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CHAPTER 15

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INDEPENDENT COUNSEL ISSUES

By: Jamie Cooper & Ernest Martin

I. INTRODUCTION

The issue of independent counsel has been at the forefront of Texas insurance relationships since the Texas Supreme Court issued its decision in *State Farm Mutual Auto Insurance Company v. Traver*.¹ More than a decade later, the issue remains difficult for insureds and insurers alike.

The topic is always included in continuing education courses, like this one, because practitioners want to be kept up to date on the latest developments that may clarify some of the issues in this area. And, despite the Bar and the industry's desire to resolve the issues in this area, the courts have not been as eager to take on the issue. Precedent in this area still allows for situations where the insured may select counsel, but the circumstances where that may occur have narrowed.

II. WHO SELECTS COUNSEL?

A. The Eight Corners Rule.

In determining an insurer's duty to defend a policyholder, Texas courts utilize the "eight corners rule." That rule requires a comparison of the allegations in the pleadings against the terms of the insurance policy.² If the pleadings allege facts within the scope of the policy's coverage, then an insurer has a duty to defend. Once the insurer's duty to defend is established, the next question which must be addressed is whether the insurer or the insured has the right to choose the insured's defense counsel.

B. The Insurer's Defense of the Insured.

An insurance company can tender its insured two different types of defense: (1) a defense subject to a reservation of rights or (2) an unqualified defense, *i.e.*, one in which the insurer does not reserve the right to later deny coverage to its insured. When an insurer tenders its insured an unqualified defense, the insurer is free, pursuant to its contractual obligation in the policy to defend its insured, to select defense counsel to represent the insured.³

Texas does not apply a *per se* disqualification rule of automatically allowing the insured to select counsel and requiring the insurer to pay for counsel's fees in

every reservation of rights situation.⁴ Other jurisdictions follow a *per se* disqualification rule where the insurer's simple act of a reservation of rights letter becomes the justification for the disqualification of insurance defense counsel and the insured's entitlement to independent counsel at the insurer's expense.⁵ Texas joins a host of other states in rejecting the *per se* disqualification rule in favor of a case-by-case analysis.⁶

On the other hand, when an insurer contends that at least one claim brought against the insured is not covered by its policy and reserves the right to deny coverage in the event that the insured is ultimately held liable on the basis of conduct excluded from coverage under the policy, the question of whether the insured or the insurer controls the selection of defense counsel turns on whether the reservation of rights by the insurer creates a material conflict of interest between the parties. When such a conflict exists, the insured properly controls the selection of its own defense counsel. A non-material conflict, on the other hand, will not preclude the insurer from controlling the

⁴ *Davalos*, 140 S.W.3d at 688 ("The right to conduct the defense includes the authority to select the attorney who will defend the claim and to make other decisions that would normally be vested in the insured as the named party in the case.")

⁵ *Nowacki v. Federated Realty Group*, 36 F. Supp. 2d 1099, 1107-08 (E.D.Wis. 1999) (once insurer tenders defense under reservation of rights, a conflict of interest is created, at which time the insured is free to control its defense and select its own counsel at the insurer's expense); *American Family Life Assur. Co. v. United States Fire Co.*, 885 F.2d 826, 831-32 (11th Cir. 1989); *CHI of Alaska, Inc. v. Employers Reinsurance Corp.*, 844 P.2d 1113, 1116-19, 1121 (Alaska 1993); *Maryland Cas. Co. v. Peppers*, 64 TIL 2d 187, 355 N.E.2d 24,31 (1976) ("Peppers has the right to be defended ... by an attorney of his choice who shall have the right to control the conduct of the case. By reason of St. Paul's contractual obligation to furnish Peppers a defense it must reimburse him for the reasonable cost of defending the action."); *Nandorf, Inc. v. CNA Ins. Co.*, 134 Ill. App. 3d 134, 88 Ill. Dec. 968, 479 N.E.2d 988 (1985).

