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Independent *Cumis* counsel: The second prong

When the insured is given the right to choose counsel and control its defense

Under the standard insuring agreement, a liability insurer has a contractual obligation to defend its insured where the factual allegations of the complaint against its insured potentially trigger indemnity under the policy. The insurer is given the right to choose counsel and control defense. There are two separate situations where the law requires the insurer to relinquish control of defense and pay for the insured's choice of counsel.

The first is codified in California Civil Code section 2860. This conflict involves a third-party suit where multiple theories are pled and the conduct of the insured is the focus of both liability and insurance indemnity and the insurer has issued a Reservation of Rights letter.

The second prong of the law governing independent counsel requires the insurer to relinquish control and pay for the insured's choice of counsel when the insurer has "no economic motive" in the outcome of the case. When the insurer's Reservation of Rights eliminates its economic interest in the third-party suit, the insurer's desire to exclusively control defense must yield to its contractual obligation to give its policy-holder a full and vigorous defense.

This "second prong" that requires independent counsel is founded in Supreme Court decisions and was not superseded by the California Civil Code section 2860, the so-called "*Cumis*" statute. The recent increase in manuscript policies and hand-drafted endorsements, particularly in construction, brings this important issue to the fore.

In 1964, the California Supreme Court in *Tomerlin v. Canadian Indemnity Company*, (1964) 61 Cal.2d 638 set forth the legal basis for independent counsel. The case involved the classic conflict of "willful" versus "negligent" conduct relating to an alleged assault by the insured. The insured hired its own counsel to join in the defense with the insurer's counsel. Before trial began, the insurer's counsel told the independent counsel that the Reservation was now moot. Independent counsel withdrew in reliance. Even though the trial proceeded only on willful theories of conduct, the insured was told coverage was available. The Court held the insurer was estopped to rely on its Reservation for the uncovered judgment, and ordered reimbursement of independent counsel's fees. The reimbursement of fees was based on the Court's finding of two inherent conflicts, separately stated:

> Similarly, in cases involving multiple claims against the insured, some of which fall within the policy coverage and some of which do not, the insurer may be subject to substantial temptation to shape its defense so as to place the risk of loss entirely upon the insured. (Cf. *O'Morrow v. Borad*, (1946) 27 Cal.2d 794, 798.) Moreover, since defendant here had previously denied all liability under the policy, its sole economic motive of prosecuting a vigorous defense had been eliminated.

(*Tomerlin, Id.* at p. 647).

> A like duty must arise in the instant case in which potential conflict stemmed not only from the multiple theories of the *Villines* complaint and the propriety of settlement, but from the total absence in defendant of any economic interest in the outcome of the suit.

(*Tomerlin, Id.* at p. 647).

> Defendant argues, however, that Best's withdrawal caused plaintiff no detriment because in any event defendant retained the right, under the policy, to conduct the defense. Defendant's contention rests upon the erroneous assumption that it could exclusively control the case even though it lacked an economic interest in its outcome. In actions in which the insurer lacks an economic motive for a vigorous defense of the insured, or in which the insurer and insured have conflicting interests, the insurer may not compel the insured to surrender control of the litigation.

(*Tomerlin, Id.* at p. 648).

In 1971, the appellate court in *Executive Aviation, Inc.* v. *National Ins. Underwriters*, (1971) 16 Cal.App.3d 799, addressed the extent of the insurer's obligation under a conflict of interest created by a Reservation of Rights. It held the defense attorney should be selected by the insured and paid for by the insurer. The court stated representation by two different attorneys promotes and protects the interests of each, guarantees adequate representation and removes the deleterious effect of the conflict placed upon a single attorney attempting to represent both the insurer and the insured's interests.

The facts of *Executive Aviation* involved a policy of airplane insurance with an endorsement requiring the pilot to be commercially licensed if the accident occurred during a commercial flight. The insured said the flight was a private sales demonstration, but the insurer reserved its rights to disclaim all coverage if found to be a commercial flight.

The insurer was required to relinquish control of defense and pay independent counsel selected by the insured. The coverage issue was not determined in the underlying wrongful-death suit resulting from the accident, but in a separate declaratory relief action.

> We hold, therefore, that in a conflict of interest situation, the insurer's desire to exclusively control the defense must yield to its obligation to defend its policy holder. Accordingly, the insurer's obligation to defend extends to paying the reasonable value of the legal services and costs performed by independent counsel, selected by the insured. While an insurer may be dismayed at having to pay the

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> cost of two attorneys for one action, we are cognizant that the necessity for this action stems from its failure to provide with any degree of clarity for this conflict of interest contingency in drafting the terms of its contract.

(*Executive Aviation*, at p. 810).

