether defense lawyers *intend* their actions to affect coverage but whether they *could* influence coverage by their conduct or decisions. *See Gafcon, Inc. v. Ponsor & Assocs.*, 120 Cal. Rptr. 2d 392, 418–19 (Ct. App. 2002).

In conclusion, the majority rule provides that no conflict of interest necessarily exists in a reservation of rights defense. *Graper v. Mid-Continent Cas. Co.*, 756 F.3d 388, 392 (5th Cir. 2014) (applying Texas law); *Downhole Navigator*, 686 F.3d at 328–31 (applying Texas law); *Twin City*

Fire Ins. Co. v. Ben Arnold-Sunbelt Beverage Co. of S.C., LP, 433 F.3d 365, 366, 372 (4th Cir. 2005) (discussing South Carolina law and collecting cases); *Tyson v. Equity Title & Escrow Co. of Memphis, LLC*, 282 F. Supp. 2d 829, 831–32 (W.D. Tenn. 2003) (applying Tennessee law); *MetLife Capital Corp. v. Water Quality Ins. Synd.*, 100 F. Supp. 2d 90, 94 (D.P.R. 2000); *Bank of Am., N.A. v. Super. Ct.*, 151 Cal. Rptr. 3d 526, 537 (Ct. App. 2013); *Delmonte v. State Farm Fire & Cas. Co.*, 975 P.2d 1159, 1174 (Haw. 1999); *Mut. Serv. Cas. Ins. Co. v. Luetmer*, 474 N.W.2d 365, 368–69 (Minn. Ct. App. 1991); *Hansen*, 357 P.3d at 342–43; *Twp. of Readington v. Gen. Star Ins. Co.*, 2006 WL 551404, at *4 (N.J. Super. Ct. App. Div. Mar. 3, 2006); *Nisson*, 917 P.2d at 490; *Eckman v. Erie Ins. Exch.*, 21 A.3d 1203, 1208–09 (Pa. Super. Ct. 2011); *Unauthorized Prac. of Law Comm. v. Am. Home Assur. Co.*, 261 S.W.3d 24, 40 (Tex. 2008); *Johnson v. Cont'l Cas. Co.*, 788 P.2d 598, 600 (Wash. Ct. App. 1990).

A few courts hold that an insurer's reservation of rights does create a conflict of interest that entitles the insured to independent counsel. *See, e.g.*, *Maister Assocs. v. State Farm Fire & Cas. Co.*, 350 F. App'x 978, 979 (5th Cir. 2009) (applying Louisiana law); *Hartford Underwriters Ins. Co. v. Found. Health Servs., Inc.*, 524 F.3d 588, 592–93 (5th Cir. 2008) (applying Mississippi law); *Am. Nat'l Prop. & Cas. Co. v. Est. of Farese*, 530 F. Supp. 3d 655, 674 (S.D. Miss. 2021) (stating that when an insurer defends under a reservation of rights there is built-in conflict of interest); *Hartford Cas. Ins. Co. v. A & M Assocs., Ltd.*, 200 F. Supp. 2d 84, 89–90 (D.R.I. 2002) (applying Rhode Island law for conflict of interest purposes); *Great Divide Ins. Co. v. Carpenter ex rel. Reed*, 79 P.3d 599, 604 (Alaska 2003); *Hackman v. W. Agric. Ins. Co.*, 2012 WL 1524060, at *14 (Kan. Ct. App. Apr. 27, 2012); *Federated Dep't Stores, Inc. v. Twin City Fire Ins. Co.*, 807 N.Y.S.2d 62, 66 n.1 (App. Div. 2006); *see also Twin City*, 433 F.3d at 370–71 (collecting cases holding that a reservation of rights creates conflict of interest entitling insured to independent counsel).The minority approach, however, is unsupportable for two reasons. First, an insurer defending under a reservation of rights must defend the insured just as zealously as it would if it had not reserved its rights. If the insurer does not do so, it risks liability for breaching its duty to defend. The insured is thus adequately protected against the risk that the insurer will defend half-heartedly based on the possible lack of coverage. Second, defense lawyers hired by insurers are called upon daily to handle cases in which the insured's and insurer's interests do not fully coincide. The defense bar has consistently shown the ability to zealously defend insureds (their clients) in those cases. Nevertheless, if the lawyer can affect coverage through the litigation of the third-party action, the insured is owed a defense by independent counsel at the insurer's expense.

B. The Potential for Excess Liability

Cases in which potential damages exceed the liability limits of the insured's policy are sometimes alleged to create conflicts of interest. A conflict allegedly arises when a plaintiff offers to settle within policy limits. As soon as a policy limits settlement offer is made, the reasoning goes, the insured's and insurer's interests diverge. The insured wants the insurer to settle to avoid possible excess liability, but settlement is not necessarily in the insurer's best interests. By going to trial, the insurer may escape liability altogether, or obtain a judgment lower than the plaintiff's settlement offer. The insurer might therefore be tempted to gamble with the insured's money. Precisely to avoid this problem, however, insurance law obligates insurers to make reasonable settlement decisions as an aspect of their implied duty of good faith and fair dealing. And, because insurance law addresses this adversity of interests through the duty to make reasonable settlement

decisions, there normally is no conflict of interest that requires independent counsel for the insured. Restatement of the L. of Liab. Ins. § 16 cmt. c (Am. L. Inst. 2019). Certainly, no conflict of interest exists where the insurer offers its policy limits in settlement or, in an appropriate case, interpleads its policy limits to achieve a settlement. *See Lehto v. Allstate Ins. Co.*, 36 Cal. Rptr. 2d 814, 820 (Ct. App. 1994) (involving an interpleader action by the insurer and stating that "[w]here, as here, the insurer early on decides to offer the policy limits in settlement of its insureds' claims, no conflict of interest arises").

Allstate Insurance Co. v. Campbell, 639 A.2d 652 (Md. 1994), is a leading case upholding the majority rule. In *Campbell*, Maryland's highest court concluded that potential excess liability alone does not create a conflict of interest that requires the insurer to surrender control of the defense and pay for the insured's representation by independent counsel. *Id.* at 659. The court acknowledged the adversity between the insurer and the insured in an excess liability scenario, but observed that the insured's and insurer's interests "are in no way adverse to the extent that exists where coverage is an issue." *Id.* The court concluded that any conflict of interest was mitigated by the insured's ability to later pursue a bad faith claim and recover the amount of any excess judgment should the insurer unreasonably refuse to accept a policy limits settlement offer. Absent a separate conflict of interest that necessitates independent counsel for the insured, the insurer retains the right to control the defense of a potential excess verdict case. *Id.* at 659–60.