⁶ *Central Michigan Board of Trustees v. Employers Reinsurance Corp.*, 117 F. Supp. 2d 627, 634-35 (E.D. Mich. 2000); *Bartels v. Romano*, 407 A.2d 1248, 1251 (N.J. Super.A.D. 1979) ("the fact that the attorney is assigned by an insurance company does not alter the basic lawyer-client relationship, or the duty owed by lawyer to client"); *The Driggs Corp. v. Pennsylvania Manufacturers' Association Ins. Co.*, 3 F. Supp. 2d 657, 659-60 (D.Md. 1998) ("a reservation of rights letter in this case did not amount to an actual conflict of interest, ... the mere fact of 'dual' representation does not raise a conflict of interest" and "an insurer is free to select counsel of its choice to represent its insured"), *affirmed*, 181 F.3d 87,1999 WL 305044 (4th Cir. 1999); *National Union Fire Ins. Co. v. Circle, Inc.*, 915 F.2d 986, 991 (5th Cir. 1990); *Johnson v. Continental Cas. Co.*, 788 P.2d 598,600 (Wash. App. 1990).

¹ 980 S.W.2d 625 (Tex. 1998)

² See *Nat'l Union Fire Ins. Co. of Pittsburgh, PA v. Merchs. Fast Motor Lines, Inc.*, 939 S.W.2d 139, 141 (Tex. 1997); *Heyden Newport Chem. Corp. v. S. Gen. Ins. Co.*, 387 S.W.2d 22, 24 (Tex. 1965).

³ See, e.g., *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 627 (Tex. 1998).

selection of defense counsel pursuant to its duty to defend. While these rules seem simple enough, the “fight” usually lies in the determination of whether the perceived conflict of interest created by an insurer’s reservation of rights is a “material” one.

C. What is a material conflict?

As Judge Rosenthal explained in *Rx.com*, under Texas law the insured bears the burden to prove that a disqualifying conflict exists because the insurer’s refusal to pay counsel chosen by the insured can be viewed as a breach of the insurance policy.⁷ To do so, the insured must show that “[a] conflict of interest does not arise unless the outcome of the coverage issue can be controlled by counsel retained by the insurer for the defense of the underlying claim.”⁸ Or, as the Texas Supreme Court articulated the test “the insured cannot choose independent counsel and require the insurer to reimburse the expenses unless “the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends.”⁹

For a while, *Davalos* served as the leading authority on this issue. *Davalos* involved two lawsuits filed in connection with an automobile accident in Dallas County. The first suit was filed by an insured motorist, *Davalos*, in Matagorda County, and the second by the other driver against *Davalos* in Dallas County.¹⁰ Instead of originally tendering the defense of the Dallas County action to *Davalos*’ insurer, Northern County Mutual Insurance (“Northern”), *Davalos* retained the attorneys hired in the Matagorda suit to assist with the defense. In connection with that defense, *Davalos*’ attorneys filed a motion to transfer venue in the Dallas action to Matagorda County. After being requested to defend, Northern agreed to do so, provided that *Davalos* agreed not to seek a transfer of venue to Matagorda County.

In response to Northern’s “qualified defense” of the Dallas County suit, *Davalos* filed suit against Northern claiming breach of the duty to defend, bad faith and violations of the Texas Insurance Code.¹¹ After adverse decisions at trial and before the court of appeals, Northern argued before the Texas Supreme Court that its dispute with its insured over venue was insufficient to defeat its contractual right to conduct the defense, and that only a dispute over coverage could entitle *Davalos* to select his own counsel.¹² Thus, the issue squarely before the Court in *Davalos* was whether any type of conflict arising in connection with

the insured’s defense constitutes a disqualifying conflict preventing the insurer from selecting counsel.

After explaining that “every disagreement about how the defense should be conducted cannot amount to a conflict of interest” the Court held that when (1) an insurer has issued a reservation of rights letter, and (2) “the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends, the conflict of interest will prevent the insurer from conducting the defense.”¹³ In addition, “the insured may rightfully refuse . . . any defense conditioned on an unreasonable, extra-contractual demand that threatens the insured’s independent legal rights” including, but not limited to, the following “four separate circumstances:”

- (1) when the defense tendered “is not a complete defense under circumstances in which it should have been,”
- (2) when “the attorney hired by the carrier acts unethically and, at the insurer’s direction, advances the insurer’s interests at the expense of the insured’s,”
- (3) when “the defense would not, under the governing law, satisfy the insurer’s duty to defend,” and
- (4) when, though the defense is otherwise proper, “the insurer attempts to obtain some type of concession from the insured before it will defend.”¹⁴

In applying these principles to the facts, the Court found that, contrary to *Davalos*’ assertions, “[t]he choice of venue should ordinarily have no impact on the insured’s legitimate interests under the policy.”¹⁵ Therefore, “because Northern’s offer to defend *Davalos* in Dallas County satisfied its obligation under the policy,” the court found that Northern did not breach the duty to defend, and *Davalos* did not have an independent right to select his own counsel.¹⁶

Since the *Davalos* decision, courts have begun to narrow the circumstances where an insured can select counsel.

