Ethical Disputes Arising Out of The Handling Of Insurance Coverage Claims Involving Multiple Policyholders

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I. INTRODUCTION

Cases involving multiple insured parties present several practical, legal and ethical difficulties for insurance companies and defense counsel.

The first group of cases concerns situations in which different insureds contend that internal conflicts between their respective positions *vis-à-vis* the underlying third-party claimant, each other or insurance coverage issues (including depleting aggregate policy limits) require that separate defense counsel be retained to represent their interests. This paper and presentation discusses whether any such alleged "conflict" give the insureds the right to separate defense panel counsel or even separate independent defense counsel of their own choosing, notwithstanding the express language in most general liability policies giving the insurer the right and duty to defend, including the right to appoint defense counsel of the insurer's own choosing.

A related issue concerns when there is an alleged "conflict" in the multiple insured situation, whether that should impact the insurer's claim handling procedures, including whether separate adjusters and claim files should be assigned for each of the insureds.

The second group of cases involve the issue of the duty to settle and, more particularly, situations where the limits of coverage are insufficient to resolve liability claims against all of the insureds under the policy. In such circumstances, does the insurer act in "bad faith" if it nonetheless agrees to pay its policy limit to resolve some but not all of the claims. Alternatively, does the insurer act in "bad faith" if it refuses to take advantage of an opportunity to pay its policy limit to protect at least some of its policyholders against the risk of an excess verdict, notwithstanding the fact that by doing so it exposes the remaining policyholders to uninsured jeopardy.

A related issue may arise in cases where only one insured has been sued but other parties who would benefit by the policy contend that the insurer should not pay its limits to settle the claims against the sued insured if such a payment would deprive them of the protections afforded by the policy by exhausting the policy limits and exposing them to uninsured liability for future claims that might arise during that policy period.

II. CONFLICTS OF INTEREST AND THE DUTY TO DEFEND

A. Conflicts of Interest Between Insured and Insurer: The *Cumis* (or Independent Counsel) Rule

The duty to defend is a valuable *right*. "It has been stated that, so far as the insured is concerned, the duty to defend may be as important as the duty to indemnify." *Buss v. Superior Court*, (1997) 16 Cal.4th 35, 46. "The insured's desire to secure the right to call on the insurer's superior resources for the defense of third party claims is, in all likelihood, typically as significant a motive for the purchase of insurance." *Montrose Chemical Corp. v. Superior Court*, (1993) 6 Cal.4th 287, 295-296. In consideration of the insurer's promise to defend, the insured has relinquished control over the defense of the case. As a consequence, the insurer has complete dominion over decisions with respect to how the case should be defended and/or settled or tried. "This right to control the defense necessarily encompasses the right to determine what measures are cost effective, bearing in mind liability and indemnity exposure." *James 3 Corp. v. Truck Ins. Exchange*, (2001) 91 Cal.App.4th 1093, 1103.

Many jurisdictions recognize that the duty to defend creates a tripartite relationship between the insured, the insurer, and the defense counsel retained by the insurer. "In the usual tripartite relationship existing between insurer, insured and counsel, there is a single, common interest shared among them. Dual representation by counsel is beneficial since the shared goal of minimizing or eliminating liability to a third party is the same." remains *San Diego Federal Credit Union v. Cumis Ins. Society,* (1984) 162 Cal.App.2d 358, 364.

Yet the right to control the defense can be forfeited in cases where coverage issues create a conflict of interests between the insured and its carrier. *Tomerlin v. Canadian Indem. Co*., (1964) 61 Cal.2d 638, 648; *Executive Aviation, Inc. v. National Ins. Underwriters*, (1971) 16 Cal.App.3d 799; *Chi of Alaska, Inc. v. Employers Reinsurance Corp.,* 844 P.2d 1113 (Alaska 1993); *Farmers Ins. Co. v. Vagnozzi,* 138 Ariz. 443, 675 P.2d 703 (1983); *Maryland Cas. Co. v. Peppers*, 355 N.E.2d 24, 31 (Ill. 1976); *Patrons Mutual Ins. Assoc. v. Harmon*, 732 P.2d 741 (Kan. 1987); *Allstate Ins. Co. v. Campbell*, 639 A.2d 652, 659 (Md. 1994); *Prahm v. Rupp Construction Co.,* 277 N.W.2d 389, 391 (Minn. 1979); *Moeller v. American Guaranty & Liability Ins. Co.,* 707 So.2d 1062 (Miss. 1996); *American Employers Ins. Co. v. Crawford*, 533 P.2d 1203, 1209 (N.M. 1975); *69th Street Garage Associates v. Ticor Title Guaranty Co.,* 622 N.Y.S.2d 13, 14 (App. Div. 1995); *State Farm Fire & Casualty Co. v. Pildiner*, 321 N.E.2d 600, 603 (Ohio 1974) and *Lima v. Chambers*, 657 P.2d 279, 285 (Utah 1982).

In these cases, courts have reasoned that an insured should not be forced to give up control of its own defense if the insurer, by raising coverage issues, has an incentive to handle the defense in a manner that supports the interest of the insurer but not the policyholder. Yet, courts have reached widely differing

conclusions with respect to the circumstances under which a conflict will be found to give the insured the right to retain counsel of its own choosing.[1]

The leading case addressing the rights of policyholders for independent counsel in "conflicts" cases remains *San Diego Federal Credit Union v. Cumis Ins. Society,* (1984) 162 Cal.App.2d 358. In *Cumis,* the insured was sued for $750,000 in general damages, and $6.5 million in punitive damages for tortious wrongful discharge, breach of the covenant of good faith and fair dealing, wrongful interference with and inducing breach of contract, breach of contract and intentional infliction of emotional distress. The insurer agreed to provide the insured a defense against the entire action and retained defense counsel, but *reserved its right* to deny coverage for any punitive damages liability. *Id.,* at 362. The insured retained its own counsel and demanded that the insurer pay for it. Although the insurer in fact paid two invoices, it later denied any further responsibility to pay for the insureds' independent counsel. The insured then brought an action against the insurer.

The court in *Cumis* recognized that when the insurer is providing a defense under a reservation of rights, "reservation of rights,"[2] the usual shared goal of minimizing or eliminating liability to the third-party claimant may not exist. The court in *Cumis* expanded and clarified prior caselaw that recognized that "[i]n actions in which . . . the insurer and insured have conflicting interests, the insurer may not compel the insured to surrender control of the litigation." *Tomerlin v. Canadian Indem. Co.*, (1964) 61 Cal.2d 638, 648. Following *Tomerlin,* the court of appeal in *Executive Aviation, Inc. v. National Ins. Underwriters*, concluded 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." *Id.*, (1971) 16 Cal.App.3d 799, 810. *Cumis,* explained the basis of the rule requiring the insurer to pay for the insured's "independent counsel" in conflict of interest situations:

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1 For a more detailed analysis of these issues and the case law that has emerged in specific jurisdictions, the reader is referred to the numerous law review articles that have been published on these issues, including : Douglas R. Richmond, *Liability Insurers' Right to Defend their Insureds*, 35 Creighton L Rev. 115 (2001); Robert H. Jerry, II, *The Insurer's Right to Reimbursement of Defense Costs*, 42 ARIZ. L. REV. 13 (2000); Ellen S. Pryor, *The Tort Liability Regime and the Duty to Defend*, 58 MD. L. REV. 1 (1999); William T. Barker, *Insurance Defense Ethics and the Liability Insurance Bargain*, 4 CONN INS. L.J. 75 (1997-98).