Campbell is a sound decision. An insurer must competently defend a potential excess verdict case to minimize its potential indemnity obligation up to the policy limits, and to avoid bad faith liability. As noted earlier, the latter factor provides special incentive. Again, the prospect of an excess verdict, standing alone, does not constitute a conflict of interest that deprives an insurer of the right to control the defense. *Littlefield v. McGuffey*, 979 F.2d 101, 108 (7th Cir. 1992) (applying Illinois law); *Nede Mgmt., Inc. v. Aspen Am. Ins. Co.*, 284 Cal. Rptr. 3d 122, 130 (Ct. App. 2021) (quoting Cal. Civ. Code § 2860(b)); *OneBeacon Am. Ins. Co. v. Celanese Corp.*, 84 N.E.3d 867, 876 (Mass. App. Ct. 2017).

C. The Plaintiff Seeks Punitive Damages

Plaintiffs often plead claims for punitive damages. States are divided on the insurability of punitive damages. Some states prohibit the insurability of punitive damages on public policy grounds. Courts in these states reason that allowing insurance for punitive damages would undermine the goals of punishment and deterrence, or that insurers would unfairly shift the burden of punitive damage awards to the public through increased premiums. Of those states that generally prohibit the insurability of punitive damages, some make an exception for punitive damages awarded solely under vicarious liability principles. Other states do not prohibit the insurability of punitive damages. In these states, standard policy language providing that the insurer will pay "all sums which the insured shall become legally obligated to pay as damages" is sufficiently broad to insure punitive damages. *See, e.g.*, *Shelter Mut. Ins. Co. v. Dale*, 914 So. 2d 698, 701 (Miss. 2005) (discussing a Mississippi statute and an auto liability insurer's ability to exclude coverage for punitive damages). *But see Heartland Stores, Inc. v. Royal Ins. Co.*, 815 S.W.2d 39, 42–43 (Mo. Ct. App. 1991) (stating that punitive damages were not covered because they were not attributable to "bodily injury" or "property damage").

In jurisdictions that prohibit the insurability of punitive damages, or where a policy excludes coverage for punitive damages or does not cover them for some other reason, an insurance company may be thought to have no interest in defending punitive damage claims against insureds. On the other side of the coin, insureds are vitally interested in avoiding liability for punitive damages. Hence defense lawyers' perceived conflict of interest where punitive damages are sought.

1. The Majority Rule: A Punitive Claim Does Not Create a Conflict of Interest

Despite these concerns, the majority rule holds that a punitive damage claim does not constitute a conflict of interest that entitles the insured to independent counsel. *See, e.g.*, Bean Prods., Inc. v. Scottsdale Ins. Co., 2018 WL 522627, at *7 (Ill. App. Ct. Jan. 22, 2018) ("[N]o actual conflict of interest existed to entitle Bean to independent counsel based simply on the fact that the complaint sought punitive damages.").

Foremost Insurance Co. v. Wilks, 253 Cal. Rptr. 596 (Ct. App. 1989), illustrates the majority rule and the rationale behind it. In *Wilks*, Delmar Brey sued Diana Wilks for defamation. Brey sought injunctive relief, compensatory damages of $100,000, and punitive damages of $250,000. California public policy prohibits insurance coverage for punitive damages. Wilks tendered the defense of Brey's lawsuit to her insurer, Foremost Insurance Co. (Foremost), which agreed to defend her. In its letter accepting her defense, however, Foremost informed her that under California law its policy would not cover any punitive damages that Brey might be awarded, and further suggested that she might want to engage personal counsel to protect her interests with respect to a potential punitive damage award. Wilks claimed that Foremost's advice created a conflict of interest that entitled her to independent counsel, but the court disagreed.

> Under the policy issued to Wilks, Foremost is obligated to indemnify for damages up to $1,000,000 sustained in a personal injury action, which is defined by the policy to include defamation actions. Foremost is prohibited from indemnifying Wilks from any punitive damages pursuant to Civil Code section 1668 and Insurance Code section 533. However, Foremost will be liable for indemnification of compensatory damages if the trier of fact in the *Brey* action finds Wilks defamed Brey regardless of whether her conduct was done with malice or reckless disregard for the truth. Contrary to Wilks' assertions, *it is in Foremost's interest to vigorously defend the suit to avoid liability for indemnification of compensatory damages. Although the nature of Wilks' conduct as developed at trial will determine whether punitive damages are awarded, under the facts of this case and the coverage afforded Wilks under the policy, Foremost gains no benefit from pursuing a theory that Wilks acted with malice or reckless disregard for the truth. Ergo, there is no conflict of interest*.

Id. at 602 (emphasis added).

The *Wilks* court reached the correct conclusion. Other courts have employed similar reasoning with the same result. In *Pennbank v. St. Paul Fire & Marine Insurance Co.*, 669 F. Supp.

122 (W.D. Pa. 1987), for example, the court banked on the insurer's interest in minimizing compensatory damages in rejecting the insured's argument that the plaintiffs' punitive damage claims created a conflict of interest that entitled it to independent counsel. As the *Pennbank* court explained:

> The interests of insurer and insured in defense of the underlying suits were the same—prevent a finding of liability or failing that, minimize damages. Punitive damages can only be awarded where compensatory damages have been awarded and the punitives must have some relation to the compensatory award. . . . For St. Paul to admit outrageous, intentional and reckless conduct on the part of its insured, or to fail to vigorously defend such charges, would guarantee a large award of compensatory damages as well as punitive damages.
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> This is not a case where liability can rest on either of two causes of action, one of which is covered and the other not (e.g., negligence and intentional tort). There an insurer would be tempted to construct a defense which would place any damage award outside policy coverage. That is not the case here. Any award of punitive damages would necessarily occasion the overwhelming likelihood of a large compensatory award. Both parties shared the desire to prevent a finding which would justify punitive damages. For this reason, the rationale in *Cumis* is inapplicable here.

Id. at 126–27.

