Ethical Issues Related to Coverage Disputes & Litigation

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GENERAL PRINCIPLES

I MULTIPLE CLIENTS

A number of overlooked aspects of any legal representation, whether involving insurance or not, are the special obligations that a lawyer incurs when representing multiple clients. In community property states, even the mere representation of a husband and wife in connection with insurance benefits payable for damage to community property still constitutes representation of multiple clients. In personal injury context problems can multiply even where only one spouse is physically injured because some elements of damage are community property and some are separate property, and it is often confusing as to which is which. See, e.g., *Moreno v. Alejandro*, 775 S.W.2d, 735,737 (Tex. App.—San Antonio 1989, no pet.); *Graham v. Franco*, 488 S.W.2d 390, 396 (Tex. 1972); *Osborn v. Osborn*, 961 S.W.2d 408, 414 (Tex. App.—

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Houston [1st Dist.] 1997, writ denied); *Perez v. Perez,* 587 S.W.2d 671,673 (Tex. 1979); *Licata v. Licata*, 11 S.W.3d 269, 273 (Tex. App.—Houston [14th Dist.] 1999, no pet.); *Douglas v. Delp,* 987 S.W.2d 879, 883 (Tex. 1999); *In re DeVine*, 869 S.W.2d 415, 429 (Tex. App.—Amarillo, 1993, writ denied) (holding that some punitive damages are separate property); cf. *Harrell v. Hochderffer*, 345 S.W.3d 652 (Tex. App.—Austin 2011, pet. denied) (holding that punitive damages are generally community property). Making matters worse, all settlement proceeds or post-judgment recoveries are presumed community property in the absence of clear and convincing evidence they are not. *Tex Fam. Code* §3.003; *Kyles v. Kyles*, 832 S.W.2d 194,198 (Tex. App.—Beaumont 1992, no pet).

Similarly, the mere representation of various interrelated but separate corporations, partnerships, or other entities and/or their liability insurers also implicates ethical rules governing attorney conduct in multiple client situations. The most recent pronouncement of the Supreme Court seems to be that in the "tripartite" lawyer-defendant-liability insurer context, "Whether defense counsel also represents the insurer is a matter of contract between them." *Unauthorized Practice of Law Committee v. American Home Assurance Co. Inc.*, 261 S.W.3d 24, 42 (Tex. 2008). This is true even though, "because the lawyer owes unqualified loyalty to the insured, the lawyer must at all times protect the interests of the insured if those interests would be compromised by the insurer's instructions…" *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 628 (Tex.1998). See also *Employers Cas. Co. v. Tilley*, 496 S.W.2d 552, 558 (Tex.1973) (holding that " [An insurance defense] attorney becomes the attorney of record and the legal representative of the insured, and as such he owes the insured the same type of unqualified loyalty as if he had been originally employed by the insured. If a conflict arises between the interests of the insurer and the insured, the attorney owes a duty to the insured to immediately advise him of the conflict.").

So, in these personal injury cases, there are landmines to look out for. The ethical rules involved are Rule 1.7, 1.8, and 1.9 of the ABA Model Rules of Professional Conduct. Rule 1.9 provides that a lawyer who is representing multiple parties in a matter shall not thereafter represent any of such parties in a dispute among the parties arising out of the matter, unless prior consent is obtained from all such parties to the dispute. Rule 1.8(g) provides that a lawyer representing two or more clients may 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."

These rules can be problematic in a number of circumstances.

A. Formation of the Attorney-Client Relationship.

Most of the duties arising under the rules attach only after the client has requested a lawyer to render legal services *and* the lawyer has agreed to do so. One notable exception is the obligation of confidentiality, which may attach before the client-lawyer relationship is established. Although reported cases have affirmed that "a violation of State Bar rules does not create a private cause of action," violations of the rules are nonetheless often evidentiary in determining whether an attorney violated the appropriate standard of reasonable care in such a suit.[2] And in determining whether disqualification is appropriate, courts do look to the *Texas Disciplinary Rules of Professional Conduct* "as guidelines that articulate considerations relevant to the merits of a motion to disqualify."[3]

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[2] See *Dyer v. Shafer, Gilliland, Davis, McCulloum and Ashley, Inc*., 779 SW2d 474, 479 (Tex App-El Paso 1989, writ denied) (refusing to apply state bar rules as liability standards); *Lajzerowicz v. McCormick*, 2006 Tex App Lexis 8744 (Tex App-San Antonio, 2006); *Jones v. Blume*, 196 SW3d 440, 450 (Tex App-Dallas 2006, no pet.); *Judd Wynne Properties, Inc. v. Griggs and Harrison, P.C.*, 981 SW2nd 868, 869-70 (Tex App-Houston [1st Dist.] 1998, pet. denied, 11 SW3d 188 (Tex 2000); *Martin v. Trevino*, 578 SW2d 763, 770 (Tex App-Corpus Christi 1978, ref'd n.r.e.). With respect to using disciplinary rules as evidence of the custom in the industry, and thus the standard of care, to be applied in a civil suit, see *239 Joint Venture v. Joe and Jenkens & Gilchrist*, 60 SW3rd 896, 905 (Tex App-Dallas, 2001).

[3] See *Dean Park and Construction and Real Estate Investment Corporation, Inc. v. Meredith, Donnell and Abernethy, P.C.*, 2005 Tex App Lexis 6134 (Tex App-Corpus Christi, 2005); *Spears v. 4th Court of Appeals*, 797

While courts are very reluctant to allow lawyers to be sued for any tort other than malpractice or breach of fiduciary duty, it is conceivable that a lawyer could be sued under a consumer protection statute such as the Texas DTPA, if a party (e.g., a prospective client, etc.) could show that he detrimentally relied on false advice from the lawyer and was a "consumer," i.e., he sought by purchase or lease the lawyer's services.[4] As for malpractice, generally the existence of an attorney-client relationship is a prerequisite to suit. Texas courts have said that "A relationship of client and lawyer arises when: (1) a person manifests to a lawyer the person's intent that the lawyer provide legal services for the person; and either: (a) the lawyer manifests to the person consent to do so; or (b) the lawyer fails to manifest lack of consent to do so, and the lawyer knows or reasonably should know that the person reasonably relies on the lawyer to provide the services."[5]

Note that the only consent required of the lawyer is that he consent to "provide legal services." Thus one might claim that merely giving advice manifests a consent to do just that, provide legal services. This why malpractice insurers and ethicists recommend sending "non-retention letters" to those who seek an attorney's services but are rejected as clients. It is also the reason to avoid giving free advice. While the lawyer prefacing his remarks with "you understand I am not 'rendering legal services,' am not your lawyer, and you shouldn't rely on this advice" or some such will help, there is always a possibility of a swearing match later as to whether the lawyer was aware the trial practitioner or prospective client would rely upon the lawyer to provide advice but the appellate lawyer did "nothing to prevent it." The best way to prevent it is

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SW2d 654, 656 (Tex. 1990). See also *National Union Fire Insurance Company of Pittsburg v. Keck, Mahin and Cate, et al*, 154 SW3d 1714, 722-23 (Tex App-Houston [14th Dist] 2004, pet. denied) (using Disciplinary Rules to determine enforceability of release).

[4] See *Latham v. Castillo*, 972 S.W.2d 66 (Tex. 1998).

[5] *MacFarlan v. Nelson*, No. 03-04--00488--CV (Tex. App. – Austin, 2005, citing *Restatement (Third) of the Law Governing Lawyers* § 14 (2000); See also *Bergthold v. Winstead Sechrest & Minick, P.C.*, 2-07-325-CV (Tex. App.- Ft. Worth, 2009).

to decline to give the advice, unless the lawyer has such a close relationship with the inquirer that such defensiveness would be both insulting and, under the circumstances, unnecessary.

B. The Husband and Wife.

It is commonplace for attorneys to represent married couples in a variety of cases. However, given the above-cited ethical rules, a lawyer, particularly one in a community property state, should take particular care in undertaking any form of multiple representations. In this context, it should be determined what the elements of damages might be and how they may be characterized, either as community property or separate property, so the attorney and the parties can be aware of the relative rights and claims belonging to each member of the community and to the community itself. Here, consultation with a family law expert or tax expert may be required. At a minimum, in a settlement context, some form of disclosure to the clients of the possible consequences of the various categorizations of items of damage reflected in the settlement should take place. The matter is further complicated by the fact that some elements of damages may be taxable as income, whereas others may not be. In this regard, it is necessary to refer clients to a CPA or other tax professional prior to categorization of elements of any recovery, and to disclaim the giving of any tax advice, in order to insulate the lawyer for any liability for adverse economic consequences.

C. Multiple Related Defendants or Entities.

It is amazing how many times the same lawyer will represent multiple entities, whether they be partners, affiliated corporations, companies and their employees, or insurance carriers and their "independent" adjusters, "independent" agents, captive agents, individual adjusters or employees, sister companies, parent companies, or others. Multiple conflicts can arise in these situations. It is often the case that employers may wish to distance themselves from their

employees or insurance carriers may refuse to be responsible for the acts or misrepresentations of their "independent" adjusters or agents. Issues on appeal often cause difficulty because of the different perspectives and interests of employers vs. their employees. One wonders the extent to which joint defense counsel explains these nuances to the underling who will presumably be left holding the bag if a "lack of authority" or "course and scope" argument is successful.

Moreover, a successful defense of contractual liability by a first-party insurer on technical grounds will often only ensure the tort liability of a related company, adjuster, or agent. Consider the following example: Suppose an insurance carrier defends against a significant claim for property damage on the basis that the policyholder should have given notice of the claim sooner. The property owning policyholder responds that she gave notice to the company's sales agent immediately upon discovery of the loss, but was told something false (a misrepresentation) that caused her not to pursue the claim or any notification any further. The agent then fails to notify the claims office of the reported loss, and the carrier claims that notice to the agent is not sufficient under the policy, in that the agent is "independent."

Or take another example: "The massive insurance group" (massive) has many subsidiaries that sell insurance under the "massive" logo. They each have slightly different names. Plaintiff turns in a claim to his carrier, Massive Indemnity, for policy benefits under a property insurance policy. Massive Indemnity has no employees. When it receives claims, they are adjusted by the employees of Massive Insurance, an allegedly separate corporate entity. Massive Insurance's adjusters commit misrepresentations while adjusting Massive Indemnity's claim. Plaintiff sues both Massive Indemnity and Massive Insurance for a breach of contract and violations of a state consumer protection statute. If Massive Indemnity settles the underlying contractual claim with the plaintiff, Massive Insurance's extracontractual liability may well become moot. On the other hand, if Massive Indemnity defends successfully against the contractual claim on some basis that

is directly connected with Massive Insurance's misconduct, the result may only be to create extracontractual liability and Massive Insurance Company by virtue of Massive Indemnity's successful contractual defense. Yet, all insurance entities sued are defended by the same law firm. This scenario is rife with dangers for the unwary.

