Strategic Insurance Considerations for Corporate Policyholders

Choice of counsel in situations with high levels of retained risk

By ROBERT CUNNINGHAM

Large energy corporations are complex organizations engaged in a host of diverse operations. In-house counsel must be prepared to handle a broad variety of legal issues, sometimes in areas where they may have practical experience but not detailed subject matter expertise. This is the fourth in a series of seven articles discussing how these corporate policyholders go about addressing the sophisticated sorts of insurance problems arising from their corporate activities, and what outside counsel can learn and do to assist them most effectively.

Part 4 of 7

Sophisticated corporate policyholders typically retain a comparatively high level of uninsured risk compared with smaller companies. It is not unusual for these corporations to carry deductibles or self-retentions in the eight-figure or even low nine-figure range, depending on the nature of the risks and exposures.

As a result, absent contrary insurance policy requirements, large corporations frequently assign counsel of their own choosing to handle losses or claims within their retained risk, and insurers normally acquiesce to counsel's continued handling if and when the insurer's interests come into play. And it is not unusual for policies to name specific counsel agreeable to both the insurers and policyholder, for coverages where the insurance provides defense at a relatively low level of retention or where immediate response, specialized expertise, and/or remedial public relations may be needed.

Nonetheless, even the large corporate policyholder must be cognizant of its rights with respect to appointment of counsel, especially when the insurer disagrees and insists upon appointing counsel to act on the policyholder's behalf.

A. Defense counsel appointed by insurer to defend policyholder from third-party claim

The standard forms of primary insurance for third-party liability include a provision giving the insurer the "right and duty" to investigate, defend and settle claims against the policyholder. When an insured is sued and the petition contains factual allegations which, when fairly and reasonably construed, state a cause of action that is potentially covered by the policy, the insurer has a duty to defend the insured in the underlying lawsuit. *See e.g. Graper v. Mid–Continent Cas. Co.*, 756 F.3d 388 (5th Cir. 2014).

When the interests of insurer and policyholder are fully congruent, then the insurer may freely exercise its contractual right and duty to defend with complete and exclusive control, is entitled to select counsel of its own choosing, and may even utilize directly employed staff counsel. *Unauthorized Practice of Law Committee v. American Home Assur. Co.*, 261 S.W.3d 24 (Tex. 2008) In that situation, defense counsel may accept reasonable direction and control from the insurer while discharging ethical duties owed to the policyholder, if the insurer's direction is not at odds with counsel's own professional

legal judgment.

In many cases, this arrangement benefits both parties. The policyholder, often unfamiliar with litigation or disinterested in the distractions of handling the matter, may benefit from the insurer's expertise in handling lawsuits. The insurer benefits from controlling the amounts it incurs for defense and in settlements paid to a claimant, while still protecting the policyholder's interest.

But the insurer's contractual right to defend is not sacrosanct, and sometimes must give way to the policyholder's interests. In the fountainhead case *Employers Casualty Co. v. Tilley*, 496 S.W.2d 552 (Tex. 1973), the Texas Supreme Court squarely rejected the practice whereby counsel appointed by the insurer defended the policyholder while concurrently developing the insurer's defenses to coverage.

B. Limited right to independent counsel

When is a Policyholder entitled to appoint its own counsel to defend a suit, rather than accept the defense lawyer selected and controlled by its Insurer?

Not every disagreement about coverage or how the defense should be conducted amounts to a conflict of interest that justifies transferring control of the defense from the insurer to the policyholder. For example, no conflict existed where the insurer fully accepted coverage but disagreed with the policyholder over venue for the suit - mere disagreement over litigation tactics did not warrant independent counsel for the policyholder. *Northern County Mut. Ins. Co. v. Davalos*, 140 S.W.3d 685 (Tex. 2004).

Even though *Davalos* involved neither an actual conflict nor a reservation of rights, that opinion cited to a secondary source treatise listing a variety of situations in which independent counsel may be warranted. Picking up on this citation and upon arguable dicta or loose wording in *Davalos*, the Fifth Circuit has interpreted the rule so that independent counsel is warranted *only* when facts determining coverage actually will be adjudicated - - not simply developed - - in the underlying suit. *Downhole Navigator, L.L.C. v. Nautilus Ins. Co.*, 686 F.3d 325 (5th Cir. 2012).

In *Downhole Navigator*, the federal court isolated a single exemplar from *Davalos*, holding that independent counsel is required only "when the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends" under the insurer's reservation. Confusingly, the court reasoned that the insurer was entitled to control defense even if its appointed defense attorney might develop facts relevant to aspects of the coverage exclusions - - but that actually engaging in such subterfuge would breach the policy and require independent counsel after the fact. Thus, the opinion effectively leaves the insurer as fox in charge of the henhouse, requiring the policyholder to keep close track of its chickens and defense counsel to act as faithful watchdog!

The court rejected Policyholder's argument that such a *Davalos* "rule" is superseded by *UPLC*, so that the critical question is whether facts affecting the coverage reservations are likely to be "developed" in the underlying lawsuit not whether they actually will be "adjudicated." Arguably, *UPLC* better conforms with *Tilley*, where insurer's counsel improperly developed a late notice coverage defense that never would have been addressed or adjudicated in the underlying suit.