2 "A reservation of rights agreement is a notice by the insurer to the insured that the insurer will defend the insured but that the insurer is not waiving any defenses . . . it may have under the policy." *Crawford v. Ranger Insurance Co.,* 653 F.2d 1248, 1252 (9th Cir. 1981).

> The Canons of Ethics impose upon lawyers hired by the insurer an obligation to explain to the insured and the insurer the full implications of joint representation in situations where the insurer has reserved its rights to deny coverage. If the insured does not give an informed consent to continued representation, counsel must cease to represent both. Moreover, in the absence of such consent, where there are divergent interests of the insured and the insurer brought about by the insurer's reservation of rights based on possible non-coverage under the insurance policy, the insurer must pay the reasonable cost for hiring independent counsel by the insured. The insurer may not compel the insured to surrender control of the litigation. Disregarding the common interests of both insured and insurer in finding total non-liability in the third party action, the remaining interests of the two diverge to such an extent as to create an actual, ethical conflict of interest warranting payment for the insureds' independent counsel.

The *Cumis* rule was codified a few years later as California *Civil Code* Section 2860, which provides that that a conflict of interest "may" exist, so to require an insurer to provide the insured "independent counsel"3 at the insurer's expense, if the "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." Stated another way, "[i]t is only when the basis for the reservation of rights is such as to cause assertion of factual or legal theories which undermine or are contrary to the positions to be asserted in the liability case that a conflict of interest sufficient to require independent counsel, to be chosen by the insured, will arise." *State Farm Fire & Casualty Co. v. Superior Court*, (1989) 216 Cal.App.3d 1222, 1226, n. 3.

Cases interpreting the *Cumis* case and its statutory codification hold that the insurer need only pay the customary hourly rate for defense counsel and may require that the counsel selected by the insured possess certain minimum qualifications, including at least five years of civil litigation experience, including substantial defense experience in the subject at issue in the litigation as well as malpractice coverage.

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3 Although *Civil Code* section 2860 speaks of "independent counsel," many cases, counsel and insurers still use the eponym "'*Cumis* counsel,'" based on the *Cumis* case; however *Civil Code* Section 2860 "partially changed the *Cumis* rule." *See, Dynamic Concepts, Inc. v. Truck Ins. Exchange*, (1998) 61 Cal.App.4th 999, n. 1.

> California Civil Code Section 2860 provides, in pertinent part:
>
> (a) If the provisions of a policy of insurance impose a duty to defend upon an insurer and a conflict of interest arises which creates a duty on the part of the insurer to provide independent counsel to the insured, the insurer shall provide independent counsel to represent the insured . . . .
>
> (b) For purposes of this section, a conflict of interest does not exist as to allegations or facts in the litigation for which the insurer denies coverage; however, when an insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim, a conflict of interest may exist. No conflict of interest shall be deemed to exist as to allegations of punitive damages or be deemed to exist solely because an insured is sued for an amount in excess of the insurance policy limits.

"As statutory and case law make clear, not every conflict of interest triggers an obligation on the part of the insurer to provide the insured with independent counsel at the insurer's expense. For example, the mere fact the insurer disputes coverage does not entitle the insured to *Cumis* counsel; nor does the fact the complaint seeks punitive damages or damages in excess of policy limits. The insurer owes no duty to provide independent counsel in these situations because the *Cumis* rule is not based on insurance law but on the ethical duty of an attorney to avoid representing conflicting interests." *Golden Eagle Ins. Co. v. Foremost Ins. Co.,* 20 Cal.App.4th 1372, 1394 (1993). For independent counsel to be required, the conflict of interest must be "significant, not merely theoretical, actual, not merely potential." *." Dynamic Concepts, Inc. v. Truck Ins. Exchange,* 61 Cal. App.4th 999, 1007, 71 Cal. Rptr.2d 882 (1st Dist. 1998).

Likewise, California courts have ruled that Cumis counsel is not required, for instance, where the coverage issue is independent of, or extrinsic to, the issues in the underling action. *Native Sun Investment Group v. Ticor Title Ins. Co.*, 189 Cal. App. 3d 1265, 235 Cal. Rptr. 34 (1987). Nor is there entitlement where the damages are only partially covered by the policy or where some of the claims are covered and others are not. *Dynamic Concepts, Inc. v. Truck Ins. Exchange,* 61 Cal. App.4th 999, 71 Cal. Rptr.2d 882 (1st Dist. 1998)(assertion of right to recover *Buss* fees) and *Foremost Ins. Co. v. Wilks*, 206 Cal. App. 3d 251, 253 (1988) (punitive damages). Further, the conflict must be significant and

actual, not merely theoretical or potential. *Lehto v. Allstate Ins. Co.,* 31 Cal. App. 4th 60, 71, 36 Cal. Rptr. 2d 814 (1994).

However, independent counsel is required where there is a reservation of rights "*and* the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim." § 2860, subd. (b); *Blanchard v. State Farm Fire & Casualty Co.,* 2 Cal.App.4th 345, 350 (1991); *Truck Ins. Exchange v. Superior Court,* 51 Cal.App.4th 985, 994 (1996).

While the *Cumis* doctrine has had a dramatic impact on the way in which courts in other states have addressed these issues, it has not been followed in every state.

A few states have taken a broader view than *Cumis* and have concluded that all reservations of rights create a conflict of interest warranting the retention of independent counsel without regard to whether the coverage dispute is of such a nature that it could influence the manner in which the case is defended. *See, e.g. Three Sons, Inc. v. Phoenix Ins. Co.,* 357 Mass. 271, 274 (1970).

In addition to Massachusetts, other states that appear to follow this "reject the defense" rule that allows an insured to demand independent counsel if the insurer reserves rights on any basis include *Boise Motor Car Co. v. St. Paul Mercury Indem. Co.,* 112 P.2d 1011, 1016 (Idaho 1941); *Medical Protective Co. v. Davis,* 581 S.W.2d 25, 26 (Ky. Ct. App. 1979); *Three Sons, Inc. v. Phoenix Ins. Co.,* 257 N.E.2d 774, 776-77 (Mass. 1970); *State Farm Mut. Auto. Ins. Co. v. Ballmer,* 899 S.W.2d 523, 527 (Mo. 1995); *Merchants Indem. Corp. v. Eggleston,* 37 N.J. 114, 127-28, 179 A.2d 505, 511-12 (1962); *National Mortgage Corp. v. American Title Ins. Co.,* 255 S.E.2d 622, 629-30 (N.C. Ct. App.1979), *rev'd on other grounds,* 299 N.C. 369, 261 S.E.2d 844 (1980).

Other courts have ruled that in the event of a conflict the insurer must allow the insured to select private counsel (paid by the insurer) who must be permitted to control the defense. *See Sauer v. Home Indem. Co.,* 841 P.2d 176, 182-3 (Alaska 1992) and *Grube v. Daun,* 496 N.W.2d 106, 123 (Wis. Ct. App. 1992).