II. CONFIDENTIALITY[6]

Rule 1.6 of the ABA rules does not limit a lawyer's duty of confidentiality to matters that are privileged by law, or even to those matters the client *wants* kept secret. Rather, under this rule, except under certain limited circumstances, a lawyer must refrain from revealing *any* 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" a stated exception to the rule. The 1969 *ABA Model Code* was more precise in limiting a lawyer's obligations in this regard. Model Code Disciplinary Rule 4-101 and Ethical Canon 4-1 made a distinction between confidences and secrets, a distinction no longer found in the *Model Code* or the Texas Rules. A "confidence" comprised information protected by the evidentiary attorney-client privilege, whereas a "secret" was in the unprivileged information that might embarrass or harm the client, or that the client had specifically or impliedly requested to be kept confidential. The 1969 *ABA Code* only enjoined lawyers from revealing "confidences" or "secrets." Beginning with the Kutak Commission of the 1970s, the impetus was to broaden the lawyer's duty of non-disclosure. This momentum was continued in the promulgation of the current model rules.

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[6] See generally Comment 3, ABA Model Rule 1.6; William J. Chriss and John F. Sutton, Jr., "Commentary on the Texas Disciplinary Rules of Professional Conduct Governing the Duties between Lawyer and Client," *Texas Lawyers' Professional Ethics*, 4th ed. (State Bar of Texas, 2007). pp. 1-15 to 1-16, from which much of the substance for this section is derived.

Under the current rule, there is no category of information relating to a client, known to the lawyer "by reason of the representation" that a lawyer may generally disclose. Thus, the commonly held belief that lawyers may discuss client information if it is "already a matter of public record," or "not privileged" or "already well-known" are incorrect. Rather, regardless of subject matter, information about "relating to" the client and obtained as a result of the representation may never be discussed with anyone or otherwise revealed (except to employees of the lawyer's own firm or the client's own designated representatives) unless such disclosure is permitted by one of the specific exceptions within Rule 1.6.

The exceptions to the general rule of confidentiality fall into two categories, permissive and mandatory. A lawyer is permitted to reveal confidential information if the client expressly authorizes it or consents to it after consultation. Some exceptions relate to either the "self-defense" of the lawyer in a dispute with the client, or the "crime and fraud" exception allowing a lawyer to reveal confidences to the extent necessary in order to prevent certain categories of criminal or fraudulent acts committed or which may be committed by a client. Other exceptions include to prevent reasonably certain death or bodily harm, to obtain legal advice, to detect conflicts of interest, or where the lawyer has reason to believe disclosure is necessary in order to comply with relevant law, and this is perhaps the broadest exception because it involves the greatest exercise of discretion by the attorney. See ABA Model Rule 1.6 (b) (1)-(7).

LIABILITY INSURANCE SITUATIONS

I. Introduction

Conflicts of interest come in many different shapes and sizes. Some are recognized as true conflicts of interest which require full disclosure and waivers executed by the clients. Others are "business conflicts" or "ethical tensions" which also require special care and handling. This paper will address both types of conflicts of interest and suggestions for their resolution in the context

of some of the practical problems confronted by defense counsel when an insurer is providing a defense or reimbursing the insured for its defense costs.

Conflicts of interest typically arise out of three scenarios: 1) the insurer selects defense counsel in private practice; 2) the insurer selects an employee/in-house/captive defense counsel; and, 3) the insured selects defense counsel whose costs are paid directly by the insurer or the insurer reimburses the insured (the "Insurance Related Conflicts"). In each instance, the lawyer owes a duty of care to the insured but may also owe certain duties to the insurer. It is these concurrent duties of care which give rise to conflicts of interest as well as ethical tensions. While it can fairly be said that both the insurer and the insured share an interest in resolving the litigation for little or no money, the insurer and the insured often have interests in the litigation which differ and, thus, conflicts and/or ethical tensions arise in determining the litigation strategy to reach the desired result.

II. Tripartite Relationship and Conflicts of Interest

Insurance Related Conflicts arise out of the "tripartite relationship" of insured, insurer, and defense counsel who is appointed and/or paid by the insurer. The conflict problem is described by one commentator as follows:

> The premise underlying much of the law that has developed in the insurance defense practice is that defense counsel generally cannot loyally and competently represent the insured in any situation where there is a conflict or potential conflict between the interests of the insured and the insurer. A typical example of the judicial mindset is the following: 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 interest of his real client -- the one who is paying his fee and from whom he hopes to receive future business -- the insurance company.[7]

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[7] Robert E. O'Malley, *Ethics Principals for the Insurer, the Insured, and Defense Counsel: the Eternal Triangle Reformed*, 66 Tul. L. Rev. 511 (1991).

ABA Model Rule 1.7(a)(2) provides that a lawyer may not represent a client whose interests are materially and directly adverse to the lawyer's own interest, or that of his firm. Yet, law firms regularly violate this ethical rule. It is common for an attorney who is personally responsible for denying an insurance claim to subsequently defend his insurance carrier principal against charges that the denial was wrongful. While both the carrier and its lawyer may share the same interest in proving that the denial was not wrongful, they do not share the same interest in settling the claim. Rather, the lawyer's interest is to defeat the claim by any means possible, or to settle the claim in such a way as to make it impossible to demonstrate that his own malfeasants exacerbated the company's liability. The company, on the other hand, while it would also like to successful defend the claim, would probably be better served settling it on any reasonable basis as quickly as possible, and in such a way as to make clear the amount of the settlement made necessary by the attorney's mistake.

Similarly, in the third party context, the "tripartite relationship" is problematic. Given the duty of defense counsel (including appellate counsel) to give "unqualified loyalty to the insured," and to "at all times protect the interests of the insured if those interests would be compromised by the insurer's instructions…,"[8] the appellate lawyer may be put in a difficult position. The insured may want to settle, while the carrier wants to appeal and fight. This can be complicated by a carrier's refusal to fully supersede the judgment, or by its inducement to the insured to take positions on the amount of the supersedeas bond that are not in the insured's best interest.

There are a variety of approaches to the potential conflicts which arise out of the tripartite relationship. Some states, such as Alaska, California and Florida have enacted statutes which

[8] *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 628 (Tex.1998).

address Insurance Related Conflicts.[9] Most states find that a dual representation exists and apply their conflict of interest rules in their codes of professional conduct to determine whether the

[9] Alaska Statute §21.89.100 ("If an insurer has a duty to defend an insured under a policy of insurance and a conflict of interest arises that imposes a duty on the insurer to provide independent counsel to the insured, the insurer shall provide independent counsel to the insured unless the insured in writing waives the right to independent counsel"); California Civil Code §2860 (a conflict of interest "may" exist "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 . . ."); and Florida Statute §627.426(2) which presumes that there is a conflict of interest and provides as follows:

> (2) A liability insurer shall not be permitted to deny coverage based on a particular coverage defense unless:
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> > (a) Within 30 days after the liability insurer knew or should have known of the coverage defense, written notice of reservation of rights to assert a coverage defense is given to the named insured by registered or certified mail sent to the last known address of the insured or by hand delivery; and
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> > (b) Within 60 days of compliance with paragraph (a) or receipt of a summons and complaint naming the insured as a defendant, whichever is later, but in no case later than 30 days before trial, the insurer:
> >
> > > 1. Gives written notice to the named insured by registered or certified mail of its refusal to defend the insured;
> > >
> > > 2. Obtains from the insured a nonwaiver agreement following full disclosure of the specific facts and policy provisions upon which the coverage defense is asserted and the duties, obligations, and liabilities of the insurer during and following the pendency of the subject litigation; or
> > >
> > > 3. Retains independent counsel which is mutually agreeable to the parties. Reasonable fees for the counsel may be agreed upon between the parties or, if no agreement is reached, shall be set by the court.

conflict is disqualifying or may be consented to by the insured and insurer.[10] Other states, such as Kentucky, Michigan, Montana and West Virginia, have declared the tripartite relationship a *per se* conflict of interest such that the attorney's only client is the insured. Yet others have recently decided to leave the identity of the client to be determined by the contract between the parties, while still maintaining some notion that the lawyer's primary duty is to the insured.[11]

A. *The Restatement (Third) of the Law Governing Lawyers*

Section 121 of *The Restatement (Third) of the Law Governing Lawyers* provides a workable framework for recognizing a conflict of interest.

> § 121. The Basic Prohibition Of Conflicts Of Interest
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> Unless all affected clients and other necessary persons consent to the representation under the limitations and conditions provided in § 122, a lawyer may not represent a client if the representation would involve a conflict of interest. A conflict of interest is involved if there is a substantial risk that the lawyer's representation of the client would be materially and adversely affected by the lawyer's own interests or by the lawyer's duties to another current client, a former client, or a third person.

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[10] *See, e.g., Paradigm. Ins. Co. v. Langerman Law Offices*, 24 P.3d 593, 597 (Ariz. 2001) (defense counsel may represent both insurer and insured unless there is an actual conflict or the potential for a conflict of interest in that particular matter is foreseeable); *Gulf Ins. Co. v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone*, 93 Cal. Rptr. 2d 534 (Cal. App. 2000) ("Attorney has two clients: the insurer and the insured"); *Waste Management, Inc. v. International Surplus Lines Ins. Co.*, 579 N.E.2d 322, 329 (Ill. 1991) (attorney represents both insured and insurer in furthering interests of each); *McCourt Co. v. FPC Properties, Inc.*, 434 N.E.2d 1234 (Mass. 1982) ("law firm is attorney for insured as well as insurer").

[11] See, e.g., *Unauthorized Practice of Law Committee v. American Home Assur. Co. and The Travelers Indemnity Co.*, 2008 Tex. LEXIS 233 (Tex. 2008).

The key phrase in the Restatement formulation is "substantial risk that the lawyer's representation of the client would be materially and adversely affected by the lawyer's own interests or by the lawyer's duties to another." While there are numerous judicial decisions addressing what is a "substantial risk of material adverse effect," the analysis is fact and, therefore, case specific.

Section 122 of *The Restatement (Third) of the Law Governing Lawyers* provides guidance regarding when the representation may proceed upon obtaining "informed consent" and when the conflict precludes the representation.

> § 122. Client Consent To A Conflict Of Interest
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> (1) A lawyer may represent a client notwithstanding a conflict of interest prohibited by § 121 if each affected client or former client gives informed consent to the lawyer's representation. Informed consent requires that the client or former client have reasonably adequate information about the material risks of such representation to that client or former client.
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> (2) Notwithstanding the informed consent of each affected client or former client, a lawyer may not represent a client if:
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> (a) the representation is prohibited by law;
> (b) one client will assert a claim against the other in the same litigation; or
> (c) in the circumstances, it is not reasonably likely that the lawyer will be able to provide adequate representation to one or more of the clients.

Similarly, Section 132 of *The Restatement (Third) of the Law Governing Lawyers* addresses the conflicts which can result from the prior representation of a client.

> § 132. A Representation Adverse To The Interests Of A Former Client
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> Unless both the affected present and former clients consent to the representation under the limitations and conditions provided in § 122, a lawyer who has represented a client in a matter may not thereafter represent another client in the same or a substantially related matter in which the interests of the former client are materially adverse. The current matter is substantially related to the earlier matter if:
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> (1) the current matter involves the work the lawyer performed for the former client; or
> (2) there is a substantial risk that representation of the present client will involve the use of information acquired in the course of

representing the former client, unless that information has become generally known.