The Restatement of the Law of Liability Insurance likewise recognizes that a punitive damage claim generally does not create a conflict of interest absent a reservation of rights to contest coverage more broadly. Restatement of the L. of Liab. Ins. § 16 cmt. d (Am. L. Inst. 2019). In doing so, the Restatement embraces the majority view that the insurer's litigation efforts to minimize compensatory damages also reduce the insured's exposure to punitive damages. *Id.*

2. The Punitive-to-Compensatory Damages Ratio Exception

Although the Restatement generally embraces the majority position that a punitive damage claim does not create a conflict of interest, it further reasons that a punitive damage claim could create a conflict where the compensatory damages sought are so small in relation to the potential punitive damages that the defense of the action "might be handled in a hard-edged manner that disproportionately risks exacerbating the punitive-damages exposure or if there was a realistic possibility that the manner of presentation at trial could affect the jury's allocation between pain-and-suffering damages and punitive damages." *Id.* This narrow exception to the general rule that a punitive damage claim does not create a conflict of interest is principally rooted in an Illinois appellate decision, *Nandorf v. CNA Insurance Cos.*, 479 N.E. 2d 988 (Ill. App. Ct. 1985).

Nandorf arose out of a lawsuit filed by Delores Scott and several other plaintiffs against Nandorf, Inc. (Nandorf), which owned a thrift shop, for false imprisonment. Each plaintiff sought $5,000 in compensatory damages and $100,000 in punitive damages. *Id.* at 990. Nandorf's insurer, CNA, appointed the law firm of Baker & McKenzie to defend Nandorf. CNA also reserved its

right not to indemnify Nandorf for any punitive damage award based on Illinois public policy. Nandorf's counsel asked CNA to waive its reservation of rights and informed CNA that they planned to control the defense of the *Scott* case if CNA refused. CNA declined to waive its reservation of rights and refused to relinquish control of the litigation.

Nandorf later sued CNA. Nandorf claimed that CNA's reservation of rights based on the plaintiffs' punitive damage claims created a conflict of interest that obligated CNA to provide it with independent counsel. The *Nandorf* court agreed:

> [T]he complaint . . . sought a large amount of punitive damages and a relatively small amount of compensatory damages. CNA disclaimed liability only for punitive damages. The insurer and the insured shared a common interest in a finding of no liability. However, if Nandorf was found liable, their interests diverged. CNA's interests would have been just as well served by an award of minimal compensatory damages and substantial punitive damages. Such an award is not inconceivable. As a result of its reservation of rights, CNA had an interest in providing a less than vigorous defense to allegations in the *Scott* complaint which, if proven, would have supported . . . punitive damages. . . . CNA's failure to vigorously defend those allegations would have had the effect of subjecting its insured to greater liability. Clearly, the insurer's fidelity to its insured was hampered by its own interests in this case.
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> In contrast, Nandorf's interest lay in reducing any potential punitive damages award, regardless of the compensatory damages awarded. Therefore, if liability was imposed, it would have been in Nandorf's interest to have a determination that its employees acted in good faith. A finding of good faith would not have prevented an award of compensatory damages but would have precluded an award of punitive damages. . . . CNA would have had little interest in seeking such a finding. Because CNA's reservation of rights placed the insurer and insured at cross purposes with respect to allegations in the *Scott* complaint, we find that an actual conflict of interests existed between Nandorf and CNA which rendered it improper for CNA to retain control of the litigation.

Id. at 992 (citations omitted).

The *Nandorf* court was careful to note that its holding was not meant to imply that an insured is entitled to independent counsel every time a plaintiff seeks punitive damages. *Id.* at 993. Rather, the "peculiar facts and circumstances of this litigation," where "punitive damages formed a substantial portion of the potential liability" and "CNA's disclaimer of liability for punitive damages left Nandorf with the greater interest and risk in the litigation," created an ethical conflict of interest that warranted Nandorf's representation by independent counsel at CNA's expense. *Id.* at 993–94.

The *Nandorf* approach is not persuasive. The fact that a potential punitive damage award may far exceed a compensatory damage award does not mean that an insurer lacks an interest in resisting punitive damages. At least one court has reasoned that where compensatory and punitive

damages arise out of the same conduct, the insurer's interest in defeating the insured's alleged liability means that the insurer will necessarily protect the insured's interests with respect to both categories of damages. *Forge Indus. Staffing*, 567 F.3d at 874. Certainly, if the potential compensatory damages are significant—even if any punitive damages will probably be much greater—the insurer will be heavily invested in defeating or minimizing the plaintiff's claims for compensatory damages and by extension the punitive damage claims. Finally, the insurer's duty to defend the insured reasonably notwithstanding its reservation of rights should ensure that the defense will be conducted in a fashion that protects the insured against liability for both punitive damages and compensatory damages. For these reasons, the defense lawyer in such a case should not suffer a conflict of interest.

D. The Defense Lawyer Represents Multiple Insureds

In a case where multiple defendants are insured by the same insurance company, it is common for the insurer to at least initially consider whether it may appoint a single lawyer to represent all the defendants. The appointment of a single lawyer has economic benefits and may afford strategic or tactical advantages through a streamlined defense. Where there are no conflicts of interest, a single lawyer may represent multiple defendants. In fact, lawyers often represent multiple defendants in litigation with no problems. Yet, a lawyer's representation of multiple defendants can lead to conflicts of interest based on the co-defendants adversity in one form or another. *See, e.g.*, *Univ. of Miami v. Great Am. Assur. Co.*, 112 So. 3d 504, 508 (Fla. Dist. Ct. App. 2013) (requiring separate lawyers where a single defense lawyer would "have had to necessarily imply blame to one co-defendant to the detriment of the other"); *Country Mut. Ins. Co. v. Olsak*, 908 N.E.2d 1091, 1099–1100 (Ill. App. Ct. 2009) (concluding that there was a conflict of interest requiring separate counsel where the two co-defendants had different interests when it came to characterizing one co-defendant's conduct as either negligent or intentional); *Murphy v. Nutmeg Ins. Co.*, 773 N.Y.S.2d 413, 415 (App. Div. 2004) (stating that insurer had to provide separate counsel for multiple insureds with potential contribution claims against each other).