D. Post-*Davalos* Decisions

Recently, the Fifth Circuit has picked up on the idea that one way to determine what the issues are in the underlying lawsuit is to look at the jury charge. This makes the material conflicts test for whether the facts overlap is to look at what the jury charge would be in the underlying lawsuit and compare it to the issues raised in the coverage suit. If the

⁷ 426 F.Supp.2d at 558-62.

⁸ 426 F.Supp.2d at 559.

⁹ *Davalos*, 140 S.W.3d at 689.

¹⁰ *Davalos*, 140 S.W.3d at 687.

¹¹ *Id.* at 688.

¹² *Id.*

¹³ *Id.* at 689.

¹⁴ *Id.* (quoting 1 ALLAN D. WINDT, INSURANCE CLAIMS AND DISPUTES § 4:25 at 393).

¹⁵ *Id.* at 690.

¹⁶ *Id.*

questions/issues/answers overlap, then a material conflict exists.

In *Downhole Navigator, L.L.C. v. Nautilus Ins. Co.*,¹⁷ a U.S. magistrate judge determined that Downhole Navigator LLC was not entitled to have insurer, Nautilus Insurance, pay for its lawyers in a contract suit after it refused a Nautilus-chosen team. In a well-reasoned opinion, the judge granted summary judgment to Nautilus on the issue of whether its reservation of rights letter had created a conflict of interest that allowed Downhole to select independent counsel. Nautilus offered a defense subject to a reservation of rights. Downhole rejected the defense, and hired its own lawyers. Nautilus refused to pay for Downhole's chosen counsel. Downhole sued Nautilus to recoup its defense costs and other damages.

In granting summary judgment, the judge turned to a well-developed body of law in Texas regarding the duty to defend. The court noted that "[t]here is no question that an insurer's right to defend a lawsuit encompasses the authority to select the attorney who will defend that claim and to make other decisions that would normally be vested in the insured as the named party in the case." The court said that "every disagreement about how a defense should be conducted cannot amount to a conflict of interest," quoting the Texas Supreme Court. It then went on to analyze the facts to be decided in the underlying litigation as set out in the underlying petition. The court compared the facts to be determined by the jury; *i.e.* - whether Downhole was negligent - to the policy provisions Nautilus had recited in its reservation of rights letter. The judge found that the facts to be decided by the jury did not involve any issue that related to whether Downhole was entitled to coverage as set forth in the reservation of rights letter. As such, Nautilus was not required to pay for Downhole's counsel. The issue of indemnity for the underlying suit remains before the court.

In another decision, the Fifth Circuit ruled that claims for misappropriation of trade secrets, unfair business practices, intentional interference with prospective economic advantage, breach of fiduciary duty, constructive trust, unjust enrichment, demand for an accounting, and interference with an at-will employment relationship fell outside a liability policy's "advertising injury" coverage. *Continental Cas. Co. v. Consolidated Graphics, Inc.*¹⁸ Daniels, an employee and relation of a family-owned company, devised a scheme to re-direct business to another company when the owners refused to give him an ownership interest in the company in exchange for a job. When the company learned of the scheme, it sued the former

employee and the companies that were complicit in the scheme, Consolidated Graphics and its related entities, in California state court. The jury awarded \$5.698 million in compensatory damages and \$8.1 million in punitive damages collectively. Continental sued the Consolidated Graphics defendants for a declaratory judgment in federal court in Texas, seeking a determination that it had no duty to defend or indemnify the California case.