1. *What is "Informed Consent" and When is it Required?*

Section 122 defines "informed consent" as that which requires "that the client or former client have reasonably adequate information about the material risks of such representation to that client or former client." This topic is the subject of numerous articles and judicial decisions.[12] While these sections of *The Restatement (Third) of the Law Governing Lawyers* address situations in which a lawyer must obtain "informed consent," courts and, in some states, legislatures, have placed that responsibility on the insurer when the conflict arises out of the tripartite relationship because it is the insurance contract which gives rise to the potential for conflicts. Conflicts of interest which arise out of the tripartite relationship are addressed in greater detail below.

However, there are instances encountered in construction litigation in which the lawyer retains responsibility to obtain informed consent from his/her client before undertaking the representation. In such cases, the lawyer must provide "adequate information about the material risks" to each potentially affected client regarding the possible material adverse effects that could result to that client from the representation so that the client can make an informed decision. Obviously the information required will depend upon the nature of the conflict, the risks of the

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[12] *See, e.g., Lawyer Disqualification – Conflicts of Interest and Other Bases*, Richard E. Flamm, §20.2 (2003) (Even when a lawyer's client or former client has provided her with consent to proceed with otherwise conflicted representation, this may not be enough to avert disqualification. On the contrary, the court may insist upon proof that the client's consent was voluntary, knowing, intelligent, effective, and informed. In fact, without informed consent a client's acquiescence in a lawyer's conflict may be deemed to be tantamount to no consent at all") (citations omitted).

potentially conflicted representation and the sophistication of the client. Stating with precision what is required in order to obtain "informed consent" for every case is not possible because it is a fact specific analysis.

For instance, when the potential conflict arises out of a proposed multiple-client representation, the lawyer should notify all of the proposed clients of the potential problems that could foreseeably result from the representation. The lawyer should advise all of the prospective clients of problems which might result from receipt and use of each client's confidential information and how the situation might differ if the lawyer represented only one client. The lawyer should advise the proposed clients that he/she may have to withdraw from the representation of all clients.

A clearer situation arises where the conflict is based upon a proposed representation that will be adverse to an existing client in an unrelated matter. For instance, a lawyer is asked to represent an architect in one matter but the lawyer represents a project owner or construction manager that is adverse to the architect in another matter. To obtain informed consent, the lawyer should address with the architect the general nature and scope of the work being performed for each client and the potential that his/her representation of the architect in the new matter may be detrimental to the architect in the other matter. Section 132 requires the lawyer to also obtain informed consent from the former client for the proposed representation.

When the consent relates to a conflict arising out of a prior representation, the former client must be advised that the consent will allow the lawyer to proceed adversely to the former client. Beyond that, the former client must have adequate information about the implications of the adverse representation, the fact that the lawyer possesses the former client's confidential information, the measures that the former lawyer might undertake to protect against unwarranted disclosures, and the right of the former client to refuse consent. Where the former client is

represented by other counsel, obviously any communication with the former client must typically be through successor counsel.

Failure to provide sufficient information to obtain "informed consent" usually results in an inadequately informed client and the consent is invalidated.[13] A lawyer's failure to inform the clients may bear on the motives and good faith of the lawyer and could even give rise to an action against the lawyer for breach of his/her fiduciary duty.[14] It is suggested that the lawyer should provide as much information as possible because clients differ as to their sophistication and experience and situations differ in terms of their complexity and the subtlety of the conflicts presented.

2. *Who is the Client: Is the Insurer a Client of the Lawyer?*

In many states, the insured and the insurer are clients of the lawyer and there is a tripartite relationship.[15] In others, the insurer is merely an accommodation party and the insured is the only

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[13] *Selby v. Revlon Consumer Products Corp*., 6 F.Supp.2d 577 (N. D. Tx. 1997) ("The acquiescence of a client without informed consent is tantamount to no consent at all").

[14] *Tydeman v. Flaherty*, 868 P.2d 755, 126 Or. App. 180 (1994) (Client's allegation that attorney failed to obtain client's informed consent for multiple representation, and that there was actual conflict of interest from beginning of representation because client's interests regarding payment of judgment were adverse to other clients' interests, stated claim for attorney negligence based on breach of fiduciary duty).

[15] *See, e.g., Armstrong Cleaners, Inc. v. Erie Ins. Exchange*, 364 F. Supp. 2d 797, 806 (S.D. Ind. 2005); *McCourt Co., Inc. v. FPC Properties, Inc.*, 386 Mass. 145, 434 N.E.2d 1234 (1982); *Lieberman v. Employers Ins. of Wausau*, 84 N.J. 325, 338, 419 A.2d 417, 424 (1980); *Central Cab Co. v. Clarke*, 259 Md. 542, 270 A.2d 662 (1970) (recognizing that counsel chosen by the insurer represents the policyholder as well as the insurer).

client, unless the parties contract otherwise. This relationship gives rise to the question of what duties the lawyer owes to the insurer.

The comment to Florida Rule 4-1.8 states that "When a lawyer undertakes the representation of an insured client at the expense of the insurer, the lawyer should ascertain whether the lawyer will be representing both the insured and the insurer, or only the insured. Communication with both the insured and the insurer promotes their mutual understanding of the role of the lawyer in the particular representation."[16]

As a matter of practicality, it is a good idea before accepting a case for the lawyer to clarify the duties he/she will owe to the insured and/or the insurer. Defining the scope of the representation before accepting a representation should help to prevent problems later.

3. *Implications for the Lawyer's Role in Any Coverage Dispute*

Construction litigation may spawn a dispute between the insured and the insurer concerning the potential applicability of insurance policy exclusions or whether a person or entity is within the coverage of the policy. In such case, the lawyer retained by the insurer to represent the insured may find him/herself involved in the dispute, even if just on the periphery. If so, the lawyer is confronted with the question of whether to remain neutral or zealously advocate on behalf of the client.

Where there is a coverage dispute between the insurer and the insured, if both are clients of the lawyer, there is a conflict of interest and the lawyer cannot advocate for one client adverse to the interests of the other client. In other situations, the lawyer owes his/her duty of care solely to the insured. However, the question of the lawyer's role in the coverage dispute, if any, depends upon the scope of his/her retention. One solution to avoiding this type of conflict is to define the scope of the lawyer's retention to exclude involvement in any coverage matters. If the lawyer

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16 Fla. Rule 4-1.8

finds him/herself unable to advocate on behalf of the insured because of a prior or present relationship with the insurer, the lawyer should give serious consideration to withdrawing from the insured's representation because his/her failure to zealously advocate for the insured, where requested to do so, could be viewed as a failure "to provide adequate representation" as described in § 121 of *The Restatement (Third) of The Law Governing Lawyers*.[17]

B. ABA Model Rules of Professional Conduct

ABA Model Rule 1.7 speaks to conflicts of interests in the representation of current clients.

> 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.

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[17] *See, Farris v. Fireman's Fund Ins. Co.*, 119 Cal.App.4th 671, 14 Cal.Rptr.3d 618 (insured's attorney had directly represented company and was most likely privy to confidential information in his personal role in shaping company's practices and procedures in handling coverage claims, and, therefore, attorney should be disqualified).

Although articulated differently, Model Rule 1.7 provides substantially the same guidance as § 122 for determining whether a conflict of interest exists in a current representation. Model Rule 1.7 goes beyond § 122 by setting forth the requirements for the representation upon obtaining "informed consent" which is "confirmed in writing." Model Rule 1.0(e) provides that "'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."[18]

Model Rule 1.8 provides specific rules with respect to conflicts of interests. Several are frequently encountered in construction litigation.

> Rule 1.8 Conflict of Interest: Current Clients: Specific Rules
>
> (b) A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client gives informed consent, except as permitted or required by these Rules.
>
> (e) A lawyer shall not provide financial assistance to a client in connection with pending or contemplated litigation, except that:
>
> > (1) a lawyer may advance court costs and expenses of litigation, the repayment of which may be contingent on the outcome of the matter; and
> >
> > (2) a lawyer representing an indigent client may pay court costs and expenses of litigation on behalf of the client.
>
> (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 judgement or with the client-lawyer relationship; and
> >
> > (3) information relating to representation of a client is protected as required by Rule 1.6.
>
> (h) A lawyer shall not:

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[18] American Bar Association Model Rule 1.0(e).

(1) make an agreement prospectively limiting the lawyer's liability to a client for malpractice unless the client is independently represented in making the agreement; or

(2) settle a claim or potential claim for such liability with an unrepresented client or former client unless that person is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel in connection therewith.

(k) While lawyers are associated in a firm, a prohibition in the foregoing paragraphs (a) through (i) that applies to any one of them shall apply to all of them.

ABA Model Rule 1.4 addresses communications with the client.

Rule 1.4: Communication

(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.

III. Practical Complications

A. *Insurer Control of Defense Under Most Policies*

Liability insurance policies typically provide that the insurer has the "right and duty to defend" suits brought against the insured so long as the suit is within the policy's coverage. We are all aware that courts have expanded this duty to defend to claims potentially within the policy's coverage. Insurers contend that their right to defend their insureds entitles them to select and

assign attorneys to defend the lawsuits brought against their insureds. Insurers view this right as valuable and important because it provides them the ability to control costs while discharging their obligations to their insureds. However, the extent to which insurers may control the defense and how they may permissibly go about doing so when a conflict exists are hotly debated topics which arise in a variety of instances.

For instance, some states do not allow an insurer to utilize an employee/in-house/captive defense counsel to defend its insureds,[19] enforce litigation management guidelines,[20] or audit the law firm's invoices.[21] These topics are beyond the scope of this paper.

Limitations on the insurer's involvement in the defense of its insured are found in legislative enactments and judicial opinions where there is a conflict of interest between the insurer and the insured. In many jurisdictions, there is substantial case law which specifically addresses

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19 *American Ins. Ass'n v. Kentucky Bar Ass'n*, 917 S.W.2d 568 (Ky. Mar 21, 1996) (approving Kentucky Bar Ass'n, Unauthorized Practice of Law Op. U-36 (1981)); *Gardner v. North Carolina State Bar*, 316 N.C. 285, 341 S.E.2d 517 (1986) (approving North Carolina State Bar, Ethics Op. CPR 326 (1983)); cf. *Unauthorized Practice of Law Committee v. American Home Assur. Co. and The Travelers Indemnity Co.*, 2008 Tex. LEXIS 233 (Tex. 2008).

20 Arizona State Bar Comm. on the Rules of Prof'l Conduct, Formal Op. 99-08; Colorado Bar Ass'n Ethics Comm., Formal Op. 107; Iowa Supreme Court Bd. of Ethics and Conduct, Op. 99-1; Mississippi State Bar Ass'n Op. 211; In re Rules of Prof'l Conduct and Insurer Imposed Billing Rules and Procedures, 2 P.3d 806 (Mont. 2000); Nebraska Advisory Comm., Advisory Op. 00-1; Ohio Supreme Court Bd. of Comm'rs on Grievances and Discipline, Op. 2000-3; Rhode Island Supreme Court Ethics Advisory Panel, Op. 99-18; Texas Ethics Op. 533.

21 *In re Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedures*, 299 Mont. 321, 2 P.3d 806 (Mt. 2000).

what constitutes a conflict of interest between an insurer and its insured and the consequences that result from that conflict. Even when there is no Insurance Related Conflict, "ethical tensions" may result where the insurer and the insured have different ideas concerning the strategy for the resolution of the lawsuit against the insured.