For example, a landowner is typically an additional insured under a general contractor's CGL policy. A lawyer hired by the general contractor's CGL insurer to defend a premises liability case may be asked to also defend the landowner; however, the doctrine of comparative fault makes the landowner and general contractor potential adversaries even though they have a common interest in defeating the plaintiff's claims. If an injured automobile passenger sues both the owner and the driver of the car, the owner and driver may be on opposing sides. It may be in the driver's best interest to argue that she is the owner's agent, while the owner may benefit by arguing that the driver was impermissibly operating the vehicle. Representing a corporate insured and its employee is sometimes problematic because of course and scope of employment issues. Co-defendants may have indemnification agreements or common law indemnity rights that effectively require defense counsel to assert cross-claims. In a direct action jurisdiction, where the plaintiff may sue the insured and its insurer in the same action, the insurer must provide the insured with separate counsel. *See, e.g.*, *Emery v. Progressive Cas. Ins. Co.*, 49 So. 3d 17, 21–22 (La. Ct. App. 2010) (holding that the insurer waived its coverage defenses by virtue of conflict of interest that resulted when it hired a single lawyer to represent both it and its insured).

Wolpaw v. General Accident Insurance Co., 639 A.2d 338 (N.J. Super. Ct. App. Div. 1994), exemplifies the conflicts of interest that a single defense lawyer's representation of multiple insureds can pose. In *Wolpaw*, Saranne Frew was insured under a $50,000 homeowners policy issued by General Accident Insurance Co. (General Accident). The policy also covered members of Frew's household, including her sister Karanne Wolpaw, and Karanne's son, Heath. Heath Wolpaw blinded a playmate, Michael Heim, when he shot him in the eye with a BB gun. Heim and his parents sued Heath, his mother, his father Ivan, and Frew. General Accident hired a single law firm to represent all the defendants except Ivan.

General Accident immediately paid its $50,000 policy limits into court as a settlement offer. The Heims rejected the offer. A jury awarded the Heims $502,000 after finding Michael Heim fifty percent at fault, Heath Wolpaw twenty percent at fault, and Ivan Wolpaw thirty percent at fault. By then, Frew was out of the case on summary judgment. Post-judgment interest brought the total judgment to over $700,000. Karanne Wolpaw then sued General Accident, alleging that its failure to provide separate counsel for each defendant was a breach of contract. *Id.* at 339.

The *Wolpaw* court noted the general rule that an insurer of codefendants whose interests conflict must retain independent counsel for each insured, or permit each insured to do so at the company's expense. That was clearly the situation here.

> The three insureds had the common interests of minimizing the amount of the Heims's judgment and maximizing the percentage of fault attributable to the other defendants. However, their interests in maximizing the percentage of the other insureds' fault and minimizing their own was clearly in conflict. For instance, it was in plaintiff's interest to argue that she adequately had secured the rifle from Heath's unattended use and had carefully instructed him in its safe use, which he negligently disregarded; on the other hand, it was in Heath's interest to argue that [his mother] negligently failed to secure the rifle, and that he was not negligent in view of his mother's negligence and his youth.
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> With the general abolition of parental immunity, . . . and in the absence of sufficient liability insurance coverage, separate attorneys representing . . . plaintiff and Heath might well have asserted cross-claims for contribution against the other's client. That was not done . . . . It was also in plaintiff's interest to assert a cross-claim against her sister and that she remain a codefendant to share the liability burden. Yet the single firm of attorneys, discharging its duty to her sister, not only did not file a cross-claim for contribution on plaintiff's behalf, but successfully moved to have Frew dismissed from the case.

Id. at 340.

The court termed the conflict of interest "obvious," and concluded that General Accident breached its policy by virtue of its failure to provide independent counsel for its insureds. *Id.* The court then remanded the case to the trial court so that damages attributable to the conflict could be apportioned in a separate trial.

The *Wolpaw* court reached the right result. A defense lawyer generally cannot represent multiple insureds in a comparative fault case. Although the insureds' interests may appear to be harmonious in the sense that they all want to defeat the plaintiff's claims, there is a significant risk that one insured will at some point have to blame the other for causing or contributing to the plaintiff's injuries.

On another point, in concluding that General Accident had a conflict of interest, the *Wolpaw* court was strongly influenced by the prospect of excess liability. The prospect of excess liability unquestionably was a complicating factor, but the defense firm had a conflict of interest even if the policy limits were sufficient to cover any potential judgment given Heath Wolpaw's obvious fault for Michael Heim's injury unless the other defendants were willing not to contest their individual liability. Any one insured's insistence on an allocation of fault would create a conflict of interest for the defense lawyer even in a case of full coverage. Whether the insured's stance in that scenario might constitute a breach of his or her duty to cooperate is a separate issue. In contrast, where the insurer's policy limits are sufficient to fully indemnify each insured defendant and there is no need to litigate their respective fault, there is no conflict of interest requiring independent counsel. *See, e.g.*, *Davenport v. St. Paul Fire & Marine Ins. Co.*, 978 F.2d 927, 932 (5th Cir. 1992). Even in a case of potential excess liability, where there is no need to allocate fault between the insured defendants or where their theories of defense are the same, there is no conflict of interest that requires the appointment of independent counsel. *See, e.g.*, *Stevenson v. Corp. of Lloyd's*, 2016 WL 524735, at *7 (M.D. Fla. Feb. 10, 2016) (finding no conflict of interest where the insureds were members of the same family and their company and their defenses were aligned); *see also Progressive Nw. Ins. Co. v. Gant*, 957 F.3d 1144, 1153–54 (10th Cir. 2020) (concluding that the insurer could not be liable for negligently hiring the defense lawyer to represent multiple insureds where the insureds had no desire to blame one another for the underlying accident, they wanted to present a unified defense, and, in addition, they all signed a conflict waiver).

E. Conflicts Attributable to the Insured's Confidential Information

Conflicts of interest are partly predicated on lawyers' duty of confidentiality. A lawyer's duty to maintain client confidences is essential to the attorney-client relationship. Almost all jurisdictions have adopted Rule 1.6(a) of the Model Rules of Professional Conduct, which provides that "[a] lawyer shall not reveal information relating to representation of a client" unless the client gives informed consent, the disclosure is impliedly authorized to carry out the representation, or one of the exceptions listed in Model Rule 1.6(b) applies. Model Rules of Pro. Conduct r. 1.6(a) (Am. Bar Ass'n 2022) [hereinafter Model Rules]. Lawyers' duty of confidentiality under Model Rule 1.6(a) and equivalent state rules, although not absolute, is very broad. The duty applies to *all* information related to a client's representation. *State v. Gonzalez*, 234 P.3d 1, 11 (Kan. 2010); State Bar of Nev., Comm. on Ethics & Pro. Resp., Formal Op. No. 41, at 3 (2009). Any exceptions that rules of professional conduct provide are narrow.