Another approach is to give the insurer a choice to either employ independent counsel to control the defense or permit the insured to select private counsel (to be compensated by the insurer) to control the defense. *See Michigan Millers Mut. Ins. Co. v. Bronson Plating Co.,* 496 N.W.2d 373, 378 (Mich. App. 1992) and *L&S Roofing Supply Co. v. St. Paul Fire & Marine Ins. Co.,* 521 So.2d 1298, 1304 (Ala. 1987).

A second approach is to permit the insured to select counsel subject to the insurer's approval. *See Employers Fire Ins. Co. v. Beals,* 240 A.2d 397, 404 (R.I. 1968). Likewise, in states such as Florida, the insurer does not lose control of the selection of counsel in the event of a conflict but is required to appoint counsel

that is acceptable to the policyholder.. *Continental Ins. Co. v. Miami Beach*, 520 S.2d 232, 233 (Fla. App. 1988)(Fl. St. 627.426(2) provides that insurer and insured should jointly select "mutually agreeable" counsel).

At the other end of the spectrum, a few states have declared that a liability insurer that is defending its insured under a reservation of rights has no obligation to pay for independent counsel for the insured. In Hawaii, for instance, the state supreme court reversed the findings of the Hawaii Court of Appeals, which had adopted a *Cumis* approach, and instead held in *Finley v. Home Ins. Co.,* 975 P.2d 1145 (Hawaii 1998) that the best course of action is to avoid interfering with the insurer's contractual right to retain defense counsel and to leave the resolution of the conflict to the integrity and professional standards of conduct mandated for defense counsel

A few states have also declared that the insurer need not give up control of the defense but will thereafter be judged by a standard of "enhanced good faith*." L&S Roofing Supply Co., Inc. v. St. Paul Fire & Marine Ins. Co.,* 521 So.2d 1298, 1304 (Ala. 1987); *Furguson v. Birmingham Fire Ins. Co.,* 460 P.2d 342, 348 (Or. 1969) and *Tank v. State Farm Fire & Casualty Co.,* 715 P.2d 1133 (Wash. 1986)

Even in jurisdictions that follow the *Cumis* approach, not every reservation of rights entitles an insured to select its own counsel. A liability insurer has the right to appoint defense counsel, even where it has reserved its rights on one or more coverage issues, unless an actual conflict of interest exists that would permit the manipulation of evidence towards non-covered bases for liability. *Mutual Service Cas. Ins. Co v. Luetmer,* 474 N.W.2d 365 (Minn. App. 1991).

For the most part, however, courts have refused to find that a disagreement about litigation strategy gives rise to a conflict or that an insured can hire counsel of its own choosing merely because it does not approve of or like the lawyers appointed by its insurer (assuming that defense counsel is otherwise competent to handle such work).

A mere dispute with respect to trial tactics does not waive the insurer's right to defend, however. The Texas Supreme Court has ruled that a venue dispute with respect to whether claims arising out of the insured's auto accident should be litigated in Dallas County or Matagorda County were an insufficient "conflict" to warrant a finding that the insurer had forfeited the right to control the defense. Amplifying on dicta in its 1998 *Travers* opinion, the court declared in *Northern County Ins. Co. v. Davalos*, 140 S.W.3d 685 (Tex. 2004), that "every disagreement about how the defense should be conducted cannot amount to a conflict of interest within *Travers* meaning. If it did, the insured, not the insurer, could control the defense by merely disagreeing with the insurer's actions." While outlining various types of coverage disputes or extracontractual demands that might give rise to such a conflict, the Supreme Court declared in this instance that the insured's unwarranted rejection of the defense offered by his

insurer precluded any right to reimbursement of his own defense costs. Also, the court ruled that the insurer's refusal to pay those costs as not a violation of Article 21.55 but sidestepped the issue of whether Article 21.55 is restricted to first party claims.

In contrast to *Davalos*, the Fifth Circuit issued an opinion a few weeks later in *Primrose Operating Co. v. National American Ins. Co.,* No. 03-10861 (5th Cir. August 23, 2004), holding that an insured was entitled to reimbursement for the legal fees incurred by independent counsel that it had retained to buttress the work performed by the law firm retained by the insurers in a pollution case. The court ruled that the insurer's reservation of rights and the risk of an uninsured exposure warranted the insured's decision to retain additional counsel. *See also National Union Fire Insurance Company v. Circle, Inc.,* 915 F.2d 986, 991 (1990)(holding that insured could reject the counsel appointed by the insurer and compel payment of the fees for its own attorneys if the defense counsel provided by the insurer was obviously inadequate).

Earlier, the Fifth Circuit had suggested that these holdings should be limited to cases in which appointed defense counsel wasn't vigorously defending the insured. In *Trinity Universal Insurance Company v. Stevens Forestry Service, Inc.,* No. 02-30442 (5th Cir. June 18, 2003), the court ruled that the fact that the underlying case was complicated did not warrant imposing an obligation on the insurer to also pay for the insured's own attorneys where there was no evidence that the appointed defense counsel was failing to vigorously and adequately defend the insured. Likewise, the mere fact that the insurer had written to its policyholder encouraging them to retain counsel of their own choosing and at their own expense in light of the fact that most of the claims were not covered under the policy did not, in the Fifth Circuit's opinion, warrant any additional obligation on the part of the insurer to also pay for independent counsel.

Likewise, the U.S. Court of Appeals for the 4th Circuit ruled in *Driggs Corp. v. Pennsylvania Manufacturers Association Ins. Co.,* 181 F.3d 87 (4th Cir. 1999)(Unpublished—full text available at 1999 U.S. App. LEXIS 9182) an environmental liability case that insurers were not required to pay the fees of "shadow counsel" (Kirkpatrick & Lockhart) merely due to K&L's belief that the five attorney defense firm retained by the carriers was not up to the job.

Similarly, in *Herbert A. Sullivan, Inc. v. Utica Mutual Ins. Co.,* 439 Mass. 837, 788 N.E.2d 522 (2003), the Supreme Judicial Court of Massachusetts declared that if an insured has already "acquiesced" in its insurer's selection of counsel, it may not later demand that the insurer also pay for shadow counsel that the insured selected to augment the defense being provided by the insurer's defense counsel.

In *State of Wisconsin v. City of Rhinelander*, 2001 WL 1155667 (Wis. App. October 2, 2001), District III of the Wisconsin Court of Appeals rejected an

insured's argument that it was entitled to reimbursement for fees incurred by its personal counsel based on a claimed conflict with respect to the law firm that its insurer had assigned to the claim or questions concerning the qualifications of assigned defense counsel. The court found that "there is no breach of the duty to defend as a matter of law merely because the attorney hired by the City represented the insurance companies in other litigation." Nor did the court accept the insured's argument that it was forced to continue to pay its own attorneys because it took several months to confirm the qualifications of the lawyer appointed by the insurer. The court held that an insurer has the right to appoint defense counsel without input from the insured and that to accept the City's argument "would allow an insurer to select its own attorney at the insurer's expense.

B. Independent Counsel's Ethical Considerations - Billing and Privilege Issues

An insured's independent counsel has certain special ethical constraints to consider that are somewhat unique to the insurance defense context.