B. *The Eight Corners Rule*

A conflict of interest arises when the allegations of the complaint compared to the terms and conditions of the insurance contract give rise to an actual or potential conflict between the interests of the insurer and the insured. This is known as the "Eight Corners Rule" as the words in the four corners of the complaint are compared with those in the four corners of the insurance contract.[22] In some instances, courts have expressly concluded that independent counsel must be provided to the insured.[23]

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[22] See, e.g., *Pekin Ins. Co. v. Fidelity & Guar. Ins. Co.*, 357 Ill.App.3d 891, 830 N.E.2d 10 (4th Dist. 2005); *West Virginia Fire & Cas. Co. v. Stanley*, 216 W.Va. 40, 602 S.E.2d 483 (W.Va. 2004); *Montgomery County Bd. of Educ. v. Horace Mann Ins. Co.*, 154 Md.App. 502, 840 A.2d 220 (Md. App. 2003); *Stevens v. United General Title Ins. Co.*, 801 A.2d 61 (D.C. 2002).

[23] *Maryland Cas. Co. v. Peppers*, 64 Ill. 2d 187, 355 N.E.2d 24 (1976); *Rx.com Inc. v. Hartford Fire Ins. Co.*, 426 F. Supp. 2d 546 (S.D. Tex. 2006) (applying Texas law); *Travelers Indem. Co. of Illinois v. Royal Oak Enterprises, Inc.*, 344 F. Supp. 2d 1358, 1372 (M.D. Fla. 2004), aff'd, 171 Fed. Appx. 831 (11th Cir. 2006) (applying Florida law); *Hartford Cas. Ins. Co. v. A & M Associates, Ltd.*, 200 F. Supp. 2d 84, 90 (D.R.I. 2002) (applying Massachusetts law); *Public Service Mut. Ins. Co. v. Goldfarb*, 53 N.Y.2d 392, 442 N.Y.S.2d 422, 425 N.E.2d 810 (1981); *Michigan Millers Mut. Ins. Co. v. Bronson Plating Co.*, 197 Mich. App. 482, 496 N.W.2d 373 (1992), (overruled on other grounds *Wilkie v. Auto-Owners Ins. Co.*, 469 Mich. 41, 664 N.W.2d 776 (2003).

1. *Insurer Provides Coverage to Multiple Insureds with Adverse Interests*

In many instances, an insurer will have a duty to defend more than one insured who may have interests adverse to each other and which interests may also be adverse to those of the insurer. One classic example of such conflicts is found in *Murphy v. Urso*.[24] In that case, a passenger injured in an automobile accident filed suit against the driver and the owner of the vehicle. A question existed as to whether the driver had the owner's permission to use the vehicle. Accordingly, because of this issue, the driver's interests conflicted with those of the owner, and also with those of the insurer, because the driver would not be insured under the owner's policy unless he was operating the vehicle with the owner's permission. Under those circumstances, the Illinois Supreme Court held that the conflicts precluded the insurer from controlling the defense of the driver.

When the interests of multiple insureds conflict with one another, by definition, the insurer cannot share all interests in common with each of its insureds. In this situation, the insurer may be required to provide not only separate, but independent counsel.[25]

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[24] 430 N.E.2d 1079 (Ill. 1981).

[25] *See, e.g., Joseph v. Markovitz*, 27 Ariz. App. 122, 551 P.2d 571 (Div. 1 1976); *Allstate Ins. Co. v. Fisher*, 31 Cal. App. 3d 391, 107 Cal. Rptr. 251 (2d Dist. 1973); *First Ins. Co. of Hawaii, Inc. v. State, by Minami*, 66 Haw. 413, 665 P.2d 648 (1983); *Allied American Ins. Co. v. Ayala*, 247 Ill. App. 3d 538, 616 N.E.2d 1349 (2d Dist. 1993); *Nationwide Mut. Ins. Co. v. Webb*, 291 Md. 721, 436 A.2d 465 (1981); *Miller v. Shugart*, 316 N.W.2d 729 (Minn. 1982); *State Farm Mut. Auto. Ins. Co. v. Commercial Union Ins. Co.*, 394 So. 2d 890 (Miss. 1981); *Bartels v. Romano*, 171 N.J. Super. 23, 407 A.2d 1248 (App. Div. 1979); *Wolpaw v. General Acc. Ins. Co.*, 272 N.J. Super. 41, 639 A.2d 338 (App. Div. 1994); *Graci v. Denaro*, 98 Misc. 2d 155, 413

In this regard, most general liability policies contain some form of purported exclusion for work the insured self-performed. Should a project owner file suit against the construction manager, contractor and subcontractor for breach of contract (or negligence to the extent the economic loss doctrine does not apply), the construction entities may find themselves involved in project-related litigation and insurance coverage litigation. In *Pepper Const. Co. v. Casualty Ins. Co.*,[26] Marshall Field & Company sued its contractor, Pepper Construction Company, and the various subcontractors after the roof of one of its recently built stores collapsed. Pepper tendered its defense to Casualty which reserved its rights and defenses under its policy. Casualty reserved its rights on certain bases but denied coverage under the policy for work Pepper self-performed. In its letter, Casualty agreed to defend Pepper and suggested that Pepper retain other counsel to proceed against the subcontractors for indemnity and its repair costs. Pepper filed suit against Casualty and a motion for injunctive relief. The injunction was granted as the court found that Pepper had no right to control Pepper's defense since Casualty's interests differed from Pepper's.[27]

2. *Coverage is Not Disputed, But Plaintiff Seeks Damages In Excess of Policy Limits*

Construction litigation also gives rise to claims with significant exposure, often in excess of the policy limits. This situation can create a potential conflict of interest because the insurer and the insured may have opposing views as to whether and when a claim should be settled. The insured will usually prefer to have a case settled quickly and within policy limits to minimize any possibility of an excess judgment. The insurer, whose exposure is contractually capped at its

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N.Y.S.2d 607 (Sup. Ct. 1979); *Bituminous Ins. Companies v. Pennsylvania Manufacturers' Ass'n Ins. Co.*, 427 F. Supp. 539 (E.D. Pa. 1976) (applying Pennsylvania law)

[26] 145 Ill.App.3d 516, 495 N.E.2d 1183 (1st Dist. 1986).

[27] *Id.* at 517, 495 N.E.2d at 1185.

policy limits, may wish to try the case or attempt to later negotiate a more favorable settlement than that initially offered by the claimant.

The fact that the insured's exposure in a lawsuit may exceed the coverage limits, standing alone, does not typically entitle the insured to representation by independent counsel in most jurisdictions, although this is often the wiser policy.[28] Rather, the insurer has an additional incentive to consider its insured's interests in settlement because most states allow the policyholder to recover against the insurer where the insurer's bad faith (or in some jurisdictions mere negligence) refusal to settle within limits ultimately results in an excess judgment against the insured. However, in many jurisdictions, an offer from the plaintiff to settle the underlying claims within the policy limits, particularly an offer in writing, does trigger a conflict between insured and insurer (see below).[29]

This situation is reversed where the insured has a large deductible. Under these circumstances, a potential conflict exists because the insurer may wish to settle for an amount within, or close to, the deductible while the insured may prefer to try the case in hope of avoiding liability entirely. This potential conflict does not entitle the insured to independent counsel.[30]

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[28] *See, e.g., Allstate Ins. Co. v. Campbell*, 639 A.2d 652, 659 (Md. 1994); *State Farm Mut. Auto Ins. Co. v. Hollis*, 554 So. 2d 387 (Ala. 1989); *Hartford Accident & Indem. Co. v. Foster*, 528 So. 2d 255, 265 (Miss. 1988); *Commercial Union Ins. Co. v. Liberty Mutual Ins. Co.*, 393 N.W.2d 161, 164 (Mich. 1986); *Rova Farms Resort, Inc. v. Investors Insurance Co.*, 323 A.2d 495 (N.J. 1974); *Crisci v. Security Ins. Co.*, 426 P.2d 173 (Cal. 1967).

[29] See G.A. Stowers Furniture Company v. American Indemnity Co., 15 SW 2d 544 (Tex. Comm. App. 1929, holding approved).

[30] *Nationwide Mut. Ins. Co. v. Public Service Co. of North Carolina, Inc.*, (N.C.App. 1993) ("Whenever there is a deductible provision in an insurance contract, there is the potential for a

However, if the insured has a large deductible or self-insured retention, they may have the right to choose their own counsel.

In addition, if the policy provides the insurer with the right to make any settlement it deems expedient, the court will generally enforce that right even where the insured objects to the settlement even where the settlement will require the insured to pay a large deductible.[31] A larger insured may be able to negotiate a provision precluding the insurer from settling without its consent. Similarly, professional liability policies also frequently contain language providing the insured with the right to consent to settlement. Nonetheless, the existence of a large deductible, without more, typically does not entitle the insured to representation by independent counsel.

C. *Reservation of Rights Letters*

A conflict of interest typically arises where the insurer has a duty to defend but reserves its rights to deny, in whole or in part, the duty to indemnify based on one or more defenses to coverage. At that point, the insurer issues a letter to the insured in which it reserves its right to deny indemnity coverage. The insurer is required to provide the insured with notice of the bases upon which it reserves the right to deny an obligation to indemnify. The purpose of the reservation of rights letter is to provide the insured with sufficient information to determine whether to accept the insurer's defense, subject to the reservation of rights, or to select its own counsel.

1. *How does the Insured Decide Whether to Accept the Defense Subject to the Reservation of Rights?*

The decision whether to accept the reservation is factually intensive and varies from case to case. An insured may decide, based upon its knowledge of the allegations, that the potential for

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conflict between the insurer and the insured"), *citing, American Home Assurance Co., Inc. v. Hermann's Warehouse Corp.*, 117 N.J. 1, 563 A.2d 444 (1989).

31 *Id.*

the denial of coverage may never come to fruition and accept the defense subject to the reservation of rights. The insured may also decide to accept the defense because of financial concerns. In other instances, the insured may wish to select its own counsel, even for reasons unrelated to the potential conflict, and utilize the reservation of rights as a basis to do so.

2. *Who Can Advise the Insured on this Issue?*

In states in which defense counsel owes a duty of care to the insurer and the insured, absent a conflict of interest, defense counsel employed by the insurer or selected by the insurer to defend the insured should refrain from rendering any advice concerning the potential insurance coverage issues. This is so because both the insurer and the insured are viewed as clients of the lawyer and providing legal advice to the insured regarding insurance coverage issues between the insurer and the insured may be construed as advising one client adversely to another client. As a best practice, the possibility of such a situation and the lawyer's proposed conduct if it arises should be dealt with up front in the lawyer retention agreement, which should be acknowledged by all parties before the representation is undertaken.

In states in which defense counsel owes a duty of care to the insurer and the insured, defense counsel may, however, discuss with the insured the various potential outcomes of the litigation without breaching any ethical obligations so long as that discussion does not address the potential impact on insurance coverage issues. Defense counsel should take great care to ensure that the discussion does not cross that line. In addition, defense counsel should advise the insured of its right to independent counsel in determining whether to accept the defense subject to the reservation of rights.