A lawyer with multiple clients in a matter owes each client an equal and undivided duty of confidentiality. Unlike the attorney-client privilege, there is no co-client exception to the duty of confidentiality. Generally, for a lawyer to be able to share a co-client's confidential information with another co-client, the clients must so agree. The clear lesson for a lawyer representing joint

clients is to explain to the clients at the outset of the representation the need to share information that is material to their representations and obtain their consent to do so. In many cases, it probably is sufficient for the lawyer to state in the engagement letter for the matter that there will be no confidences between the co-clients and then explain what this means from a practical perspective. The clients' agreement to the lawyer's joint representation after being so informed reflects their consent to the sharing of their confidences related to the matter. The better practice is for the lawyer to also explain to the clients how the duty of confidentiality operates either in person, via videoconference, or over the telephone.

Independent duties to multiple clients may become a problem in the insurance defense context, where a defense lawyer must keep both the insurer and the insured informed about the status of a case. Insurers' outside counsel guidelines typically require defense lawyers to report to the insurer significant case developments and to report after specified events, such as depositions. If the insured reveals confidential information to the defense lawyer, can the lawyer pass along that information to the insurer? Two situations stand out: First, the insured shares with the lawyer information the insured considers confidential that does not affect coverage but is material to the defense of the case. Second, the insured shares with the lawyer information that affects coverage.

Foundationally, a defense lawyer should explain to the insured up front the lawyer's relationship with the insurer and the lawyer's obligation to keep the insurer informed about the status of the case. This is a logical component of the lawyer's explanation to the insured of the scope of the representation. The lawyer should also outline her duty of confidentiality and how that duty may come into play in the insured's representation. For example, the insured needs to understand that the lawyer is impliedly authorized to disclose to the insurer information that is necessary to carry out the insured's representation. The lawyer should further explain the insured's duty to cooperate in the defense and the effect a failure to cooperate may have on coverage or on the insurer's defense obligation. The insured needs all this information regardless of whether the insurer is a co-client of the defense lawyer, or the insured is the defense lawyer's sole client.

Where the lawyer is asked to defend co-defendants in a case, the lawyer must further explain her duty of confidentiality to each co-defendant and obtain their consent to the mutual sharing of information between them that is material to the defense. If the defendants do not agree to share such information, this is a sign that there perhaps is a conflict of interest that requires the defendants to have separate counsel.

It is generally accepted that because the scope of the defense lawyer's representation is limited to defending the insured in the third-party action, the lawyer has no obligation to disclose to the insurer any information that bears on coverage. This is true even where the insurer is also a client of the defense lawyer. *See* CA Eth. Op. 1995-139, 1995 WL 255397, at *3 (Cal. State Bar, Comm. on Pro. Resp. & Conduct 1995). For example, section 11(2) of the Restatement of the Law of Liability Insurance states that an insurer "does not have the right to receive any information of the insured that is protected by . . . a defense lawyer's duty of confidentiality under rules of professional conduct, if that information could be used to benefit the insurer at the expense of the insured." Restatement of the L. of Liab. Ins. §11(2) (Am. L. Inst. 2019). A comment to section 134 of the Restatement (Third) of the Law Governing Lawyers similarly provides:

> When there is a question whether a claim against the insured is within the coverage of the policy, a lawyer designated to defend the insured may not reveal adverse confidential client information of the insured to the insurer concerning that question . . . without explicit informed consent of the insured. . . . That follows whether or not the lawyer also represents the insurer as a co-client and whether or not the insurer has asserted a "reservation of rights" with respect to its defense of the insured. . . .

Restatement (Third) of the L. Governing Laws. § 134 cmt. f (Am. L. Inst. 2000) (citations omitted). The lawyer needs to advise both the insured and the insurer of this limitation on the lawyer's duty to communicate early on.

An insurer that is a client of the defense lawyer under the dual client doctrine is not entitled to obtain from the lawyer information relevant to coverage on the rationale that such disclosure is impliedly authorized to carry out the insurer's representation. Implied authority applies only when the lawyer reasonably believes that disclosure is necessary to protect the interests of the client whose information will be disclosed. ABA Comm. on Ethics & Pro. Resp., Formal Op. 08-450, at 6 (2008). In other words, it is the insured's implied authority that counts here, not the insurer's. It is not logical to believe that an insured would authorize the defense lawyer to disclose to the insurer information that might deprive the insured of coverage. To the same point, a client may never be presumed to have impliedly authorized the disclosure of information adverse to its interests. *Id.*

Where the insured's confidential information relates solely to the defense of the case, the insured should be understood to have impliedly authorized the lawyer's disclosure to the insurer even if the insured did not expressly authorize it. The insured will almost certainly be agreeable to the defense lawyer's disclosure to the insurer in any event. An insured may not welcome disclosure, however, where the lawyer is representing the insured and another co-defendant and the co-defendant will also receive the information the lawyer plans to disclose to the insurer.

Assume, for example, that a company and its employee are sued in connection with a serious accident and the employee is an insured as defined in the company's CGL policy. The company's insurer appoints a lawyer to jointly defend the company and the employee. The case proceeds smoothly until the employee confides in the lawyer that unbeknownst to everyone—including the company and, so far, the plaintiff because the employee has yet to be deposed—he was intoxicated when he allegedly caused the accident. The insurer needs to know this information because it may prompt the insurer to settle the case before the employee's impairment is revealed and potentially inflates the case's value. The employee is fine with the lawyer's disclosure of his impairment to the insurer, but he does not want the information revealed to the company because he anticipates that the company will fire him for violating its substance-free workplace policy. Of course, the company would like to know the information because it also affects the case against it.

The lawyer should remind the employee that he consented to the lawyer's disclosure of any information material to the case to the company at the outset of the representation. The lawyer should also advise the employee that the information will likely come out at his deposition, which a company representative may well attend, and that the employee cannot lie under oath to conceal his impairment. Unfortunately, if the lawyer did not previously obtain the employee's consent to

the disclosure of information related to the joint representation, she cannot seek consent now because the information is adverse to the employee's interests, and it does not fall within one of the exceptions to confidentiality listed in Model Rule 1.6(b).