The Ninth Circuit addressed the issue of independent counsel in *Previews, Inc. v. California Union Ins. Co.* (9th Cir. 1981) 640 F.2d 1026 applying California law. The case involved a class action against the insured and the insurer reserved rights that each member of the class was subject to a single "claim" deductible under its endorsement. As is common, the insurer had not defined the word "claim" in its deductible. Even though the coverage reservation would not be decided in the defense of the underlying action, the Ninth Circuit found a conflict in the insurer's complete lack of economic motive under the reservation of rights.

> California law provides that in a conflict of interest situation, the insurer's desire to control exclusively the defense must yield to its obligation to defend the policyholder. Accordingly, the insurer's obligation to defend extends to paying the reasonable value of the legal services and costs performed by independent counsel selected by the insured.

(See *Executive Aviation, Inc. v. National Ins. Underwriters* (1st Dist. 1971) *16* Cal.App.3d 799, 810; *Outboard Marine Corp v. Liberty Mutual Ins. Co*. (7th Cir. 1976) 536 F.2d 730, 737 applying California Law). (See also, *Tomerlin v. Canadian Indemnity Company*, (1964) 61 Cal.2d. 638 (where insurer lacks an economic motive for vigorous defense of the insured or where there is a conflict of interest, the insurer may not compel the insured to surrender control of the litigation). (*Previews, Inc. v. California Union Ins.* Co. (9th Cir 1981) 640 F.2d 1026, 1028.)

In 1984, *San Diego Navy Federal Credit Union v. Cumis Ins. Society, Inc.*, (1984) 162 Cal.App.3d 358 exploded out of the Fourth Appellate District and changed the face of insurance defense thereafter. At the time I was in charge of one of the largest coverage/bad-faith departments in California, the Haight firm, and there I was called upon to lecture and otherwise guide the insurance industry through this very broadly written opinion on independent counsel.

The author of the *Cumis* case, Judge Gamer, was sitting by assignment. The case was a broadside against large independent firms with multiple insurance clients: "Insurance companies hire relatively few lawyers and concentrate their business. A lawyer who does not look out for the Carrier's best interest might soon find himself out of work." (*Cumis, Id*. at p. 364). Now an insured is represented by "law divisions" of the insurer or boutique firms servicing but one insurer-client.

The *Cumis* case was by its facts a classic conflict situation. The insurer's reservation of rights on multiple theories involved wrongful misconduct. The *Cumis* opinion left the plaintiff's bar with the belief and position that any reservation, or speculative set of facts, would require independent counsel.

The issue of the scope of independent counsel in the "multiple theory" conflict case was not clarified until 1987 when the Legislature defined and set guidelines for its application to independent counsel. (See Cal. Civ. Code, § 2860).

Civil Code section 2860, sometimes referred to as the "*Cumis*" statute, was never intended to address all possible conflicts or to preclude judicial determination concerning the insured's right to independent counsel. (See *Gafton, Inc. v. Ponsor & Assoc.*, (2002) 98 Cal.App.4th 1388, 1421).

It is important to note the *Cumis* case itself cited both *Tomerlin* and *Executive Aviation* for the understanding that a conflict can stem from both "multiple theories" and lack of "economic motive." (*Cumis, Id.* at p. 369). The *Cumis* court stated that payment of independent counsel was implicit in the *Tomerlin* opinion: "If the insurer must pay for the cost of defense and, when a conflict exists, the insured may have control of the defense if he wishes, it follows the insurer must pay for such defense conducted by independent counsel" (*Cumis, Id*. at p. 369).

Over the years the California Supreme Court has clarified many issues. In general, the Court has strongly backed the right of the insurer to draft its contract and not have speculative ambiguity serve as a basis for independent counsel. The Court has also taken the view, in my opinion, that settlement is the primary object or goal in insurance contract interpretation.

Settlement is not thwarted by independent counsel. The insurer is not prevented from exercising its contractual right to settle as it deems expedient. (See *Western Polymer Technology, Inc. v. Reliance Ins. Co.*, (1995), 32 Cal.App. 14, 22.) When the insurer's reservation of its rights effectively eliminates economic motive, the desire to prosecute the action on behalf of the insured is affected. When two counsel are participating in settlement issues, the settlement process is, in fact, facilitated. (See Cal. Civ. Code, § 2860(f), *Novak v. Low, Ball & Lynch*, (1991) 77 Cal.App.4th 278.)

When no economic motive rests with the insurer to prosecute a vigorous defense for its insured, only inherent conflict and unnecessary tension can be the result. The insured may wish to move quickly so a problem or issue does not get out of hand, while the insurer has no economic motive to settle. The insured may wish a vigorous defense, but the insurer's hired counsel may be told to put a tight lid on defense expenses.

I am not an expert on the ethical issues relating to the Rules of Professional Conduct. However, as an insurance expert, I know that after issuance of a reservation of rights letter that effectively eliminates economic motive in the insurer to defend or settle a case, the insurer may be required to relinquish control of defense and pay for the insured's choice of counsel.

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