3. *How Does the Insurer Selected Defense Counsel Respond to Discovery that Touches Upon Coverage Issues?*

Problems may arise in connection with discovery that inquires into either the underlying facts of the litigation or the parties' contentions regarding them. For example, a request for

admission might seek to have the insured admit a proposition that seems irrelevant or relatively uncontroversial but that could possibly vitiate any coverage under the liability insurance policy. Or, a request for production might seek documents that are arguably privileged but that would normally not be worth fighting over. In both cases, lawyers may court trouble for the insured client by responding affirmatively or making production. While there might be little reason to resist such discovery on the merits, the lawyer who owes duties to both the insured and insurer may fail to recognize the impact of the matter on the coverage situation. This is particularly true of contention-based rather than factual discovery, where the client or lawyer must decide what they are claiming, and thus where estoppel to claim otherwise elsewhere might arise. Under such circumstances, a lawyer representing only the insured should advise of the consequences of discovery responses without in any way discouraging complete honesty and candor. A lawyer representing both carrier and insured has a trickier situation that may require advice that the policy-holder seek independent counsel to review or comment upon proposed discovery responses before they are made.

4. *What if the Nature of the Letter Is, of Itself, an Indication of Such Severe Conflict Between the Carrier and Policyholder that the Lawyer Selected by the Carrier Feels the Insured Should Have the Right to Control Its Own Defense and/or Select Its Own Counsel?*

It is not unforeseeable that, in a dual representation state, defense counsel retained by the insurer could believe that the insured should have independent counsel because defense counsel cannot represent the insured and at the same time owe a duty of care to the insurer because of a conflict of interest identified in the reservation of rights letter. In fact, the jurisprudence of some states may actually require this in some circumstances.[32] Defense counsel may find him/herself in a quandary because raising the issue with the insured may be viewed as taking a position adverse to the insurer which would violate Model Rule 1.7. Especially in those states in which the lawyer

[32] E.g., *Employers Casualty Co. v. Tilley*, 496 SW 2d 552 (Tex. 1973).

owes a duty of care to the insurer and its insured, the lawyer should explain to both the insurer and the insured the potential conflicts that may "hypothetically" arise from the representation.

D. *Inherent Tensions in Litigation Involving Eroding Within Limits Policies*

Generally, the limits of liability on professional liability insurance policies issued to architects and engineers erode by the amounts spent in the defense of claims. This means that for every dollar the lawyer spends to defend the design professional, there is one less dollar available to satisfy a judgment or pay a settlement.[33] Thus, the dynamics between insured and insurer when the insured seeks defense and indemnification under an eroding within limits policy are different than those under most general liability insurance policies where defense costs are in addition to and do not erode the policy limits.[34]

Defense counsel should be mindful from the onset of litigation in cases where the potential exposure exceeds policy limits that any and every opportunity for potential resolution should be evaluated and reported to the insurer. Counsel should also take care to appropriately document their files in order to protect themselves where they have recommended settlement at a time when the opportunity existed to settle within policy limits but the insurer or the insured did not wish to explore settlement at that time for any reason. It is all too easy for the public to believe that a lawyer will favor his/her own interests in earning a living while depleting the available policy limits to satisfy a judgment or settlement for his/her client. The lawyer should take great care to ensure that he/she has provided all available information to both the insurer and the insured concerning the potential liability and the potential damages exposure. No lawyer wants to be on

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[33] Shaun McParland Baldwin, *Legal and Ethical Considerations For "Defense Within Limits" Policies*, 61 Def. Coun. J. 89 (Jan. 1994).

[34] Gregory S. Munro, *Defense Within Limits: The Conflicts Of "Wasting" Or "Cannibalizing" Insurance Policies*, 62 Mont. L. Rev. 131 (2001).

the defense end of a verdict in excess of policy limits, especially where he/she has not provided a copy of the smoking gun memo to all of his/her clients.

E. *The Insurer Requests Certain Strategies That Will Either Negatively Impact Full Coverage of the Underlying Claim, or Else May Ultimately Vitiate Coverage and Defense Altogether*

It is not unforeseeable that an insurer would request defense counsel to file a motion for partial summary judgment where facts have been developed in discovery that would indicate that summary judgment would be entered in favor of the insured on claims that are within the policy's coverage leaving only those claims not covered pending. In such case, the insurer would eliminate its obligation to defend because the potentially covered claims would no longer be pending. Depending upon the case, creative defense counsel may be able to utilize this fact scenario to lever a favorable settlement by advising plaintiff's counsel that the available insurance coverage is evaporating. Otherwise, defense counsel should discuss with the insured the potential for success on a motion for partial summary judgment and suggest that the insured obtain coverage advice on this issue, to the extent that the insured has not yet done do. Defense counsel should refrain from filing dispositive motions without consent of both clients. To the extent that both clients do not agree, a conflict of interest may result because of which the lawyer will owe his/her duties solely to the insured. While the conflict is, in essence, created by the clients, the lawyer should carefully document his/her file in the event that there is later litigation between the insurer and the insured arising out of this disagreement.

F. *Ethical Conflicts in Connection with Communicating Sensitive Information to the Insurer Against the Policyholder's Interest*

It is foreseeable that defense counsel will come into possession of information that could provide a basis for the insurer to deny coverage.[35] In such case, defense counsel may find him/herself in a quandary when the insurer makes a request that would include such information. Certain states have addressed the issue of whether such information must be produced.

Although the minority view, Illinois Supreme Court ruled in *Waste Management, Inc. v. International Surplus Lines Ins. Co.*, that "the attorney-client privilege and work-product doctrine are not applicable to bar disclosure of defense counsel's files in either the [underlying] litigations."[36] The *Waste Management* court relied upon the policy's cooperation clause and the common interest doctrine and found that the materials were prepared for the mutual benefit of insureds and insurers against a third-party adversary and reasoned that the insurers were not the adversary from whom such information, trial strategies and opinions required protection.[37] Courts following *Waste Management* have applied its rationale even where the insurer denied coverage and did not provide a defense to the insured.[38] In Illinois, the insured may only assert privileges

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[35] In at least some states, however, the insurer cannot pursue a declaration of non-coverage under its policy during the pendency of the underlying claim where the declaration would determine facts binding on the insured detrimental to the insured in the underlying case. *See, e..g., Maryland Cas. co. v. Peppers*, 64 Ill. 2d 187, 355 N.E.2d 24 (1976) (where there is a conflict of interest, the declaratory judgment cannot be adjudicated as to policy defenses raising such a conflict until the underlying action is concluded).

[36] 579 N.E.2d 322, 329 (Ill. 1991).

[37] *Id.* at 330-31.

[38] *CSX Transportation, Inc. v. Lexington Ins. Co.*, 187 F.R.D. 555, 560 (N.D. Ill. 1999) (in coverage action for underlying case in which insurer did not provide a defense and did not

for materials relating to insurance coverage as that is the only issue in which the insurer and insured have different interests.[39]

California, among other states, takes the opposite view. In *Rockwell International Corp. v. Superior Court*, the court rejected *Waste Management* and refused to find that the policy's cooperation clause effected a wholesale waiver of the insured's right to confidential communications with counsel.[40] The court further found that the common interest doctrine did not apply under the facts of that case as the attorney retained by the insurer to represent the insured owes the same fiduciary duty to the insured as would have been owed had the insured made the selection of counsel and the attorney's primary duty is to further the best interests of the insured.[41] Of those states which have addressed this issue, most have followed *Rockwell*.[42]

If the issue has not been addressed in the jurisdiction in which the request was made, defense counsel would be well served by notifying his client, the insured, of the insurer's request for information and allow the insured to determine the response. If the information has not been produced (or received) in discovery, the lawyer may fairly consider the information to be

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participate in underlying action, insurer is entitled to depose defense counsel employed by insured in underlying litigation as to substantive issues of that litigation).

39 *See, Waste Management, supra.*

40 26 Cal. App. 4th 1255 (1994).

41 *Id*. at 1267.

42 *See, e.g., Eastern Air Lines, Inc. v. U.S. Aviation Underwriters, Inc.,* 716 So.2d 340 (Fla. App. 3d Dist.); *Owens-Corning Fiberglas Corp. v. Allstate Ins. Co.*, 74 Ohio Misc.2d 174, 660 N.E.2d 765 (Ohio Com.Pl. 1993); *Metropolitan Life Ins. Co. v. Aetna Cas. and Sur. Co.*, 249 Conn. 36, 730 A.2d 51 (Conn. 1999); *Bituminous Cas. Corp. v. Tonka Corp.*, 140 F.R.D. 381 (D.Minn. 1992); *North River Ins. v. Philadelphia Reinsurance*, 797 F.Supp. 363 (D.N.J. 1992).

confidential and the lawyer should act to protect the confidences. Indeed, Model Rule 1.6 imposes such a requirement.[43] While a conflict of interest may result, the lawyer owes a duty to his client, the insured, to protect the client's confidences. For example, a problem could arise in connection with the lawyer's duty when the policy-holder client answers a deposition question in such a way as to implicate a coverage defense raised in a carrier's reservation of rights letter. Again, in states in which defense counsel owes an attorney-client duty of care to both the insurer and the insured, it is crucial to specify in advance, in the lawyer retention agreement, how such a situation will be handled within the framework of any client reporting obligation of the lawyer to his or her clients. In states where the lawyer represents only the policy-holder, given that the matter is irrelevant to the merits of the case, the lawyer may be justified in withholding such information, depending upon whether the state follows the majority or the minority view and depending on relevant state ethical rules defining confidential client information, even if he or she has a contractual duty to "keep the carrier reasonably advised."

G. Ethical Issues in the Context of Settlements

1. *Obligations of Defense Counsel when a Demand for Settlement within the Policy Limits is Received*

Perhaps the most prevalent conflict of interest problem for appointed defense counsel occurs in the context of settlement. For example, on the eve of trial the plaintiff makes a settlement demand within policy limits in a case in which the claim exceeds policy limits. If the insured

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[43] Model Rule 1.6 (a) provides that "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)."

wants the case to be settled but the insurer refuses to do so, there is a conflict of interest. Some cases hold that when a conflict arises between insurer and insured over settlement strategy, the insurer must provide new counsel for the insured at the insurer's expense.[44] Some courts have determined that defense counsel in this situation must inform both clients of any settlement offer in order to enable them to make a fully informed decision as to what needs to be done to protect their interests, but should not advise either on the propriety of settlement.[45]

The conflict is exacerbated when the insured and the insurer disagree on whether the claim should be settled. If the insurer refuses to settle when the insured is insisting upon it, defense counsel's obligations are defined by the lawyer's ethical obligations to the client, not the terms of the insurance policy. Defense counsel may be required to withdraw from representation of the insured under these circumstances.[46] To avoid potential malpractice liability, defense counsel faced with the obligation to withdraw should give ample notice to the insured and obtain court permission prior to withdrawal.[47]

2. *The Insured's Right to Consent to Settlement*

Sophisticated and/or larger corporate insureds may negotiate an endorsement which provides the right to consent to settlement. Such endorsements are frequently found in professional liability policies. Although insurers are typically willing to allow the insured the right to consent

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44 *See, e.g., Purdy v. Pacific Auto. Ins. Co.,* 203 Cal. Rptr. 524 (Ct. App. 1984); *Hamilton v. State Farm Mut. Auto. Ins. Co.,* 511 P. 2d 1020, 1024 (Wash. Ct. App. 1973).

45 *See, e.g., Hartford Accid. & Indem. Co. v. Foster,* 528 So. 2d 255 (Miss. 1988).