For instance, an independent counsel's billing rate and billing practices are subject to a certain amount of insurer control. For instance, California *Civil Code* Section 2860(c), the statutory codification of the *Cumis* case, expressly provides that "[t]he insurer's obligation to pay fees to the independent counsel selected by the insured is limited to the rates which are actually paid by the insurer to attorneys retained by it in the ordinary course of business in the defense of similar actions in the community where the claim arose or is being defended." Accordingly, insurers still get the advantage of the volume discounts they usually negotiate with defense firms in most markets. Insured selected Independent counsel are often shocked by the panel defense rates most carriers pay and demand that the insured make up the difference between the insurer's panel defense counsel rate and the counsel's "market rate." In one reported case, the court rejected the insured's attempt, where several insurers where providing it independent counsel, to combine the insures' defense funding payments to make up the difference between the insurers' *Cumis* rate and the attorney's regular hourly rate; in other words, independent counsel was not entitled to a separate fee from each of the insurers involved. *San Gabriel Valley Water Co. v. Hartford Acc. & Indem. Co.* (2000) 82 Cal.App.4th 1230, 1239-1242.

"While *Cumis* may prohibit an insurer from dictating the tactics of litigation, it does not delegate to *Cumis* counsel a meal ticket immunized from judicial review for reasonableness." *United Pacific Ins. Co. v. Hall*, (1988) 199 Cal.App.3d 551, 557. Thus, even before *Civil Code* Section 2860 was enacted, California courts recognized that the *implied covenant of good faith and fair dealing* imposed on insured's "the obligation to act reasonably in selecting as independent counsel an experienced attorney qualified to present a meaningful defense and willing to engage in ethical billing practices susceptible to review at

a standard stricter than that of the marketplace." *Center Foundation v. Chicago Ins. Co.,* (1991) 227 Cal.App.3d 547, 560. The court in *Center Foundation* further stated that '[c]onduct arguably acceptable in the ordinary attorney client relationship where the latter pays the former from his own pocket is not necessarily appropriate in the tripartite context created when independent counsel undertakes to represent the insured at the expense of the insurer. This is not a new concept."

In light of *Center Foundation,* insured's independent counsel often find themselves subject to insurance company billing rules and guidelines. In Montana, the defense bar successfully challenged such guidelines.4 In California, the court of appeal questioned "the wisdom and propriety of so-called 'outside counsel guidelines'" in conflict of interest situations." *Dynamic Concepts, Inc. v. Truck Ins. Exch*., (1998) 61 Cal.App.4th 999, 1009. In that case the court stated "[u]nder no circumstances can such guidelines be permitted to impede the attorney's own professional judgment about how best to competently represent the insureds. If the attorney's representation is to be limited in any way that unreasonably interferes with the defense, it is the insured, not the insurer, who should make that decision." Nonetheless, the court in that case found that the guidelines in question were not improper.

Another major ethical consideration concerns privilege issues. California *Civil Code* Section 2860(d) expressly provides that "it shall be the duty of [independent] counsel and the insured to disclose to the insurer all information concerning the action except privileged materials relevant to coverage disputes, and timely to inform and consult with the insurer on all matters relating to the action." Thus, consistent with counsel's ethical and legal obligations to the insured, independent counsel must cooperate fully in the exchange of information on all matters relating to the action. *See, Assurance Co. of Am. v. Haven,* (1995) 32 Cal. App. 4th 78, 87-88.

A final set of ethical issues to note concern the insurer's right to select its own counsel to serve as co-counsel with the insured's independent counsel. *Civil Code* Section 2860(f) provides an insurer's right to retain its own counsel, and imposes an express cooperation duty on the insured's independent counsel: "both the counsel provided by the insurer and independent counsel selected by the insured shall be allowed to participate in all aspects of the litigation. Counsel shall cooperate fully in the exchange of information that is consistent with each counsel's ethical and legal obligation to the insured." The flip side is also true: the insurer's shadow counsel cannot exclude the insured's independent counsel from participating in settlement negotiations. *See, Novak v. Low, Ball & Lynch,* (1999) 77 Cal.App.4th 278, 284-285.

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4 In a unanimous decision, the Montana Supreme Court held in 2000 that insurer-imposed billing rules and procedures violated Montana's *Rules of Professional Conduct. See, Inre Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedures,* 2 P.3d 806 (Mont. 2000).

C. Whether Separate Defense Counsel are Required in Additional Insured Situations

The starting point to answer the question of whether separate defense counsel is required in multiple insured cases is the applicable *Rules of Professional Conduct.* For instance, Rule 3-310(C) of the *California Rules of Professional Conduct* provides:

> (C) A member shall not, without the informed written consent of each client:
>
> (1) Accept representation of more than one client in a matter in which the interests of the clients potentially conflict; or
>
> (2) Accept or continue representation of more than one client in a matter in which the interests of the clients actually conflict;

Similarly, Rule 1.7 of the *Model Rules of Professional Conduct* provides:

> (a) A lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless:
>
> (1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and
>
> (2) each client consents after consultation.
>
> (b) A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:
>
> (1) the lawyer reasonably believes the representation will not be adversely affected; and
>
> (2) the client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.

California state courts have addressed claims for separate defense counsel in a number of cases and have held that separate defense counsel is required if there is an "*actual*" conflict between insureds; but separate defense counsel is not required if there only exists a "*potential*" conflict of interest. *See, Lehto v. Allstate Ins. Co.,* (1994) 31 Cal.App.4th 60, 71; *Spindle v. Chubb/Pacific Indemnity Group*, (1979) 89 Cal.App.3d 706, 713 ("none of the three conflicts in interest alleged constitute an actual conflict of interest between the two codefendants and without such actual conflict between jointly represented persons, there is no actionable impropriety in their joint representation.") Although joint representation is permissible in California if the conflict is only "potential," defense counsel is still needs the informed written consent, as required by Rule 3-310(C) of the *California Rules of Professional Conduct.* The Ninth Circuit has not always recognized the *potential*/*actual* conflict distinction. *See, e.g., St. Paul Fire & Marine Ins. Co. v. Weiner,* 606 F.2d 864, 870 (9th Cir., 1979)("it is questionable whether St. Paul can discharge its duty to defend the individual partners by representing the partnership alone, because the defendants' interests may conflict with those of the other members of the firm.")

Outside of California, some states have followed the "actual" *versus* "potential" conflict of interest dichotomy, but other states, seem to rarely allow joint representation of multiple insureds.

In *Dairy Farmers of Am., Inc. v. Travelers Ins. Co.*, 292 F.3d 567, 573-574 (8th Cir. 2002), the court noted that although Missouri has yet to decide whether an insurer's duty to defend includes an obligation to address conflicts of interest arising between insureds, applying general attorney-client rules it stated that "joint representation of adverse interests can occur but only after 'complete disclosure and with the express consent of all parties concerned," but "cautioned that certain interests may be so adverse and conflicting, that joint representation, even with disclosure and consent, would violate public policy." Thus, the court concluded that the insurer must (1) 'fully disclose the conflict of interest" to the two insureds; (2) explain the consequences of and alternatives to joint representation, and (3) obtain from both insureds their express consent to joint representation." The court further stated that "[i]n the absence of informed consent, [the insurer's] duty to defend obligated it to appoint separate and independent counsel to represent" the two insureds." *Id.*

In *Brown v. Nat'l Union Ins. Co.*, 2003 U.S. Dist. LEXIS 15933 (D. Minn., 2003), the U.S. District Court, applying Minnesota law and citing *Dairy Farmers of Am., Inc. v. Travelers Ins. Co.*, stated that if an "actual conflict of interest existed," which the insurer knew of or had notice of, the insurer "had a duty to disclose any conflicts it was aware of at the time, explain the consequences of joint representation, and obtain from its insureds their express consent to joint representation."