If the employee consented to the lawyer's disclosure of such information to the company at the start of the representation, he could still revoke his consent. If the employee did not consent in advance to the disclosure of his confidential information to the company and now refuses to permit disclosure or, alternatively, revokes any consent previously given, the lawyer has a conflict of interest that requires her to withdraw from the case. The lawyer cannot tell the company specifically why she must withdraw even though her inability to do so will surely frustrate the company. For that matter, the lawyer cannot tell the insurer why she must withdraw because doing so might derivatively reveal the employee's confidence to the company. Finally, the lawyer cannot give the court any reason for her withdrawal beyond (1) citing the governing ethics rule (Model Rule 1.16(a)(1)); or (2) saying that professional or ethical considerations necessitate her withdrawal, or that there has been an irreconcilable breakdown in the attorney-client relationship with the employee that prevents her continued participation in the case.

Next, consider a case in which the insured is being deposed about an accident on its property and, during the deposition, discusses several prior accidents. *See* William T. Barker & Charles Silver, Professional Responsibilities of Insurance Defense Counsel § 10.02, at 10-9 (2012 & Supp. 2017) (providing this example). If the insured was asked about prior accidents on the application for the policy under which coverage is being provided and did not disclose them, the insurer may be able to rescind the policy based on the insured's misrepresentation. In all probability, the defense lawyer will be unaware of the contents of the insured's application and therefore would have no reason to withhold this information when reporting on the deposition to the insurer. *Id.* Plus, the prior accidents may be relevant to the insured's defense, so relating the insured's testimony seems natural.

If, however, the defense lawyer has reviewed a copy of the application and recognizes the threat to coverage that the insured's testimony potentially poses, trouble is percolating. If the prior accidents are not relevant to the insured's liability—they might be dissimilar to the accident at issue or occurred on unrelated areas of the property—the defense lawyer can avoid reporting the insured's related testimony to the insurer because coverage issues are outside the scope of the defense lawyer's representation. But if the prior accidents *are* relevant to the insured's liability, they are exactly the sort of information the insurer expects to receive from the defense lawyer. Furthermore, because of the coverage implications, the lawyer cannot assume that the insured has impliedly authorized the lawyer to disclose the prior accidents to the insurer. It is no answer to say that the lawyer can report the insured's testimony to the insurer without the insured's consent because the insured's knowledge of the accidents was revealed to the plaintiff or became "public" through the deposition. As lawyers should know, the duty of confidentiality under Model Rule 1.6(a) encompasses information that may be considered a public record or that is thought to be in the public domain. *See People v. Braham*, 470 P.3d 1031, 1044 (Colo. 2017); *In re Anonymous*, 654 N.E.2d 1128, 1129–30 (Ind. 1995); *Iowa Sup. Ct. Att'y Disciplinary Bd. v. Marzen*, 779 N.W.2d 757, 766 (Iowa 2010); *In re Bryan*, 61 P.3d 641, 656 (Kan. 2003); *Sullivan Cnty. Reg'l Refuse Disposal Dist. v. Town of Acworth*, 686 A.2d 755, 758 (N.H. 1996); *Law. Disciplinary Bd. v. McGraw*, 461 S.E.2d 850, 861–62 (W. Va. 1995).

Assuming that the prior accidents are relevant to the defense of the current case, the lawyer should explain the situation to the insured, inform the insured of the conflict, and encourage the insured to consult with a coverage lawyer. Unless the insured knowingly agrees that the defense lawyer may reveal the prior accidents to the insurer or the insured's coverage counsel does so (perhaps having concluded that rescission is not available to the insurer), the defense lawyer's inability to disclose the insured's related testimony to the insurer creates a conflict of interest that requires the lawyer to withdraw from the representation.

Happily, problems attributable to an insured's confidential information are rare. A defense lawyer can avoid or mitigate many of them through appropriate disclosures at the outset of the representation. When they do surface, conflicts and other problems related to an insured's confidential information can be incredibly nuanced and require significant care to navigate.

F. Disagreements over Litigation Strategy as Conflicts of Interest

An insurer's right to control its insured's defense naturally encompasses the right to control litigation strategy in conjunction with the appointed defense lawyer. As long as the insurer conducts the defense reasonably, the insured cannot rightly insist on representation by independent counsel based on its dissatisfaction with the direction of the defense. The insured's disagreement with the insurer's or defense lawyer's litigation strategy does not create a conflict of interest. *See Nede Mgmt.*, 282 Cal. Rptr. 3d at 131; *Roussos v. Allstate Ins. Co.*, 655 A.2d 40, 44 (Md. Ct. Spec. App. 1995); *Steinman v. Silbowitz*, 714 N.Y.S.2d 209, 210 (App. Div. 2000).

Northern County Mutual Insurance Co. v. Davalos, 140 S.W.3d 685 (Tex. 2004), is an interesting case in which the court held that the insured's disagreement with the insurer over litigation strategy was not a conflict that entitled the insured to independent counsel. The insured there, Timoteo Davalos, was injured in a car accident in Dallas County, Texas. He resided in Matagorda County, Texas. He sued the driver of the other car in Matagorda County. The other driver and his wife then sued Davalos and another party in Dallas County. Although Davalos had insurance with Northern County Mutual Insurance Co. (Northern), he turned over the Dallas County litigation to his lawyers in the Matagorda County case, who answered the suit and moved to transfer it to Matagorda County. Davalos's lawyers then notified Northern of the Dallas County suit. In response, Northern informed Davalos that it would defend him without a reservation of rights, that it would not hire his lawyers to defend the Dallas County case, that it opposed transfer of the Dallas County case to Matagorda County, and that it had retained another lawyer to defend him in the Dallas County action. *Id.* at 687. Northern also warned Davalos that his coverage might be jeopardized if his personal counsel did not drop their motion to transfer venue and withdraw. *Id.* Lastly, Northern told Davalos that he was free to retain his personal counsel at his own expense to consult on the Dallas County case, and that Northern's chosen lawyer would cooperate with that lawyer so long as it did not jeopardize the defense. *Id.* Northern reasonably believed Dallas County to be the proper venue for both actions arising out of the accident.