46 ABA Formal Opin. 96-403 (1996) (withdrawal from representation of insurer and insured may be counsel's only option in some cases).

47 *See, e.g., State ex rel. Wilke v. Rush,* 814 SW.2d 687 (Mo. Ct. App.1991).

to settlement, it is not beyond limitation. Policies which contain a right to consent to settlement frequently also contain what is known as "a hammer clause." The

An example of a hammer clause is as follows:

> The **Company** shall not settle a **claim** without the written consent of the **Named Insured**. If the **Named Insured** refuses to consent to a settlement or compromise recommended by the **Company** and acceptable to the claimant, then the **Company's** limit of liability under this Policy shall be reduced to the amount for which the **claim** could have been settled plus all **claim expenses** incurred up to the time the **Company** made its recommendation, which amount shall not exceed the remainder of the limit of liability specified in Section II.A.

Under this language, the insured has the right to consent to the settlement but if the insured declines to do so, he does so at his own peril.

Some policies contain a deductible provision which is especially helpful to design professionals that service real estate developers and/or condominium associations to allow the design professional to decline to consent to "cost of litigation" settlements. These deductibles are found in what is generally known as "dollar one defense policies" where the insured does not pay any amounts until there is a settlement or judgment. Creative defense counsel can use the existence of this deductible provision to his/her benefit in settlement discussions because, unlike many other insured entities whose settlements are paid by insurers, the design professional that purchases a policy with this deductible is actually paying from its own funds the first dollars of any settlement.

H. Seriously, who is my master?

In dual-representation states, defense counsel may have a "business conflict" or "ethical tension" where the insurer wants the insured to file cross or third-party claims against some or all of the entities on a construction project in order to minimize the insured's exposure and spread the risk. Problems arise where the insurer wants the insured to file cross or third-party claims against entities with which the insured does business, or wants to do business, and the insured does not want such claims to be filed for business or other reasons. These conflicts must be evaluated and potentially resolved based upon the unique facts of each case.

For instance, defense counsel may wish to explore the potential for a stand-still or tolling agreement to preserve the ability to bring cross or third-party claims at a later date. If the insured's adversity to filing such claims is based upon business considerations, a tolling agreement should be achievable, if the business interests are mutual, and would protect everyone's interests. While insurers do not want to resolve litigation on behalf of their insureds and later pursue a third-party for its contribution or indemnity, a tolling agreement may resolve the conflict for at least a period of time during which complete resolution, with the cooperation of the third-party, can be evaluated and potentially obtained.

Where a tolling agreement cannot be agreed upon, defense counsel may find him/herself in a conflict because the insurer wants cross or third-party claims to be filed in order to minimize its risk but the insured does not want to damage its business relationship with the entities that the insurer wants to sue. In such case, defense counsel should advise his/her client to consult with independent counsel. Defense counsel should not file pleadings on behalf of his/her client that are not expressly authorized as damage to the client's business relationship with another entity may be actionable under the tort of intentional interference with prospective business relationships or contractual relationship.

Similarly, a tolling agreement can protect an insured in cases in which an insurer does not want to file cross or third-party claims also insured even under other policies. If a tolling agreement is not possible, a conflict may arise between the insurer and the insured. While defense counsel should refrain from filing a cross or third-party claim without the insured's permission, not filing such claims may increase the insured's exposure or subject him/her to joint and several or a potentially personal liability.

FIRST PARTY INSURANCE

I. Counsel Involvement in Claims

INSERT MATERIAL HERE>>>

II. Dealing wth Public Adjusters

`Adjusters for insurance companies have been regulated for many years, but prior to 2005, "public adjusters" had no official status in Texas. They were not licensed or regulated. In fact, some people argued that prior to 2005, there was no such thing as a public adjuster, since there was no definition of such an entity. However, other states have been licensing public adjusters for decades, and for decades these companies and Texans who identified themselves as public adjusters have done business in this state. The general idea is that a public adjuster is an insurance adjuster who works for the insured instead of the insurer. The section of the Texas Insurance Code was added in 2005 to deal with "public adjusters," and it defines such an entity subject to licensure as:

> (A) a person who, for direct, indirect, or any other compensation: (i) acts on behalf of an insured in negotiating for or effecting the settlement of a claim or claims for loss or damage under any policy of insurance covering real or personal property; or (ii) on behalf of any other public insurance adjuster, investigates, settles, or adjusts or advises or assists an insured with a claim or claims for loss or damage under any policy of insurance covering real or personal property; or (B) a person who advertises, solicits business, or holds himself or herself out to the public as an adjuster of claims for loss or damage under any policy of insurance covering real or personal property. Tex. Ins. Code § 4102.001 – Definitions.

Attorneys engaged in the practice of law, clerical personnel, appraisers, arbitrators, engineers, and various other professional consultants are exempted from such definition and are not subject to public adjuster regulations or licensing as long as they confine

themselves to their professions or lines of work and do not hold themselves out as public adjusters. Tex. Ins. Code § 4102.002.

The remaining provisions of the insurance code governing public adjusters prohibit them from practicing law and enact rules and a code of ethics that are applicable to public adjusters, including certain regulations and requirements concerning their contracts and behavior. Tex. Ins. Code § 4102.003-006; 4102.151-164. For example, PA's may not may not "solicit or attempt to solicit business, directly or indirectly, or act in any manner on a bodily injury loss covered by a life, health, or accident insurance policy or on any claim for which the client is not an insured under the insurance policy." Tex. Ins. Code § 4102.157. Practically speaking, this limits PA activity to first party property claims. And the insurance commissioner is specifically authorized to promulgate additional rules regulating PA's. Tex. Ins. Code § 4102.003.

This paper describes common violations (or torts and breaches of contract) committed by public adjusters and how these impact their right to recover fees and how they subject the adjuster to liability to his principal and/or employing owner.

1. A provision of any contract between the owner and PA calling for a

> percentage contingent fee based on a settlement or recovery on a claim against an insurer after litigation has ensued is void, or in the alternative voidable at the owners' option. Most PA's contracts provide for percentage fees based upon the recovery they assist in making on an insurance claim. Some adjusters will have their customers sign and agree to contracts that provide for fees ranging from 5% to 10% (the statutory maximum) of *any* recovery on the claim, without restriction as to whether the adjuster did anything to produce the settlement or whether litigation was required. Enforcement of the contingent fee portion of such a contract would be against Texas public policy because once litigation ensues it is unethical, and/or improper for any non-lawyer witness or anyone connected with any such witness to be paid a fee contingent on the outcome of the litigation in which they testify.

It is beyond dispute that in the courts of this state, "a lawyer shall not…pay, offer to pay, or acquiesce in the offer or payment of compensation to a witness or other entity contingent on the content of the testimony of the witness or the outcome of the case." See Texas Disciplinary Rules of Professional Conduct, Rule 3.04(b).[48] It makes no difference if the witnesses themselves or the witnesses' corporate employer or other related entity claims the contingent interest. Indeed, the Professional Ethics Committee appointed by the Supreme Court of Texas to provide advisory opinions on the meaning of the disciplinary rules has held that: "The payment of a contingent fee to an entity that is the employer of an expert witness clearly comes within the prohibition of Rule 3.04(b),

[48] This provision does not apply to attorneys who properly testify in a case they are handling on a contingent fee basis. A separate ethical rule governs this situation and courts have routinely dealt with cases where such testimony was allowed without comment. See. T.D.R.P.C. 3.08.

particularly in view of the fact that the employing entity could itself be a witness only through an employee or other agent. Accordingly, it would be a violation of Rule 3.04(b) for a lawyer to use an employee of the Company as an expert witness in the property owner's lawsuit when the Company has a contingent fee interest in the outcome of the case."[49]

The Ethics Committee made clear in another case that the reason for the rule is that "it would seem to be the only logical conclusion available, that when you pay a fee based on a percentage of the recovery to a consulting firm providing expert witnesses, in essence you are paying for testimony. Theoretically, the better the testimony, the larger the recovery and hence, the larger the fee to the witness (however)... witnesses should always testify truthfully and should be free from any financial inducements that might tempt them to do otherwise."[50] Like the old English common law rule against barratry, champerty, and maintenance, the reason for this Disciplinary Rule is the public policy of this state to protect the very integrity of the court system itself. Indeed, the title of Rule 3.04 is: "Fairness in Adjudicatory Proceedings."

Several courts have similarly struck down as unenforceable fee contracts that violate the public policy of this state as expressed in the disciplinary rules governing the conduct of the attorneys that practice in its courts. The rule is that although The Texas Disciplinary Rules of Professional Conduct do not define standards for civil liability and do not give rise to private claims, "Nonetheless, a court may deem these rules to be an

[49] Professional Ethics Committee for the State Bar of Texas, Opinion 553 (August 2004).
[50] Professional Ethics Committee for the State Bar of Texas, Opinion 458 (March 1988).

expression of public policy, so that a contract violating them is unenforceable as against public policy."

The Texas Supreme Court and several courts of appeal have voided fee contracts that violate the Texas Disciplinary Rules because such rules, insofar as they are designed to protect the integrity of the court system, express the public policy of this state. See *Johnson v. Brewer & Pricthard*, P.C., 73 S.W.3d. 193 (Tex. 2002) (" A fee sharing agreement between lawyers who are not in the same firm violates public policy and is unenforceable unless the client is advised of and consents to the sharing arrangement."); *Lemond v. Jamail,* 763 S.W.2d 910, 914 (Tex.App.-Houston [1st Dist.] 1988, writ denied) (" In substance, the trial judge ... found ... that the referral agreement is void and unenforceable as being against public policy because ... the client ... was never informed of the fee-splitting agreement...."); *Quintero v. Jim Walter Homes, Inc.,* 709 S.W.2d 225, 229-30 (Tex.App.-Corpus Christi 1986, writ ref'd n.r.e.) (holding a settlement agreement was void and unenforceable because the clients were not informed of the nature and amounts of all the claims involved in the aggregate settlement as required by DR 5-106); *Fleming v. Campbell,* 537 S.W.2d 118, 119 (Tex.Civ.App.-Houston [14th Dist.] 1976, writ ref'd n.r.e.) (holding an attorney's referral fee contract was void because it was against the public policy expressed in DR 2-107).

It appears from the cited authorities that any contingent fee agreement with a non-lawyer witness or his affiliates is a violation of the Texas Disciplinary Rules of Professional Conduct once litigation ensues. It is equally clear that such rule evinces the

public policy of this state that "witnesses should always testify truthfully and should be free from any financial inducements that might tempt them to do otherwise."[51]

As the Supreme Court said in *Hoover v. Slovacek*, 206 SW3d 557, 562 (Tex. 2006): "Whether a contract, including a fee agreement between attorney and client, is contrary to public policy and unconscionable at the time it is formed is a question of law. *See, e.g.*, Tex. Bus. & Com.Code § 2.302 (courts may refuse to enforce contracts determined to be unconscionable as a matter of law); *Ski River Dev., Inc. v. McCalla*, 167 S.W.3d 121, 136 (Tex.App.-Waco 2005, pet. denied) ("The ultimate question of unconscionability of a contract is one of law, to be decided by the court."); *Pony Express Courier Corp. v. Morris*, 921 S.W.2d 817, 821 (Tex.App.-San Antonio 1996, no writ) (distinguishing procedural and substantive aspects of unconscionability)."