States rarely allowing joint representation include Hawaii, New Jersey and in Pennsylvania. Courts in those states have held that in multiple insured

situations, each insured was entitled to separate counsel because a conflict of interest existed regarding the separate insured's potential insurance coverage for the underlying claims. In *Yeomans v. Allstate Insurance Company*, 130 N.J.Super. 48, 54, 324 A.2d 906 (App.Div.1974), the court stated that "[a] liability insurer that insures codefendants whose interests conflict with one another must retain separate and independent counsel for each insured or permit each insured to do so at the insurer's expense." Ten years later, a New Jersey court explained that although "it may be that in a particular case the separate attorneys would manage the case the same way as one attorney representing all insureds,"… "where there is the risk of a judgment that will exceed the policy limit, separate independent counsel for each insured must be employed to decide whether and how to act in light of the conflict." *Wolpaw v. Gen. Accident Ins. Co.*, 272 N.J.Super. 41, 44,639 A.2d 338, 340 (N.J. Super. Ct. App. Div. 1994).

Cases concerning additional insureds situations have generally held that the additional insured was entitled to its own separate defense counsel.

For instance, in *Consolidated Rail Corp. v. Hartford Acc. & Indem. Co.*, the insurer had issued a Railroad Protective Liability Policy to Consolidated Rail Corporation (Conrail); and a contractor doing work for Conrail was listed an additional insured. *Id.,* 676 F. Supp. 82, 86 (D. Pa 1987). The contractor admitted damaging a Conrail crossing gate, so as to dislodge a signal light, which dangling light struck and injured a Conrail employee. The employee brought a Federal Employers' Liability Act action against Conrail, which later apparently cross-complained against the contractor as a third-party defendant. Thus, one of the issues in the underlying personal injury action was the allocation of liability between the named insured and additional insured. The court noted that "[i]t is not unusual for an insurance carrier to insure opposing interests in a particular case." *Id.,* 86. Because the insurer had the duty to provide competent counsel to represent both insureds' interests, the court stated that "[o]ne appropriate resolution is for the insurer to obtain separate, independent counsel for each of its insureds, or to pay the costs incurred by an insured in hiring counsel." *Id.*

The Supreme Court of Hawaii also found that separate defense counsel would be required for the named insured and additional insured both sued in an underlying personal injury action because "a potential conflict between the interests of the [additional insured] and [named insured] is apparent." *First Ins. Co. v. State, 66 Haw*., 413, 422, 665 P.2d 648 (Haw., 1983). The insurance policy at issue was a comprehensive liability insurance policy issued to a contractor (named insured). The contractor was building a public highway and was required to name the State of Hawaii as an additional insured. On the morning of the day after the highway was opened, a two-car accident occurred, resulting in the death of one of the drivers. The heirs filed an action against the contractor and the state. The insurer had retained separate defense counsel for the named insured (contractor) and the additional insured (State).

After defending both insured against the underlying action, the insurer in *First Ins. Co. v. State* brought a declaratory relief claim against the additional insured for the defense fees and judgment it had paid for the underlying action. The court, after concluding that the insurer owed the additional insured a duty to defend the entire action,5 held "[w]here the interests of such codefendants do not coincide, the insurer is required to provide separate counsel by selecting independent outside counsel for each insured."

For those jurisdictions like California that permit joint representation of multiple insureds, cases have considered insureds' demands for separate counsel in a variety of contexts. The cases provide certain themes or frameworks for evaluating demands for separate defense counsel.

In *Spindle v. Chubb/Pacific Indem. Group*, (1979), 89 Cal.App.3d 706, the California Court of Appeal addressed an insured doctor's claim that separate counsel were required for the defense of an underlying malpractice case brought against him and another surgeon. The two insured doctors, David Spindle and Chester McReynolds, in that case were insured under separate policies issued by Chubb/Pacific Indemnity Group, which policies even had different limits - $500,000 for Reynold's policy and $1,000,000 for Spindle's policy. Chubb retained one law firm to defend both doctors. The court rejected Spindle's claims that separate counsel were required because the two doctors/ insureds / defendants had different maximum amounts of insurance protection and their respective potentials for liability differed. The court stated: "The difference in the personal exposure of the two insureds resulting from the difference in their maximum coverage, by itself and without more, creates no actual conflict of interest between them in the matter of their joint representation.... Similarly, the difference in the potential for liability of the two insureds, standing alone, does not necessarily result in an actual conflict of interest between them so far as their joint defense is concerned." *Id.,* at 713. *See also, Lehto v. Allstate Ins. Co.* (1994) 31 Cal.App.4th 60 (court rejected a bad faith claim based on the insurer's failure to appoint separate counsel to defend the named insured and his teenage son, even though there was a potential conflict of interest because the father

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5 The insurer contended that its defense obligation to the additional insured was limited because the policy provided "coverage to the [additional insured] with respect to any liability 'arising out of' [the named insured's] operations …" but the policy also excluded coverage for claims "'arising out of any act or omission of the additional insured or any of his employees, other than general supervision of work performed for the additional insured by the named insured.'" *Id., 66 Haw.*, 413, 424. *See, also, Presley Homes Presley Homes, Inc. v. American States Ins. Co.*, (2001) 90 Cal.App.4th 571 (holding that insurer owes additional insured defense against entire action, even though potential coverage only limited to liability arising from the named insured's acts or omissions.)

might be separately liable to the underlying claimant on a negligent entrustment theory).

In more recent cases, California courts have found that there actual conflicts of interest in multiple insured cases. For instance, in an unpublished decision (which cannot be cited), the court of appeal held that separate defense counsel were required for the defense of a doctor and hospital, even though the policy provided that that the individual doctor "would accept a 'common defense of all claims," by a single attorney or law firm retained to represent all insureds, thus 'waiving and relinquishing his rights to be independently represented in any such claim.'" *Donald v. Truck Ins. Exch*., 2004 Cal. App. Unpub. LEXIS 2859, 1, 42 (California Unpublished Opinions, 2004). Citing *Spindle,* the court held that there were at least triable issues of fact to preclude summary judgment on the separate defense counsel claim, including because "'all the defendants [were] pointing the finger at each other . . . .'" *See also, Mosier v. Southern Cal. Physicians Ins. Exchange* (1998) 63 Cal.App.4th 1022 (court held insurer subject to breach fiduciary duty claim for providing a courtesy defense to a doctor who was not an insured, based on allegation that joint medical malpractice defense sought to minimize comparative fault of two insured physicians *vis-a-vis* the third doctor that it was providing the courtesy defense).