Continental argued that an "advertising injury" had not occurred within the meaning of the coverage, and won a summary judgment on that basis. The court noted that the policy did not define "advertising injury." It noted that Texas decisions on point have held that the term "contemplates dissemination to the public." As part of its analysis, the court went on to consider the jury charge in the underlying suit and what questions were appropriate. In affirming the lower court, the court held that the coverage "requires a measure of public dissemination" and, here, all the transactions were private and direct. The court held that the insurers did not have to defend or indemnify the Consolidated Graphics defendants on the claims.

The decision in *Coats, Rose, Yale, Ryman & Lee, P.C. v. Navigators Specialty Ins. Co.*¹⁹ further narrowed the insured's right to select counsel in the face of potential conflicts of interest.

In *Coats*, lawyers sued for malpractice brought action for declaratory judgment against Navigators Specialty Insurance Company ("Navigators") to require Navigators to pay for attorney's fees and expenses occurred in Coats defense of a state-court malpractice action. Coats had taken the position that it was entitled to select counsel because any attorney selected by Navigators would have a conflict. The Court found that the insured's right to select counsel is triggered only if "the attorney appointed by the insurance company would have an incentive to act for the insurance company's interest rather than the insured's interest."²⁰ Coats failure to prove the attorney had an incentive to act for the insurance company prevented it from selecting defense counsel.

E. The Role of Defense Counsel.

Underlying the issue of whether the insurer or the insured is entitled to select counsel for the insured when the insurer defends pursuant to a reservation of rights is the question: Who does the defense attorney represent? Defense counsel selected by an insurer frequently will be on retainer by the insurance company, representing multiple of its insureds at any particular time. Given that the insurance company may represent a lucrative source of fees for retained defense

¹⁷ C.A. 4:10-cv-695 (S.D. Tex. May 9, 2011) (Milloy, J.)

¹⁸ 646 F.3d 210 (5th Cir. 2011)

¹⁹ 830 F. Supp. 2D 216 (N.D. Tex. 2011)

²⁰ *Id.* at 219.

counsel, insureds may be concerned that defense counsel's true allegiance lies with the insurer, rather than the insured.

The leading Texas case addressing the ethical dilemma resulting when the policyholder's attorney is hired by the insurer under a reservation of rights is *Employers Cas. Co. v. Tilley*, 496 S.W.2d 552 (Tex. 1973). *Tilley* was a declaratory judgment action by Employers Casualty Company, the insurer, against Joe Tilley, the insured, seeking a determination that a policy violation by the insured (late notice) relieved the carrier of any obligation to defend Tilley in a personal injury suit against him. Prior to filing the declaratory judgment action, Employers secured a standard non-waiver agreement from Tilley and engaged an attorney to represent Tilley in the personal injury suit.

For a period of eighteen months, the attorney not only performed services for Tilley in defending the personal injury action, but he also performed services for Employers involving the question of coverage. The attorney did not advise Tilley of the conflict of interest. Instead, he continued to act as Tilley's attorney while actively working against Tilley in developing evidence for Employers on the coverage issue.

The Texas Supreme Court's primary focus in *Tilley* was to determine the duty of insurers and attorneys employed by them to represent insureds. The court held that an attorney, although selected, employed and paid by the liability carrier, was nonetheless the attorney of record and the legal representative of the insured, and as such he owed the insured the same type of unqualified loyalty as if he had been originally employed by the insured. *Id.* at 558. Following this pronouncement in *Tilley*, Texas courts have generally recognized that the insured is defense counsel's only client. *See, e.g., APIE v. Garcia*, 876 S.W.2d 842, 844 n.6 (Tex. 1994); *Bradt v. West*, 892 S.W.2d 56, 77 (Tex. App.—Houston [1st Dist.] 1994, writ denied) (stating that "there is no attorney-client relationship between an insurer and an attorney hired by the insurer . . . to provide a defense to one of the insurer's insureds").²¹

²¹ More recently, in a case involving the issue of whether an insurer's use of its in-house attorneys to defend its insureds against third party liability actions constitutes the unauthorized practice of law, the Eastland Court of Appeals nevertheless concluded that "reality and common sense dictate that the insurance company is also a client" of the insured's defense counsel. *Am. Home Assur. Co., Inc. v. Unauthorized Practice of Law Comm.*, 121 S.W.3d 831, 838 (Tex. App.—Eastland 2003, pet. granted). Clarification of this statement may be forthcoming, however, as the Texas Supreme Court has accepted a petition for writ of error in the case.