The unconscionability or unenforceability of the contingent fee or assignment portion of any alleged agreement does not necessarily render the entire agreement unenforceable. *See* Restatement (Second) of Contracts § 208 (1981) ("If a contract or term thereof is unconscionable at the time the contract is made a court may refuse to enforce the contract, or may enforce the remainder of the contract without the unconscionable term, or may so limit the application of any unconscionable term as to avoid any unconscionable result."); *Williams v. Williams*, 569 S.W.2d 867, 871 (Tex. 1978) (explaining that an illegal provision generally may be severed if it does not constitute the essential purpose of the agreement). An insured can pay a public adjuster a

[51] Professional Ethics Committee for the State Bar of Texas, Opinion 458 (March 1988).

contingent fee on benefit payments received from an insurer *before litigation ensues* but a lawyer could not pay any such fee (or agree to ever pay such a fee) on any payment made *after litigation ensued and once adjuster personnel were witnesses* in that pending litigation. Similarly, in *Hoover*, "Walton paid Hoover its contingent fee for settlements that Parrott negotiated with Texaco and El Paso Natural Gas, and Walton does not contend that this portion of the agreement is unconscionable." *Hoover v. Slovacek*, 206 SW3d 557 (Tex. 2006). In essence, a contingent fee provision in any adjuster contract authorizing payment of a percentage contingent fee to the adjuster on amounts obtained from the insurer *after litigation ensued in which the adjuster was a witness* is void and unconscionable *ab initio.* A legitimate contract should specify a contingent percentage fee calculated only upon payments obtained by the adjuster from the carrier prior to litigation on the claim, or else provide that the contract is cancelled once litigation on the claim ensues.

2. Another problem that is common in PA contracts that may void them as against public policy is where the contract itself it violates the Texas Insurance Code and administrative law promulgated thereunder in any of the following respects (or others; I have listed the ones I am most familiar with):

    a. Violation of Sec. 4102.162. of the Texas Insurance Code providing that "A license holder may not use a name different from the name under which the license holder is currently licensed in an advertisement, solicitation, or contract for business";

b. Where there is evidence that the contract was procured in violation of Sec. 4102.160 providing that "a license holder may not…" pay a referral fee "to a person who is not a licensed public adjuster…"

c. Where it violates Texas Administrative Code Title 28, Part 1, Chapter 19, Subchapter H, Rule §19.708(b) regarding Public Insurance Adjuster Contracts providing that "A public insurance adjuster's written contract with an insured must contain: (1) the name, address, and license number of the public insurance adjuster negotiating the contract and, if applicable, the name, address, and license number of the public insurance adjuster's employing public insurance adjuster";

d. Where it violates Section 6 of Rule 19.708(b) requiring that any out of state adjuster entity use a contract that "for each non-resident public adjuster named in the contract," states "the name and address of the non-resident public adjuster's agent for service of process";

e. Insurance Code Section 4102.162 provides that no public adjuster contract may "contain any terms or conditions which have the effect of limiting or nullifying any requirements of the Insurance Code, this subchapter, or other rules of the department"; Likewise, Rule 19.713(10) specifically provides that "Licensees shall only

use contracts that comply with Insurance Code Article 21.07-5[52] and this subchapter";

3. Another argument for invalidating PA contracts where one can show violations such as those listed above is to show that the violations were involved in the procurement of the contract and employment of the PA. Texas Insurance Code and regulations promulgated thereunder specifically disapprove of such contracts. They also declare violations to each be Class B Misdemeanors (see Tex. Ins. Code, Section 4102.206). Where one party to a contract can show that the contact was procured through illegal activity, that party is excused from the contract, and furthermore, the other party may not recover in *quantum meruit* or on any other theory predicated upon such illegal conduct. Under Texas law, the longstanding "unlawful acts" rule states that ***no action or claim*** may be predicated upon an admittedly unlawful act of the party asserting it. *Denson v. Dallas County Credit Union*, 262 S.W.3d 846, 855 (Tex. App.—Dallas, 2008, pet. denied) (emphasis added), citing *Stevens v. Hallmark*, 109 S.W.2d 1106, 1106 (Tex. Civ. App.—Austin 1937, no writ) ("A person cannot maintain a cause of action if, in order to establish it, he must rely, in whole or in part, on an illegal or immoral act or transaction to which he is a party.")

A contract to do a thing which cannot be performed without violation of the law violates public policy and is void. *Denson v. Dallas County Credit Union*, 262

[52] Former Article 21.07-5 referred to in the still applicable 2005 regulations has since been recodified without substantial change as Chapter 4102 of the Texas Insurance Code.

S.W.3d 846, 852 (Tex. App.—Dallas, 2008, pet. denied); *Villanueva v. Gonzalez,* 123 S.W.3d 461 (Tex. App.—San Antonio 2003, no pet.); *Lewis v. Davis*, 145 Tex. 468, 199 S.W.2d 146, 148-49 (1947). The purpose behind the rule is not to protect or punish either party to the contract, but to benefit and protect the public. *Id*., *Lewis,* 199 S.W.2d at 151; *In re Kasschau*, 11 S.W.3d 305, 312 (Tex. App.-Houston [14th Dist.] 1999, orig. proceeding). As explained in *Denson*, where public policy concerns have led to a governmentally supervised statutory licensing scheme (such as the statutory licensing scheme for "public adjusters" administered by the Texas Department of Insurance), courts consistently hold the unlawful or unlicensed participation in such regulated business cannot form the basis for recovery. *Denson,* 262 S.W.3d at 853-54. To hold otherwise would allow a person to accomplish indirectly what he is prohibited from doing directly and frustrate the public policies behind the legal protections. *Id*. at 854. In *Denson,* the court held that a car dealer who was not licensed to sell cars in Dallas County was barred from recovering against its credit union because the Texas Transportation Code clearly prohibited a car dealer from selling cars unless properly licensed. *Id*. at 855. The court held that the transaction of selling cars was illegal because on the day of the transactions, the plaintiff car dealer did not have the statutorily required license. *Id*.

If a PA claims a fee as a result of a contract that it entered into illegally, because the Texas Insurance Code and regulations promulgated thereunder specifically disapproves of such contracts and declares violations of its provisions each Class B Misdemeanors (see Tex. Ins. Code, Section 4102.206), the PA has engaged in illegal

activity and thus its contract with the owner would be void and unenforceable under Texas law. *Denson*, 262 S.W.3d at 853-54; *see also*, *In re Heritage Org., LLC*, 354 B.R. 407, 433 (N.D. Tex. 2006) (noting that "[c]ourts will not aid in the enforcement of a contract made for the illegal practice of law;" and since Heritage could not collect a fee from its own client if it was engaged in the unauthorized practice of law, the court concluded that it should not be able to collect that fee from a non-client either); *Robnett v. Kirklin Law Firm*, 178 S.W.3d 45 (Tex. App.-Houston [1st Dist.] 2005) (holding attorney not entitled to recover fees under contingency-fee contract signed with clients while attorney was suspended from practice); *M. M. M., Inc., v. Mitchell*, 153 Tex. 227, 265 S.W.2d 584 (1954) (holding that engineer, who had been issued an original license under Texas statute regulating professional engineers, was illegally practicing when he provided engineering services during a year for which he failed to pay his annual licensing renewal fee as required by the statute, and thus, his contract for services was illegal and he could not recover for such services.)*; In re Kasschau*, 11 S.W.3d 305, 312 (Tex. App.-Houston [14th Dist.] 1999, orig. proceeding) (holding that divorce settlement violated law in part, and court refused to enforce entire agreement).

Further, where the illegal activity is so commingled with legal activity, courts refuse to enforce any part of the contract because the activities cannot be differentiated. *See e.g.*, S*acks v. Dallas Gold & Silver Exch., Inc.*, 720 S.W.2d 177, 180 (Tex. App.—Dallas 1986, no writ) (affirming trial court's refusal to enforce

entire contract to pay employee for services rendered because to do so would reward fraudulent rent scheme; time the employee worked in legal activity was so commingled with his illegal activity that no differentiation could be made, and thus, the entire agreement was held invalid.)

If the unlawful acts rule applies, it would arguably bar any PA claims, including those arising in *quantum meruit* because the *quantum meruit* claims are inextricably intertwined with the PA's illegal public adjuster contract.

4. Another remedy available to an owner is to simply cancel any PA contract before any fee is earned or owed. If there is good cause for such cancellation, by analogy to the substantial corpus of law developed in attorney contingent fee contracts, the PA cannot recover any fee interest and would be relegated to a theory of recovery, if any, sounding only in *quantum meruit.*

Any attempt to collect an illegal fee after litigation ensues, or likewise to refuse to do further work on the insured's claim except in exchange for a contingent fee would seem to be good cause to cancel the PA contract as a matter of law because cancellation would be necessary to avoid committing conduct prohibited by relevant Texas law. Another common reason to cancel a PA contract and/or sue the PA for damages is where the PA involves itself in the repair process. Texas law prohibits such involvement. Tex. Ins. Code 4102.158 provides that it is illegal for any public adjuster to

> participate directly or indirectly in the reconstruction, repair, or restoration of damaged property that is the subject of a claim adjusted by the license holder; or (2) engage in any other activities that may reasonably be construed as presenting a conflict of interest, including soliciting or accepting any remuneration from, having a financial interest in, or deriving any direct or indirect financial benefit from, any salvage firm, repair firm, construction firm, or other firm that obtains business in connection with any claim the license holder has a contract or agreement to adjust.

Several courts have stated the rule that a claims agent who is terminated for cause (or "good cause") by a client forfeits the benefit of his contingent fee contract with the client and is reduced to recovering, at most, *quantum meruit*—and then only assuming that the underlying fee contract was otherwise valid and enforceable (unlike where the contract was illegal or illegally procured). *Auguston v. Linea Aerea Nacional-Chile S.A.*, 76 F.3d 658, 662 (5th Cir. 1996); *Campbell Harrison & Dagley LLP v. Blue*, 2011 WL 6935324, at *9 (N.D. Tex. 2011). For example, an attorney discharged with cause can recover in *quantum meruit* for services rendered up to the time of discharge. *Rocha v. Ahmad*, 676 S.W.2d 149, 156 (Tex.App.--San Antonio 1984, writ dism'd). And when an attorney, "without just cause, abandons his client before the proceeding for which he was retained has been conducted to its termination, or if such attorney commits a material breach of his contract of employment, he thereby forfeits all right to compensation." *Royden v. Ardoin*, 160 Tex. 338, 331 S.W.2d 206, 209 (1960).

5. As a separate matter, unless the insured assigns an interest in the claim to the PA and the insurer gives written consent to such assignment, any claim by a PA that it can hold up payment or distribution of an insurance settlement is wrong. Even if the PA contract contains assignment language, the PA will usually only be a general creditor of the insured and hold no ownership interest in any funds recovered by the insured from its insurer because most insurance policies prohibit any assignment of interest without the written consent of the insurer.

One standard policy provision states that: ."Your rights and duties under this policy ***may not be transferred without our written consent*** except in the case of death of an individual named insured."