Further, although differences in insurance coverage do not *per se* create an *actual* conflict, courts have found that an actual conflict of interest may exist where the insurer acknowledges coverage for one defendant, but denies coverage for the other. For instance, in *Industrial Indem. Co. v. Great American Ins. Co.* (1977) 73 Cal.App.3d 529, an employee of one of the insured's subcontractors was killed on the job. The employee's heirs sued, among others, the insured, and the city which had contracted to have the insured do the work. The insurance policy named the city as an additional insured, but the policy had an exclusion, which only applied to the additional insured city, for "'active, independent negligent conduct.'" The insurer retained one counsel to defend both the contactor and the city. About two months before trial, defense counsel acquired knowledge the city was actively negligent and, on the eve of trial, he sent a reservation of rights letter to the city and hired independent counsel to represent it.

The court in *Industrial Indem. Co.* held that the city was entitled to separate defense counsel because the defense attorney was "bound to investigate all conceivable bases on which City might be liable . . . These might run the gamut from active negligence on the part of a City employee . . . to wholly vicarious liability for the acts or omissions of (Contractor)." *Industrial Indem. supra,* 73 Cal.App.3d at 535. But the court's holding is explained by some additional facts: The insurer settled the underlying case and then sued the city and its other insurer in declaratory relief for reimbursement, using the same counsel it had retained to defend the third party suit. *See also, Allstate Ins. Co. v. ,* (1973) 31 Cal.App.3d 391, 397 (court held that Allstate was required to

provide separate defense counsel because differences in liability between named insured and additional to the underlying claimant and impact that had on coverage).

The rule from the above cases is that both the insurer and defense counsel in multiple insured situations have to evaluate whether the joint representation requires separate defense counsel, and perhaps even separate independent defense counsel. If there is a *potential* conflict of interest between the insureds, even regarding coverage issues extraneous to the underlying third-party liability case, both defense counsel and the insurer may want to consider obtaining informed written consent of such representation.

D. Insurance Company Claims Handling Issues in Multiple Policyholder Situations

As also discussed in the next section regarding the "duty to settle," additional insured and multiple insured situations cause special claims handling challenges to insurers. At least in the context of independent counsel or *Cumis* counsel situation, courts have been rejected claims that insurers are required to erect ethical walls and appoint separate adjusters to handle the claim and coverage files. *State Farm Fire & Cas. Co. v. Superior Court,* (1989) 216 Cal.App.3d 1222, 1227 ("we conclude it would be unwise to impose yet another layer of administration.")

Following that case, also in the *Cumis* context, at least one court held that an insurer's outside coverage counsel can serve both as the insurer's shadow counsel for the underlying third-party claims and its coverage counsel in the coverage dispute. *See, Employers Ins. of Wausau v. Albert D. Seeno Constr. Co.,* 945 F.2d 284, 286 (9th Cir., 1991) (The insured "asserts, where the carrier reserves its right to assert a coverage defense, it must use different people on the liability side and the coverage side, without exchange of information between them. This court concludes that California law is to the contrary.")

Outside of the *Cumis* context, the need for separate adjusters was recognized long ago if the two or more insureds are on the opposite sides of a dispute, *e.g.,* tortfeasor and accident victim. In *O'Morrow v. Borad*, (1946) 27 Cal.2d 794, 167 P.2d 483, both parties to an automobile accident had liability insurance policies issued by the same insurer. Insured #1 sued Insured #2, and Insured #2, through counsel retained by him, filed a cross-complaint for damages against Insured #1. Insured #2 notified the insurer that his own counsel would also present his defense to Insured's #1's cause of action. Nonetheless, the insurer insisted on retaining its own but separate counsel for each of insureds. The court rejected that, and instead held that Insured #2 was entitled his own independent counsel, at the insurer's expense, because the insurer, through its defense counsel, would have access to all information in regard to the entire case. Based on the rule "it is contrary to public policy for a person to control both

sides of litigation," the court concluded that the insurer "may not control the defenses of the two policyholders against their respective claims."

O'Morrow arguably compels that there should be separate adjusters if there is a conflict between the insureds. Under the implied covenant of good faith and fair dealing, an insurer "cannot favor the interests of one insured over the other." *Lehto v. Allstate Ins. Co.* (1994) 31 Cal.App.4th 60, 72. For attorneys advising insurance companies, perhaps the most logical framework to apply is the jurisdiction's *Rules of Professional Conduct*. Academia has already begun to advocate this approach. Law School Professor Jeffrey Parness in a recent article stated that the "time is ripe to discuss and implement broad legal guidelines on third-party adjusting," and suggested that at least third-party adjusters "should be governed by the same or similar professional legal services and civil procedure standards that govern lawyers who facilitate civil claim settlements for their clients." J. Parness, *Civil Claim Settlement Talks Involving Third Parties And Insurance Company Adjusters: When Should Lawyer Conduct Standards Apply?*, 77 St. John's L. Rev. 603, 624 (Summer 2003). If the applicable Rules of Professional Conduct require appointment of separate defense counsel, then there may be a strong argument that separate adjusters should be assigned.

For instance, the need for separate adjusters in separate defense counsel situations may be for preservation of each insured's attorney-client privilege rights. Defense counsel reports and even bills reflect confidential strategy that must be kept confidential. The adjuster in the middle of the conflict is placed in an impossible dilemma of possibly having information that would help one insured but harm the other.

The importance of maintaining the separateness of insureds' claim files is highlighted by the extreme conduct in *Betts v. Allstate Ins. Co.*, (1984) 154 Cal.App.3d 688, which resulted in a $3 million punitive damage award against the insurer. That was a failure to settle automobile accident case, where the insurer went to great lengths to conceal the facts that clearly warranted an early policy limits settlement. In discussing the many reasons why the bad faith and punitive verdicts were being affirmed, the court of appeal listed the insurer's "disreputable practice of violating its duty to one insured by 'backdooring'--examining into the cross-file of another--suggests an intent to defraud or oppress its own clients." *Id.,* at 709. Both the driver and accident victim were insured under separate policies. Discovery in the bad faith case revealed that the insurer had a "general practice" of "'backdooring' (invasion of cross-files)," *e.g.,* to disguise the transfer of information between the insured/accident victim's first-party (medical payment) claim file and the third-party claim file, the district casualty claims manager "crossed out the file marks identifying it as part of [accident victim's] medical payments claim and substituted a styling to indicate the material originated in connection with [accident victim's] injury claim against [the other insured]." *Id.,* at 700-701.

III. CONFLICTS OF INTEREST AND THE DUTY TO SETTLE

Insurers may also face claims of bad faith where their duty to settle is at issue. Specifically, what should an insurer do where, despite its best efforts, its policy limits are only sufficient to resolve some of the claims against its insureds. Is it bad faith to pay the limits under such circumstances, immunizing some insureds against liability but leaving others without coverage? Alternatively, is it bad faith not to enter into such a partial settlement, since the failure to do so leave all the insurer's policyholders at risk of an excess verdict.