III. WHO CAN BE INDEPENDENT COUNSEL?

The *Davalos* opinion speaks of giving up the right to select the counsel. But, there is no mention of what qualifications the person or persons needs to have in order to be the independent counsel.

California addressed the issue by way of statute, giving the insurer some minimum standards to anticipate. The statute requires that the counsel be experienced with a minimum number of years and have errors and omissions coverage.²² Other states, like Rhode Island, have instituted similar rules.²³

Florida, on the other hand, gives the insured much more leeway to select counsel. The courts have recognized this in their decisions in Florida.²⁴

We would expect Texas would look at similar issues in the event that the issue ever came up. No Texas court has yet to address the issue. And, it may be an interesting problem to place before the court as to how the objections would be made and how the cause of action would be preserved.

In the meantime, the bar must be conscious that it is self-policing on this issue under the Texas Disciplinary Rules of Conduct. The rules require that lawyer's not take on work that they know they are not qualified to do:

Rule 1.01 Competent and Diligent Representation

- (a) A lawyer shall not accept or continue employment in a legal matter which the lawyer knows or should know is beyond the lawyer's competence, unless:
- (1) another lawyer who is competent to handle the matter is, with the prior informed consent of the client, associated in the matter; or
 - (2) the advice or assistance of the lawyer is reasonably required in an emergency and the lawyer limits the advice and assistance to that which is reasonably necessary in the circumstances.²⁵

²² *Centennial Ins. Co. v. Murat*, 253 Cal. Rptr. 914 (Cal. 1988).

²³ *Employer's Fire Ins. Cov. Beals*, 240 A.2d 397 (R.I. 1968), *rev'd on other grounds*, 667 A.2d 785 (R.I. 1995).

²⁴ *American Empire v. Gold Coast*, 701 So.2d 904 (Fla. App. 1997).

²⁵ T.D.R. 1.01.

This rule is further explained in the comments:

Comment:

Accepting Employment

1. A lawyer generally should not accept or continue employment in any area of the law in which the lawyer is not and will not be prepared to render competent legal services. Competence is defined in Terminology as possession of the legal knowledge, skill, and training reasonably necessary for the representation. Competent representation contemplates appropriate application by the lawyer of that legal knowledge, skill and training, reasonable thoroughness in the study and analysis of the law and facts, and reasonable attentiveness to the responsibilities owed to the client.
2. In determining whether a matter is beyond a lawyer's competence, relevant factors include the relative complexity and specialized nature of the matter, the lawyer's general experience in the field in question, the preparation and study the lawyer will be able to give the matter, and whether it is feasible either to refer the matter to or associate a lawyer of established competence in the field in question. The required attention and preparation are determined in part by what is at stake; major litigation and complex transactions ordinarily require more elaborate treatment than matters of lesser consequences.

For example, an attorney without a specialization in IP work should consider whether acting as independent counsel in an IP matter is in the best interest of the client if they would not normally qualify for panel counsel for the carrier if the carrier requires an IP specialization.

A. How are Attorney's Fees Paid?

Unfortunately, Texas courts have been less than clear in answering this issue as well. It appears from *Tilley* and *Davalos* that the carrier will pay the fees if the material conflict exists. But, there is no guidance as to whether panel counsel rates are sufficient or if off-the-street rates apply to the carrier.

Again, California clarified by statute that the insurer pays the rate that the carrier would normally pay.²⁶ And, again, Florida has gone the other direction requiring that the fees be agreed by the parties.²⁷ Texas has the chance, again, to find some middle ground between these extremes.

From a practical perspective, with no legal guidance in Texas, the parties are generally negotiating these elements as the counsel is selected and brought onto the case. There are other factors that the parties can look to in their negotiations to bring this about. For example, the Texas Bar released its survey of hourly fees in 2009.²⁸ There are even options to bring in third-party fee-bill auditors to determine whether the fees charges are reasonable.