Davalos's lawyers rejected Northern's offered defense. They asserted that Northern's offered defense was qualified and thus breached the duty to defend, and that Northern could not select defense counsel because its dispute with Davalos over the venue motion created a conflict of interest. *Id.* The Matagorda County action ultimately was transferred to Dallas County on

another party's motion. Northern settled the original Dallas County case against Davalos. Meanwhile, Davalos sued Northern in Matagorda County, claiming that Northern had breached its duty to defend him in the Dallas County action, that Northern was guilty of bad faith, and that it had violated the Texas Insurance Code. *Id.* at 688.

Both the trial court and a lower appellate court concluding that Northern had breached its duty to defend by insisting that Davalos withdraw his venue motion and violated the Texas Insurance Code by neither accepting nor rejecting his defense within the statutorily-mandated time. Northern successfully sought review by the Texas Supreme Court, which reversed the lower appellate court.

The Texas Supreme Court rejected Davalos's argument that Northern had improperly conditioned his defense. An insurer's right to conduct an insured's defense includes the authority to select defense counsel and make other decisions that would normally be entrusted to the insured as the named party in the case. *Id.* Moreover, not every disagreement between an insurer and an insured about the conduct of a defense creates a conflict of interest; were that the case, the insured could commandeer the defense merely by disagreeing with the insurer's tactics. *Id.* at 689. Instead, an insured may "rightfully refuse an inadequate defense and may also refuse any defense conditioned on an unreasonable, extra-contractual demand that threatens the insured's independent legal rights." *Id.* Thus, and by way of example, Northern could not have conditioned Davalos's defense on his agreement to dismiss his Matagorda County action. *Id.* Here, however, the disagreement centered on the appropriate venue for the defense of the Dallas County action, not Davalos's right to pursue his own remedy.

Northern never deprived Davalos of a defense. It was difficult for the *Northern County* court to imagine a situation in which a choice of venue might spawn a disqualifying conflict of interest. *Id.* at 690. Choosing venue is a strategic litigation decision entrusted to the insurer or to defense counsel. *See id.* According to the court, the selection of venue "should ordinarily have no impact on the insured's legitimate interests under the policy." *Id.*

The *Northern County* court concluded that Northern did not breach its duty to defend. Its offer to defend Davalos in the Dallas County action satisfied its contractual obligations. The court also found that Northern did not violate the Texas Insurance Code. Northern's disagreement with Davalos over venue did not render its offer to defend him equivocal.

The *Northern County* court reached the correct decision given its focus on Northern's alleged breach of its duty to defend but Davalos's venue stance arguably had some merit. The court decided against Davalos by reasoning that venue is a convenience issue. But Davalos's lawyers surely believed that venue is more than that. They probably believed based on known jury verdicts that Matagorda County was a favorable plaintiffs' venue, or was at least better than Dallas County. Consolidating the cases in Dallas County therefore reduced the chances of winning Davalos's case against the other driver or diminished that case's verdict value. From Davalos's perspective, then, Northern's insistence on keeping venue in Dallas County was an unreasonable demand that threatened his independent rights.

On the other hand, the Dallas County and Matagorda County actions were going to be consolidated in one county or the other. Assuming that Matagorda County was a favorable plaintiffs' venue, consolidation of the cases there would have enhanced the value of the other driver's lawsuit against Davalos. Northern was only obligated to give Davalos's interests consideration equal to its own; it was not required to submerge its own interests. Northern was therefore within its rights to demand that Davalos maintain venue in Dallas County.

G. The Insured's Pursuit of Affirmative Claims for Relief

In *Northern County*, Davalos and Northern became antagonistic because of Davalos's desire to prioritize the pursuit of his claim against the other driver over Northern's defense of the other driver's suit against him. In fact, an insurer generally has no duty to finance an insured's prosecution of affirmative claims—such a counterclaims, cross-claims, or even separate actions—as part of its duty to defend the insured. *Aldous v. Darwin Nat'l Assur. Co.,* 851 F.3d 473, 483 (5th Cir. 2017) (applying Texas law), *vacated in part on other grounds on reh'g*, 889 F.3d 798 (5th Cir. 2018); *Spada v. Unigard Ins. Co.*, 80 F. App'x 27, 29–30 (9th Cir. 2003) (applying Oregon law); *Emerald Bay Cmty. Ass'n v. Golden Eagle Ins. Corp.*, 31 Cal. Rptr, 3d 43, 57 (Ct. App. 2005); *Int'l Ins. Co. v. Rollprint Packaging Prods., Inc.*, 728 N.E.2d 680, 694 (Ill. App. Ct. 2000) *Ramsey v. Lee Builders, Inc.*, 95 P.3d 1033, 1040 (Kan. Ct. App. 2004); *Mount Vernon Fire Ins. Co. v. Visionaid, Inc.*, 76 N.E.3d 204, 213 (Mass. 2017); *St. Paul Fire & Marine Ins. Co. v. Nat'l Comput. Sys., Inc.*, 490 N.W.2d 626, 632 (Minn. Ct. App. 1992); *Red Head Brass, Inc. v. Buckeye Union Ins. Co.*, 735 N.E.2d 48, 56 (Ohio Ct. App. 1999); *Towne Realty, Inc. v. Zurich Ins. Co.*, 548 N.W.2d 64, 68–69 (Wis. 1996); *Shoshone First Bank v. Pac. Emps. Ins. Co.*, 2 P.3d 510, 516–17 (Wyo. 2000).

A defense lawyer appointed by an insurer may, if she chooses, prosecute an insured's affirmative claim. In that case, the insured must pay the lawyer to prosecute its claim. After all, the prosecution of the insured's affirmative claim is outside the scope of the defense lawyer's representation. The lawyer's unwillingness to represent the insured in prosecuting its affirmative claim unless the insured agrees to pay the lawyer for those services on terms acceptable to the lawyer does not pose a conflict of interest that requires the lawyer's replacement by independent counsel. *Flexi-Van Leasing*, 837 F. App'x at 147. Of course, a defense lawyer may not want to represent an insured in its planned prosecution of an affirmative claim. The defense lawyer's refusal to represent the insured in connection with its affirmative claim is not a conflict of interest, either. *Simonyan v. Nationwide Ins. Co. of Am.*, 293 Cal. Rptr. 3d 555, 564 (Ct. App. 2022).