A. Jurisdictions Imposing Extracontractual Liability

1. California

In resolving duty to settle claims involving multiple insureds, California courts start with the basic proposition that an "insurer owes the duty of good faith and fair dealing to each of its insureds, and cannot favor the interests of one insured over the other." *Lehto v. Allstate Ins. Co.*, (1994) 31 Cal.App.4th 60, 72. Thus, California courts have ruled that an insurer must act to protect the interests of all of its insureds and cannot pay its limit to settle claims against one insured that would leave other insureds bare. *Shell Oil Co. v. National Union Fire Ins. Co. of Pittsburgh,* 44 Cal.App.4th 1633, 52 Cal.Rptr.2d 580 (1996)(insurer had continuing good faith obligations to co-insured and could not terminate its policy obligations by paying its policy limits to settle claims against only one insured); *Strauss v. Farmers Ins. Exchange*, (1994) 26 Cal.App.4th 1017, 1021-22, 31 Cal.Rptr.2d 811 (The court held that the insurer had no duty to accept a settlement offer exhausting the policy in exchange for the release of only one of its three insureds. The court said that the insurer's duty extended to all of its insureds, and that acceptance of a settlement offer leaving two of them bereft of coverage would have breached the insurer's implied covenant of good faith and fair dealing); *Cf. Rankin v. Curtis,* 183 Cal. App. 3d 939, 228 Cal. Rptr. 753 (1986) (insurer breached duty of good faith and fair dealing by not informing the additional insured of a lawsuit filed against the named insured and by providing her with *Cumis* counsel).

In *Shell Oil Co. v. National Union Fire Ins. Co.*, 44 Cal. App.4th 1633, 1646 52 Cal. Rptr.2d 580 (1996), the Court of Appeals ruled that even though an insurer believed that it would have been liable to bad faith had it failed to effect a partial settlement of the claims against one policyholder in return for the payment of policy limits, it had thereby breached its obligations to other insureds by paying its limits. The court concluded that, "When there is more than one insured, an insurer owes the duty of good faith and fair dealing to each of its insureds and cannot pay over the interests of one insured over the other."

In *Lehto v. Allstate Ins. Co.*, 31 Cal. App.4th 60, 36 Cal. Rptr.2d 814 (1994), the underlying claimant demanded payment of the policy's full limits for release of one insured while leaving him free to pursue claims against the other

insured under the policy. The California Court of Appeal declared that insurers should not be forced to make claims decisions based upon which of their policyholders had adequate independent financial resources that would enable them to resist the underlying claims without the benefit of insurance since such a resolution would encourage tort claimants to pursue defendants with limited resources and leaving the corporate defendant with deeper pockets to defend the claim alone. The Court of Appeal concluded that had the insurer agreed to settle the claim on behalf of the operator only, "It would have left one of its insureds bereft of coverage, an act of bad faith." 31 Cal.4th at 75.

2. New York

New York, which otherwise takes a relatively conservative approach to bad faith claims, is among the few that have found that an insurer breaches the implied covenant of good faith and fair dealing with it pays its policy limits to resolve the claims against some but not all of its insureds

In *Smoral v. Hanover Ins. Co.*, 37 A.D.2d 23, 322 N.Y.S.2d 12 (1971), Leonard Smoral was sued by Whitaker, who was injured while a passenger in a car being driven by Smoral. Hanover initially denied coverage on the grounds that the vehicle had been sold by its insured to Smoral prior to the accident but eventually took over the defense of all defendants after a court declared that it owed coverage to Smoral. Subsequently, however, Hanover settled with the plaintiff on behalf of the vehicle owner and its President for its policy limits and withdrew its defense of Smoral. Glen Falls, Smoral's personal insurer, assumed its policyholder's defense and settled the claims for $32,500, for which it brought suit against Hanover.

Although the Supreme Court dismissed Glen Falls' suit, the Appellate Division ruled that Hanover owed Smoral a duty of good faith and fair dealing as an additional insured under the policy it had issued to the vehicle owner. The court declared that:

> Good faith in this connection means more than an absence of intent to harm. It means an inadequate protection of the interests of the assured…While this duty has most frequently been considered where the interests of the company have been preferred to the detriment of the insured…the same considerations would apply with equal force where the company preferred one of its insureds over another. It is no answer for the company to say that it paid the full amount of its policy if in doing so it fully protected one of its insureds and left the other completely exposed. While it is easy to see why Hanover acted as it did – the insured it protected was a policyholder, the one whose rights it ignored was an insured and was by

> law required to defend – there was no legal justification for its preferring one over the other.

322 N.Y.S.2d at 14.

B. Jurisdictions Rejecting Extracontractual Liability

In contrast to this New York analysis, courts in California, Florida, Illinois, Missouri, and Texas have concluded that insurers are free to effect a settlement for policy limits on behalf of some of their insureds but not all where such payments are made pursuant to good faith settlements and the insurer's inability to effect a more comprehensive settlement is beyond the insurer's control. *See Matter of Vitek, Inc.*, 51 F.3d 530 (5th Cir. 1995)(Texas law)(holding that there is no general prohibition against a liability insurer paying policy limits to resolve some but not all claims).

1. California

In contrast to *Shell*, the Court of Appeal has ruled that in appropriate circumstances, an insurer does not act in bad faith in paying policy limits to settle claims that leave some insureds unprotected.

In *Strauss v. Farmers Insurance Exchange*, 26 Cal.App.4th 1017, 31 Cal. Rptr.2d 811 (1994) the court ruled that a liability insurer had not acted in bad faith in refusing to accept a settlement offer that would have exhausted its policy limits but would not have resulted in a full release of all of the underlying claims against the separate insureds under the Farmers' policy.

Strauss was injured as a result of a collision involving Senseney, an employee of New Wave Pool and Spa, the named insured under the policy issued by Farmers with limits of $100,000 per person and $300,000 per occurrence. Strauss offered to settle his claims in return for a payment of the Farmers' policy limit but conditioned this settlement upon a release of Senseney only*. Id.* at 2020. Farmers rejected the offer as it did not extend to New Wave or its owner, Fagundes. Strauss responded that it would release all three insureds for a total payment of $950,000, which offer was rejected by Farmers. The plaintiff proceeded to settle with Senseney for the $50,000 limit of his personal policy limit with California Casualty along with an assignment for any claim of bad faith he might have against his employer's insurer.

On appeal from an entry of summary judgment for Farmers, the California Court of Appeal ruled that a liability insurer's good faith obligations extend to all policyholders and as a result the insurer may in good faith reject a settlement offer that does not effect a release of claims against all of the insurer's policyholders. *Id.* at 1021. In contrast to the analysis of cases such as *Smoral*, the California Court of Appeal ruled that the insurer would have in fact acted in bad faith by accepting a settlement offer that would have left two of the three entities that were insured under its policy without coverage. The court noted that

imposing bad faith in some circumstances places insurers in a catch-22 situation wherein they might be held liable for either settling or refusing to settle. *Id.* at 2022.

2. Illinois

Illinois courts have likewise ruled that an insurer may enter into good faith settlements that resolve claims against certain policyholders even if they do not extinguish the liability of all parties entitled to claim coverage under the policy. *Pekin Ins. Co. v. Home Ins. Co.*, 479 N.E.2d 1078 (Ill. App. 1985) and *Country Mut. Ins. Co. v. Anderson*, 628 N.E.2d 499, 501 (Ill. App. 1993).

The *Smoral* analysis was rejected by the Appellate Court of Illinois in *Pekin Ins. Co. v. Home Ins. Co.*, 479 N.E.2d 1078 (Ill. App. 1985). Joseph Vilet was injured in an automobile accident with a vehicle driven by an employee of the Chicago White Sox. At the time of the accident, the employee had personal auto coverage with Pekin and was also entitled to coverage under the commercial automobile liability policy issued to the Chicago White Sox by Home. After Pekin agreed to resolve the claims against its policyholder for $25,000, Home sued Pekin contending that its conduct had acted in bad faith since its settlement had left the White Sox open to future liability.