And, there is a host of law in Texas on the reasonableness of attorneys' fees in other contract scenarios. And the Texas Supreme court has stated that, "generally, the party seeking to recover attorney's fees carries the burden of proof."²⁹ All of which is left to the jury: "The reasonableness of attorney's fees is ordinarily left to the factfinder, and the reviewing court may not substitute its judgment for the jury's."³⁰ "[T]he factfinder should consider 'the amount involved and the results obtained,' among other things."³¹

In *Smith*, the plaintiff sought \$215,391.50 in damages and \$47,438.75 in attorney's fees.³² The jury awarded the plaintiff \$65,000 in damages but no attorney's fees. The trial court awarded the \$65,000 in damages and rendered judgment notwithstanding the verdict on attorney's fees for \$7,500 for trial and up to \$15,000 for appeal. The court of appeals vacated the \$7,500 attorney's fees award and rendered judgment for \$47,438.75 instead, holding that because the plaintiff had presented competent, uncontroverted evidence of its right to attorney's fees and because the defendant did not challenge the amount, nature, or necessity of the fees, the trial court should not have awarded just \$7,500.00.

The plaintiff sought a total of \$62,438.75 in attorney's fees. The Supreme Court of Texas held that "the fee, that is supported by uncontradicted testimony, was unreasonable in light of the amount involved and the results obtained, and in the absence of evidence

²⁶ California Civil Code §2860.

²⁷ Florida Claims Administration Statute 627.426.

²⁸

http://www.texasbar.com/AM/Template.cfm?Section=Research_and_Analysis&Template=/CM/ContentDisplay.cfm&ContentID=11240

²⁹ *Smith v. Patrick W.Y. Tan Trust*, 296 S.W.3d 545, 547 (Tex. 2009).

³⁰ *Id.*

³¹ *Id.* at 548 (quoting *Arthur Andersen & Co. v. Perry Equip. Corp.*, 945 S.W.2d 812, 818 (Tex. 1997)).

³² 296 S.W.3d at 546.

that such fees were warranted due [to] circumstances unique to this case.” The Court noted that, “although the [plaintiff] sought some \$215,000 in damages, the jury found that ‘the amount involved’ was much lower – \$65,000.” “‘The most critical factor’ in determining the reasonableness of a fee award’ is the degree of success obtained.”³³

The Court went on to hold that, “although it could have rationally concluded that, in light of the amount involved and the results obtained, a reasonable fee award was less than the full amount sought, no evidence supported the jury’s refusal to award any attorney’s fees [.]”³⁴ The Court ruled that the trial court could have directed the jury to reform its verdict, but was not free to set a reasonable fee on its own. Thus, a new trial on attorney’s fees was necessary. The Court reversed the judgment as to attorney’s fees and remanded that part of the case to the trial court for a new trial.

This First Court of Appeals has written:

Factors that a fact finder should consider when determining the reasonableness of a fee include: (1) the time and labor required, the novelty and difficulty of the questions involved, and the skill required to perform the legal service properly; (2) the likelihood that the acceptance of the particular employment would preclude other employment by the lawyer; (3) the fee customarily charged in the locality for similar legal services; (4) the amount involved and the results obtained; (5) the time limitations imposed by the client or by the circumstances; (6) the nature and length of the professional relationship with the client; (7) the experience, reputation, inability of the lawyer or lawyers performing the services; and (8) whether the fee is fixed or contingent on results obtained or uncertainty of collection before the legal services have been rendered.³⁵

³³ *Smith*, 296 S.W.3d at 548 (quoting *Farrar v. Hobby*, 506 E.S. 103, 114) 1992)).

³⁴ *Smith*, 296 S.W. 33d at 548.

³⁵ *USAA County Mut. Ins. Co. v. Cook*, 241 S.W.3d 93, 102-103 (Tex. App.—Houston) 1st Dist. 2007, no pet.) (citing *Arthur Andersen & Co. v. Perry Equip. Corp.*, 945 S.W.2d 812, 818 (Tex. 1997)). “Attorney’s fees must bear some reasonable relationship to the amount in controversy.” *Cook*, 241 S.W.3d at 103. “But, the amount of damages awarded is only one factor in determining the reasonableness of the fee award.” *Id.*

While the Arthur Andersen factors may be considered, a court is not required to receive evidence on each of those factors.³⁶ The Court can also look at the entire record, the evidence presented on reasonableness, the amount in controversy, the common knowledge of the participants as lawyers and judges, and the relative success of the parties.³⁷

All of this means that the parties are not without guidance to negotiate these issues. And, few policyholders have the wherewithal to fund the legal fees up front in the underlying litigation and take on the carrier in the coverage action. This means it may take a while before any court gets a chance to look at this issue.