III. Representing Insureds Under Defense-Within-Limits Policies

Standard liability insurance policies include a supplementary payments provision that states that the insurer will pay all defense expenses incurred in litigation against the insured in addition to the policy limits. Accordingly, no matter how costly the litigation, the full policy limits are always available to indemnify the insured in the event of a covered judgment or to fund a settlement. Some liability insurance policies, however, provide that the policy limits are reduced by defense expenses, including defense counsel's fees, investigation costs, and litigation costs, rather than the insurer paying those expenses outside the policy limits as supplementary payments. *See Fed. Ins. Co. v. Singing River Health Sys. Found.*, 850 F.3d 187, 198 (5th Cir. 2017) (rejecting

the insured's claim that an insurer that issued a defense-within-limits policy was required to pay defense costs in addition to the policy limits on the basis that the policy should be enforced as written). These policies are variously described as "burning limits," "defense-within-limits," "eroding limits," "wasting," "spend down," "self-consuming," "self-liquidating," "cannibalizing," or "depleting limits" policies because their liability limits are reduced by defense expenses. Indeed, every dollar spent on defense correspondingly reduces the amount of money available to settle the case or indemnify the insured. Defense-within-limits policies are common in directors and officers (D&O) liability insurance, employment practices liability (EPL) insurance, and errors and omissions (E&O) insurance, including lawyers' professional liability (LPL) insurance.

To understand how coverage under defense-within-limits policies operates, consider this hypothetical case. Lawyer *L* is insured under a defense-within-limits LPL policy with liability limits of $1 million per claim. Client *C* sues *L* for professional negligence and breach of fiduciary duty. The case goes to trial and defense expenses through trial are $250,000. If *C* wins a $500,000 judgment against *L*, the insurer will fully indemnify *L* because it has $750,000 available under the policy after paying the defense expenses. If, however, *C* obtains a $1 million judgment, the insurer will pay $750,000 (its available policy limits) and *L* will have to pay the remaining $250,000 unless *L* has excess insurance.

Most defense-within-limits policies are defense-cost-indemnification policies, meaning that the insured controls the defense—including selecting defense counsel—and the insurance company either advances or reimburses the insured's "defense expenses," including defense counsel's legal fees, or advances or reimburses the insured's "claim expenses," which include defense costs. Under some defense-within-limits policies, however, the insurer retains the duty and right to defend the insured.

Defense-within-limits policies pose few problems for defense lawyers or insurers where the insured controls the defense and the insurer simply pays the expenses. Nonetheless, some commentators and courts have diagnosed defense-within-limits policies as being infused with conflicts of interest. *See, e.g.*, *Edwards v. Daugherty*, 883 So. 2d 932, 942 (La. 2004) ("The cause for concern [with a defense-within-limits policy] is the interest conflict that arises in every case between the insured and the insurer when dollars spent on defending claims result in fewer dollars being available for settlement of the claims or satisfaction of judgments."). This prognosis is most acute where the insurer controls the defense. One scholar has characterized the problem as follows:

> Under the [defense-within-limits] policy, there is an inherent conflict between the insured and the insurer in every case where payment of loss plus payment of defense costs could exceed the limits of liability, since every dollar spent on defense of the claim is a dollar that will not be available for settlement or satisfaction of judgment. This is no problem as long as the insured and insurer are fully agreed (and continue to agree) on the merits of settling versus defending including issues of timing and resources invested in the process.
>
> The problem is that the insured has a direct interest in assuring that the limit of liability is available for settlement or payment of judgment, while the insurer may seek to defend on the merits. It may be in the financial interest of a risk averse

> insured to offer the entire limits even in a case of poor liability rather than run the risk that a hard fought defense will deplete the limits and block settlement later or leave an unsatisfied judgment. On the other hand, it may be in the insurer's interest to establish through a hard fought defense that "nuisance" claims will not invoke any settlement offers from this insurance company. Hence, a conflict is born.

Gregory S. Munro, *Defense Within Limits: The Conflicts of "Wasting" or "Cannibalizing" Insurance Policies*, 62 Mont. L. Rev. 131, 148–49 (2001).

Despite these concerns, conflicts of interest linked to defense-within-limits policies are an exaggerated threat. An insurer that has the right to control the insured's defense under a defense-within-limits policy has no incentive to spend wastefully in the process. In fact, in most cases, the insured's interests and the insurer's interests will be aligned. Where the insured has a defense-cost-indemnification policy, it controls its own defense and can balance its interests in defeating the plaintiff's claims versus settling within available policy limits.

Nevertheless, to protect its insured and itself, an insurer that controls the defense under a defense-within-limits policy should remind the insured at the outset of the case that the policy limits are eroded by defense expenses. Thereafter, the insurer should keep the insured reasonably informed about defense costs and the remaining policy limits. *See Ross v. Frank B. Hall & Co. of Wash.*, 870 P.2d 1007, 1011 (Wash. Ct. App. 1994). In managing the defense, the insurer should also confirm that the defense expenses are reasonable. *Id.*

For lawyers who are either appointed to defend an insured under a defense-within-limits policy or hired by the insured directly, communication—especially with the insured—is essential. At the outset of the representation, the lawyer should remind the insured that the policy will be eroded by defense expenses. The lawyer should engage both the insured and the insurer in developing the litigation strategy and then provide them both with a projected litigation budget. To the extent reasonably possible, the lawyer should evaluate the insured's potential liability and the verdict value of the case at the first opportunity and share those evaluations with the insured and the insurer. As the case progresses, the lawyer should either copy the insured on invoices the lawyer sends to the insurer or timely inform the insured of the amounts billed. If the insurer is controlling the defense, the lawyer should copy the insured on all status reports to the insurer. Consistent with a lawyer's duties generally, the lawyer should promptly inform the insured and the insurer of all settlement offers or demands from the plaintiff. Finally, when producing a copy of the insured's policy in discovery, the defense lawyer may want to consider highlighting for the plaintiff's lawyer the fact that the defendant is insured under a defense-within-limits policy. The thought here is that this information may cause the plaintiff to moderate its settlement demands to avoid reducing its potential source of recovery through continued or aggressive litigation.

IV. Conclusion

Conflicts of interest are an inevitable hazard for lawyers with insurance defense practices. Fortunately, over time lawyers have learned how to navigate most of the recurring conflict of interest situations that characterize insurance defense practice. Still, thorny problems surface often enough that lawyers cannot afford to let down their guard.