Generally, a contract of insurance is subject to the same rules of construction as other contracts. *National Union Fire Ins. Co. v. Hudson Energy Co. Inc.* 811 S.W. 2d. 522, 555 (Tex. 1991); *Texas Farmers Ins. Co. v. Gerdes.* 800 S.W. 2d 215, 217 (Tex.App.-Fort Worth 1994, writ denied). If the insurance contract is worded so that it can be given a certain definite meaning or interpretation, then it is not ambiguous, and the court will construe the contract as a matter of law. *Gerdes,* 800 S.W. 2d at 218; *GT & MC, Inc. v. Texas City Refining, Inc.*,822 S.W.2d 252, 255-56 (Tex.App.-Houston [1st Dist.] 1991, writ denied). Moreover, where there is no ambiguity, it is the court's duty to give the words their plain meaning. *Puckett v. U.S. Fire Ins. Co.*, 678 S.W.2d 936, 938 (Tex.1984); *Gerdes*, 880 S.W.2d at 218.

Additionally, Texas courts have consistently enforced anti-assignment clauses. *See*

Island Recreational Dev. Corp. v. Republic of Texas Savings Ass'n, 710 S.W.2d 551, 556 (Tex.1986) (opinion on reh'g) (letter of commitment); *Gerales*, 880 S.W.2d at 218 (insurance policy anti-assignment clause enforced); *Texas Pacific Indem. Co. v. Atlantic Richfield Co.,* 846 S.W.2d 580 (Tex.App.-Houston [14 Dist.] 1993, no writ) (insurance policy anti-assignment clause enforced); *Cloughy v. NBC Bank-Seguin, N.A.*, 773 S.W.2d 652, 655 (Tex.App.-San Antonio 1989, writ denied); *Dallas County Hospital Dist. V. Pioneer Casualty Co.*, 402 S.W.2d 287, 288 (Tex.App.-Forth Worth 1966, writ ref'd n.r.e.). The Fifth Circuit, in applying Texas law, has also enforced anti-assignment clauses contained in insurance policies. *See Ins. Co. of Pennsylvania v. Hutter*, 34 Fed.Appx. 963, 2002 WL 663778. *1 (5th Cir. 2002); *Conoco, Inc. v. Republic Ins. Co.*, 819 F.2d 120, 123-24 (5th Cir. 1987); *ARM Prop. Mgmt Group v. RSUI Indem. Co.*, 642 F. Supp.2d 592 (W.D.Tex.2009).

The *Gerdes* and *ARM Prop. Mgmt Group* cases cited above are particularly instructive. In the *Gerdes* case, the court analyzed an anti-assignment clause in an insurance policy that stated "[y]our rights and duties under this policy may not be assigned without our written consent." 880 S.W.2d at 218. The Court held that the anti-assignment clause was unambiguous and barred the assignment of rights to the assignee. Thus, the purported assignee had no rights against the insurer, 880 S.W.2d at 218-19.

Likewise, in *ARM Prop. Mgmt Group*, the insured brought an action against its excess first party property insurer for damage sustained during Hurricane Katrina to several apartment buildings. The owners of the buildings assigned their claims to a management group. 642 F.Supp.2d at 608. The language in the policy at issue in that case was as follows:

F. Transfer of Your Rights and Duties Under This Policy

Your rights and duties under this policy may not be transferred without our Written consent except in the case of death of an individual named insured.

642 F.Supp.2d at 608 (emphasis in original).

Based on that anti-assignment policy language, the court held that under Texas and Fifth Circuit law the policy's anti-assignment provision applied and barred the post-loss assignment of claims. 642 F.Supp.2d at 610.

And under Texas law, no distinction is drawn between as assignment of the policy or claims on one hand and the assignment of proceeds on the other hand. Further, the case law is clear that an anti-assignment clause bars even post-loss assignments even if they purport to only assign proceeds. *See Hutter*, 34 Fed.Appx. 963, 2002 WL 663778, *1 (the Fifth Circuit expressly rejected the post-loss assignment argument); *Conoco*, 819 F.2d at 123-24 (post-loss assignment of insurance proceeds barred by the insurance policy's anti-assignment clause); *Gerdes*, 880 S.W.2d at 218 (post-loss assignment barred by anti-assignment clause of insurance policy); *see also Hoffman & asso.c ex rel. Dallas Med. Holdings, Ltd. v. St. Paul Guardian Ins. Co.*, 2005 WL 1950848 (Tex.App.-Dallas 2005) (court rejects argument that anti-assignment provision in insurance policy did not apply to proceeds assigned after loss to the purchaser of property that was the subject of an insurance claim).

6. Liability of Public Adjusters

A. Breach of Contract and Negligence

Public adjusters, since they normally don't get involved in claim situations other than by contract, can be liable for breach of contract. In addition, if the breach of their adjusting contract causes damage to the owner or his property beyond loss to the subject of the contract, i.e., the insurance claim itself, the PA will be liable under a negligence theory. See, e.g. *Chapman Custom Homes, Inc. v. Dallas Plumbing Co*., 445 S.W.3d 716, 718 (Tex. 2014). In Chapman, the Texas Supreme Court expressly rejected the economic loss rule as a bar to a homeowner recovering from a subcontractor. The court's holding bears quoting at length:

> Having undertaken to install a plumbing system in the house, the plumber assumed an implied duty not to flood or otherwise damage the trust's house while performing its contract with the builder. Although the court of appeals views this property damage as a mere economic loss arising from ²'the subject [matter] of the contract itself,'² *446 S.W.3d at 35, 2014 Tex.LEXIS 509 at *26* (quoting *Jim Walter Homes, Inc. v. Reed, 711 S.W.2d 617, 618 (Tex. 1986)*, and purports to apply the economic loss rule as a bar to any tort claim, the rule does not apply here. The economic loss rule generally precludes recovery in tort for economic losses resulting from a party's failure to perform under a contract when the harm consists only of the economic loss of a contractual expectancy. *LAN/STV, 435 S.W.3d at 243, 2014 Tex. LEXIS 509 at *26*; *Jim Walter Homes, 711 S.W.2d at 618*. But it does not bar all tort claims arising out of a contractual setting. ***As we have said, ²a party [cannot] avoid tort liability to the world simply by entering into a contract with one party [otherwise the] economic loss rule [would] swallow all claims between contractual and commercial strangers***.² *Sharyland WaterSupply Corp. v. City of Alton, 354 S.W.3d 407, 419 (Tex.2011)*. ***Thus, a party states a tort claim when the duty allegedly breached is independent of the contractual undertaking and the harm suffered is not merely the economic loss of a contractual benefit***. *See LAN/STV, 435S.W.3d at 242-43, 2014 Tex. LEXIS 509 at *26* (discussing the limitations on recovery of purely economic damages by contractual strangers); *DeLanney, 809 S.W.2d at 494-95* (suggesting that the source of the duty and the nature of the wrong should be examined to determine whether the underlying claim is in tort or contract). Such was the case in *Scharrenbeck*, and such is also the case here. ***The plumber's duty not to flood or otherwise damage the house is independent of any obligation undertaken in its plumbing subcontract with the builder, and the damages allegedly caused by the breach of that duty extend beyond the economic loss of any anticipated benefit***

> ***under the plumbing contract***. Because the court of appeals erroneously concludes that the pleadings and summary judgment evidence negate the existence of a negligence claim, we grant the petition for review and, without hearing oral argument, reverse the court of appeals' judgment and remand the case to trial court. (emphasis added).

The Supreme Court has made clear that where a contractor (adjuster) agrees to do something for an owner and that work causes damage beyond the (adjusting) work itself, the adjuster may be liable in *either* tort or contract *or both* and the economic loss rule does not apply. See *Chapman Homes* stating that:

> In *Montgomery Ward &Co. v. Scharrenbeck, 146 Tex. 153, 204 S.W.2d 508, 510 (Tex. 1947)*, we observed that a common law duty to perform with care and skill accompanies every contract and that ***the failure to meet this implied standard might provide a basis for recovery in tort, contract, or both under appropriate circumstances***. (emphasis added).

Moreover, there is good reason to believe that even with respect to mishandling of the insurance claim itself, tort remedies by way of malpractice should be available against the PA, in addition to a straight breach of contract. This is the rule as regards other licensed professionals subject to malpractice liability, e.g., lawyers, doctors, architects, engineers, etc.

B. Breach of Fiduciary Duty

All agents have common law fiduciary duties to their principals. By analogy to attorneys, this should be particularly true of public adjusters, especially when they constitute themselves as "attorneys in fact" for the owner. *Johnson v. Brewer & Pritchard, P.C.*, 73 S.W.3d 193, 200–203 (Tex. 2002); *Thigpen v. Locke*, 363 S.W.2d 247, 253 (Tex. 1962); *Schiller v. Elick*, 240 S.W.2d 997, 999–1000 (Tex. 1951); Fiduciaries owe their clients a duty to act in the utmost good faith, with absolute candor,

openness, honesty and loyalty to the client. *See Won Pak v. Harris*, 313 S.W.3d 454, 458 (Tex. App.—Dallas 2010, pet. denied).

A breach of fiduciary duty is shown where any of the following occur:

a. The client enters into a transaction with agent that was not fair and equitable to the client/principal;
b. The agent failed to make reasonable use of the confidence placed in him;
c. The agent failed to act in the utmost good faith and exercise the most scrupulous honesty;
d. The agent placed his own interests above those of his principal, used the advantage of his position to gain any benefit for himself at the expense of the client, or placed himself in any position where his self-interest might conflict with his obligations as a fiduciary; OR
e. The agent failed to fully and fairly disclose all important information concerning any transaction to the other parties to it. (See PJC 104.2).

If a breach of fiduciary duty occurs, such as conduct that would constitute a conflict of interest (for example, participating directly or indirectly in repairs), the PA may be liable not only for damages caused thereby, but also for disgorgement of all fees paid or owed in the future, if the breach is clear and serious, which is generally a question of law for the court. Equitable relief can also include recission of any contract. *Burrow v. Arce*, 997 S.W.2d 229, 245 (Tex. 1999); *Kinzbach Tool Co. v. Corbett-Wallace Corp.*, 160 S.W.2d 509 (Tex. 1942). And if a fiduciary breach also amounts to fraudulent inducement, the contractual consideration received by the fiduciary is recoverable regardless of whether the breach caused actual damages. *ERI Consulting Engineers, Inc. v. Swinnea*, 318 S.W.3d 867, 873 (Tex. 2010).

Public adjusters make many mistakes that expose them to substantial liability. There are stories of payments of referral fees to non-adjusters, and other misconduct. Adjuster

contracts may violate one or more of the many strict requirements of the insurance code and the regulations promulgated by the TDI thereunder.

IV. Concluding Remarks.

It is impossible to predict the complete universe of ethical problems or conflicts that might arise in the typical lawyer-client-insurer arrangement. The triangular nature of the relationship and the economic and business considerations at play are inherently rife with possibilities for conflict and difference of opinion. The situation is further complicated by the diversity of approaches to both the conceptualization and the regulation of the problem from jurisdiction to jurisdiction. In states that adopt the "one-client" approach, the situation is clearer ethically but perhaps more dangerous for that very reason and because of the pressures exerted by the economic need for law firms to please insurer sources of business.

The safest practice is to remain thoroughly familiar with the case law and ethical rules of the state within which the lawyer practices; to generally err on the side of precaution; and, through explicit provisions of the initial attorney-client retention agreement, to document and agree in advance how the lawyer will proceed when and if a conflict arises.

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