B. What is the Downside for Insurers?

The Texas Supreme Court has issued two decisions signaling insurers that the duty to defend is difficult and costly to escape:

- Coverage disputes regarding the duty to defend create unreasonable conflicts of interest between insureds and insurers, and insurers should avoid putting its interests above those of its insured. *GuideOne Elite Ins. Co. v. Fielder Rd. Baptist Church*, 197 S.W.3d 305, 307, 310-311 (Tex. 2006).
- The Texas Insurance Code Chapter 542, Prompt Payment of Claims Act, applies to a request for a defense. *Lamar Homes Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1 (Tex. 2007).

But, at the same time, the Texas Supreme Court allowed some leeway for insurers who accept a defense and later learn that a policy provision will control. In a ground-breaking decision, the Texas Supreme Court determined that policy defenses cannot be waived if they are not included in an initial reservation of rights.³⁸

These are not mixed messages. The court has, instead, made clear that coverage actions are permissible but that insurers’ obligations to their insureds will be enforced.

C. What is the Downside for Policyholders?

If an insured’s rejection of an offered defense is not founded on a coverage conflict of interest, the insured’s rejection relieves the insurer of the duty to

³⁶ *Hagendorn v. Tisdale*, 79 S.W.3d 341, 353 (Tex. App.—Amarillo 2002, no pet.).

³⁷ *Id.*; accord *Shilton Ins. Co. v. Pate & Pate Enters.*, 930 S.W.2d 877, 896 (Tex. App.—San Antonio 1996, writ denied).

³⁸ *Ulico Casualty Co. v. Allied Pilots Association*, 262 S.W.3d 773 (Tex. 2008).

defend.³⁹ This means that an insured must consider the reservation of rights letter that the insurer sends carefully. A reservation of rights is not an invitation to the insured to select independent counsel.

The policyholder or insured should respond with an appropriate letter to the carrier that points out the conflict of interest and raises the coverage issues. This is not “telling on itself” because the carrier has already notified the policyholder that there is a conflict of interest. The response needs to document the policyholder’s meeting of its burden to show that the conflict is material and that it involves coverage – the standard the court applied in *Rx.com*.

If the policyholder does not do this and merely rejects, the carrier can defend on the basis that the policyholder never met its burden. This is especially true in those situations where the underlying petition does not offer enough facts for the carrier to determine what coverage issues apply to the claim.

D. What risks do independent counsel face?

The challenge to ordinary *Tilley counsel* is to maintain their independent legal judgment. Independent counsel would not, on the surface, appear to have that issue. But, there are other issues that independent counsel have to be concerned about.

For example, the insured/policyholder is usually going to have a cooperation requirement in the liability policy as a condition precedent to coverage. The independent counsel, acting as an agent of the insured/policyholder, does not want to be responsible for violations of the cooperation clause. A typical cooperation clause will require the insured to provide information about the claim to the insurer:

SECTION II –CONDITIONS

3. Duties After Loss

In case of an accident or **occurrence**, the **insured** will perform the following duties that apply or will help us by seeing that these duties are performed;

- c. At our request, help us:
 - (1) to make settlement.
 - (3) with the conduct of suits, including hearings and trials.
 - (4) to secure evidence and obtain the attendance of witnesses.

The existence of independent counsel does not waive these duties under the policy. And, independent counsel should take care to ensure that any other obligations of the insured to the carrier are met. This may include having to conform to carrier reporting requirements if they will ensure that the insured maintains its duties to the carrier.

IV. CONCLUSION

It is difficult to imagine that parties to these negotiations will not continue to seek clarification on issues that surround independent counsel from the courts. But, the costs for both sides are high in terms of time, money, and risk of developing the law in unfavorable ways. This paper is in no way intended to answer the issues. It does, however, hopefully provide some guidance as practitioners deal with these issues on a regular basis.

³⁹ 140 S.W. 3d at 688.