The Appellate Court rejected Home's contentions, declaring that the *Pekin* settlement might actually benefit Home to the extent that the plaintiff's claims were less than the settlement amount and in any event had not resulted in a real injury to the White Sox and had not met the standard of "unreasonable and outrageous behavior" necessary to satisfy a claim for bad faith under such circumstances. 479 N.E.2d at 1081.

A decade later, the Illinois Appellate Court ruled in *Country Mut. Ins. Co. v. Anderson*, 628 N.E.2d 499, 501 (1993), *appeal denied*, 633 N.E.2d 4 (Ill. 1994) that the primary insurer had not acted in bad faith in entering into a partial settlement where it had sought to extinguish claims against all of the policyholders but had been unable to do so in light of the refusal of the excess carrier to release funds sufficient to effect a global settlement. The court ruled that, "It is an insurer's unreasonable failure to pursue a settlement offer, rather than its acceptance of one, which will expose it to liability for bad faith." 628 N.E.2d at 503.

3. Florida

In *Underwriters Guaranty Ins. Co. v. Nationwide Mut. Fire Ins. Co.*, 578 So.2d 34 (Fla. App. 1991), the District Court of Appeal ruled that an insurer's decision to pay its policy limits extinguished its duty to provide a defense to other entities who had asserted a claim under the policy inasmuch as there was no dispute that the settlement in question was a good faith resolution of the potential liabilities of the settled insured.

4. Missouri

In *Millers Mut. Ins. Assoc. of Illinois v. Shell Oil Co.*, 959 S.W.2d 864 (Mo. App. 1997), the operator of a gasoline service station company purchased liability insurance from Millers Mutual and, pursuant to an operating agreement with Shell, included Shell as an additional insured under its policy. After a gruesome case in which a patron was abducted from the service station and later assaulted and killed, Millers Mutual provided a defense to both the station operator and Shell but eventually paid its policy limit of $500,000 to settle the claims against the operator since the plaintiff had made clear that settlement could only be achieved for this sum as to the operator and refused to proceed with settlement negotiations that would have included Shell and would have pursued a bad faith action against Millers Mutual if it had refused to enter into a settlement in exchange for its policy limits. Despite Millers Mutual's attempt to offer its policy limits to effect a settlement of both the operator and Shell, it was ultimately unable to do so and paid its limits solely to effect a settlement for the operator. The insurer therefore terminated its defense of Shell and filed a declaratory judgment action seeking a determination that it had no further obligation to provide a defense to Shell.

After the trial court agreed with the insurer, the Missouri Appeals Court ruled that the *Smoral* analysis was limited to cases in which the insurer's payments of its policy limits were pursuant to an unreasonable settlement. Where, as here, the insurer had effected a resolution of the underlying claims as to certain policyholders based upon a *bona fide* and reasonable settlement of certain (but not all) claims, the court refused to find that the insurer had acted in bad faith, particularly where the insurer had previously done its best to effect a more comprehensive settlement. 959 S.W.2d at 871-72("we hold an insurer relying on unambiguous policy language may terminate his duty to defend an additional insured when the policy limits are exhausted in a good faith settlement on behalf of the named insured").

5. Texas

Under Texas law, an insurer is free to pay its policy limits to settle one of several claims against its insured notwithstanding the fact that extinguishing its policy limits will leave the insured exposed to other pending claims. *Texas Farmers Ins. Co. v. Soriano,* 881 S.W.2d 312, 315 (Tex. 1994).

The U.S. Court of Appeals for the Fifth Circuit extended this doctrine to situations involving multiple insureds in *Travelers Indemnity Co. v. Citgo Petroleum Corp.,* 166 F.3d 761 (5th Cir. 1999). The court ruled that whether a settlement was reasonable must be considered in the isolated context of that specific settlement and that an insurer is not required to take into account the claims of additional insureds under the policy.

Citgo Petroleum, a franchisee of Wright Petroleum, sought coverage for wrongful death claims arising out of an automobile accident in which a Wright tanker truck collided with a vehicle driven by Richard Friedrich. Travelers, acting on behalf of Wright Petroleum, paid its $1.5 million policy limit to release the claims against Wright, despite the fact that it became aware during the course of the negotiations that the plaintiffs were refusing to release potential claims against Citgo Petroleum.

The Fifth Circuit refused to find that the failure to resolve claims against all policyholders where the insurer's decision to settle had reflected a good faith evaluation of the liabilities of specific insureds, holding that:

> Fulfillment of this duty will reduce the funds available to satisfy the claims of other plaintiffs over the defense of other insured parties. However, if insurers are subject to both liability for failure to settle…and liability for disparate treatment of non-settling insureds, insurers would find the policy limits they bargained for of little utility…They would be obliged to settle up to the limit of a policy or face a lawsuit by the covered insured as to whom the settlement within policy limits was offered. But if they in fact settled, they would leave themselves open to claims by the insureds excluded from the settlement, and any additional recovery would be in excess of the limits they had originally relied on.

166 F.3d at 764.

Additionally, the court expressed concern that the inability to settle under such circumstances could result in the imposition of liabilities beyond the available policy limits, declaring that:

> While we recognize that the Travelers' position may lead to some strategic behavior on the part of plaintiffs, we are skeptical that the rule proposed by Citgo would better serve the policy goal of encouraging settlements in these cases. In essence, Citgo is asking that the settlement hold out power be given to each insured party, regardless of whether or not it has actually been sued. The difficulty with this position is readily apparent when one considers the type of situations in which *Stowers* intersects with multiple insured policies to produce the dilemma seen here. A valid *Stowers* demand in the context of multiple insureds requires that the settlement offer be reasonable and the insured party reasonably fear

> liability over the policy limits. In other words, for the issue to come up at all there usually has to be an objective possibility that the liability of at least one of the insureds would ultimately exceed the policy limits.
>
> It is almost certain then that no happy compromise will emerge that can settle the case for all of the insureds within the policy limits. Whatever litigation this rule produces will not come at the expense of readily available comprehensive settlements. The mandatory injection of new parties and new issues into settlements that Citgo's rule would likely produce seems calculated to increase the costs of negotiations and decrease the likelihood of their ultimate success.

166 F.3d at 767.

C. Independent Counsel and The Insurer's Right to Settle

However, it has been held that independent counsel's control over the defense does not extend to preventing the insurer from exercising its contractual right to settle a claim as the insurer deems expedient. *W. Polymer Tech., Inc. v. Reliance Ins. Co*. (1995) 32 Cal. App. 4th 14, 22, 38 Cal. Rptr. 2d 78 (involving settlement of claim within policy limits).

IV. MAKING SENSE OF IT ALL

Several general themes are evident in the litigation with respect to the obligation of insurers in cases involving multiple policyholders.

First, an insurer may not take sides. It must make every effort to effect the most global settlement possible and must, at least at the outset, attempt to deploy its policy limits to resolve claims against all policyholders.

The insurer's payment must be pursuant to an actual settlement and may not simply be paid into court or tendered to a party to effect a claimed exhaustion of the insurer's defense obligations.

Even to the extent that the settlement only extinguishes the liability of certain policyholders, that payment must additionally offset the obligations and liabilities of the remaining insureds.