Downhole Navigator recognizes but does not adequately address core ethical considerations the Texas Supreme Court found critical in *Tilley* and *UPLC*. For example, counsel is not permitted to take direction from an insurer when the lawyer reasonably believes the representation of her client, the policyholder, will be materially affected. Texas Ethics Opinion No. 533 (2008), citing *State Farm Mut. Auto. Ins. Co. v. Traver,* 980 S.W. 2d 625, 628 (Tex. 1998) ("Loyalty to the client/insured demands that the lawyer must at all times protect the interests of the insured if those interests would be compromised by the insurer's instructions."). Yet, *Downhole Navigator* perversely precludes the policyholder from appointing independent counsel, even while acknowledging that an ethical defense lawyer cannot accept direction from the Insurer to develop facts in the underlying suit that might adversely affect the policyholder's coverage interests.

As might be expected, the holding in *Downhole Navigator* has been rigorously applied by all subsequent district courts and appellate panels within the fifth circuit. To date, only a Texas intermediate appellate court has adopted *Downhole's* "same facts that will be adjudicated" standard for determining when independent counsel is owed to a policyholder. *Allstate County Mutual Insurance Company v. Wootton*, 494 S.W.3d 825, Tex.App.-Hous. [14 Dist.], 2016, pet. denied)(conflict of interest exists preventing the insurer from insisting on contractual right to control the defense when the insurer has reserved its rights and the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends; a potential conflict of interest is insufficient.

Notwithstanding the rule enunciated in *Davalos* as interpreted by *Downhole Navigator*, defense counsel cannot simply ignore a reservation of rights and concentrate solely on handling the defense. Counsel must ensure the Policyholder gives informed consent to direction by the Insurer, after full disclosure of the existence, nature, implications, and possible adverse consequences of following the Insurer's direction and the advantages involved, if any. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §134 (2000). Yet, such informed consent is seemingly pointless, for if a policyholder refuses proffered representation because of a potential but not-yet actual conflict, under *Downhole Navigator* the policyholder apparently breaches the policy and must pay its own costs of independent counsel.

To discharge their ethical obligations, insurance defense lawyers must fully appreciate the issues raised by the insurer's reservation of rights. As usual, counsel are caught smack in the middle between interests of the insurer who hires the lawyer and the policyholder to whom fiduciary duty is owed. While the policyholder remains reliant upon the tender mercies of the insurer and faithful counsel.

Moreover, the policyholder is at risk of losing any right for reimbursement of fees if it insists on independent counsel without the necessary predicate. *Davalos* and *Downhole Navigator* both denied the policyholder's claim for reimbursement of independent counsel fees.

Given this substantial risk of uninsured expense, many corporate counsel are naturally reluctant to press the issue and insist on independent counsel without the insurer's full agreement. And where the insurer does not agree, then perhaps the safer course is for corporate counsel to closely monitor the handling and be prepared to assert claims for liability against either or both the insurer and defense counsel if they mishandle the suit and compromise the policyholder's interests in favor of their own.

C. Counsel for coverage action against insurer

When engaging in formal litigation against the insurer, corporate counsel must consider whether to hire counsel who normally handle their commercial matters or whether to hire specialized insurance coverage counsel. On the appellate level, a similar decision must be made whether to hire specialized appellate counsel or specialized coverage counsel, to the extent that lawyers who specialize in both may be rare.

Standard litigation counsel may have the advantage of superior familiarity with the personnel, processes, and operations of the client from prior experience. That familiarity may translate into increased efficiency of handling the coverage action, and minimize internal disruptions for the company. Standard counsel may also possess significant litigation and trial skills, and may offer resources designed to handle difficult discovery and procedural issues, contentious opposing counsel, and vagaries of the judicial system.

Specialized coverage counsel, on the other hand, may have an efficiency advantage in better understanding the critical issues upon which the matter truly hinges. Coverage counsel also is more familiar with interpreting detailed and complex insurance policies, which can seem dense and almost indecipherable to a non-specialist. Coverage counsel may also be better attuned to discrete legal issues that can be asserted for early disposition, which may actually resolve the claim or provide increased clarity and/or leverage for settlement. Since many insurance coverage disputes involve issues of policy

interpretation and not extensive fact problems, trial to a jury may not be necessary or appropriate in a particular matter.

Where a particularly large or complex case warrants the expense, both litigation and coverage counsel may be employed together effectively. In these circumstances, in-house counsel may need to assert a greater degree of involvement and control to ensure that respective counsel work together efficiently and without undue duplication. In-house counsel should be prepared to consider and affirmatively decide important strategic and tactical issue, and provide that guidance firmly.

Similar consideration affect the corporate policyholder's decision about counsel retained for handling an appeal; since insurance disputes often involve pure questions of law based on policy interpretation, appeal may be the true battlefield where the trial court is unwilling or unable to competently construe complicated insurance contract.

The trial lawyer or coverage specialist who has handled the underlying suit is one alternative. But trial skills seldom translate well to appellate practice, where the one skill relies on facts and jury persuasion; while the other skill is restricted to legal argument, not facts, and must persuade a small number of highly educated jurists rather than a jury of peers. And deep knowledge of all the underlying facts often has little utility for making the narrow legal arguments called for on appeal. As noted above, to some extent insurers relish the prospect of facing non-specialized trial counsel on the appellate level, and take advantage of those situations by countering with their own well-prepared coverage and appellate experts.

An appellate specialist is likely to be more experienced with the sort of persuasive briefing and convincing oral argument needed to pare down a case and address the issues upon which the appellate court should focus. But an appellate lawyer rarely also appreciates the particular issue within the full context of the insurance jurisprudence, and so may not even be aware of issues and avenues of argument that may bolster or even be foundational to the appellate project.

Specialized coverage counsel, on the other hand, may have a keen appreciation of the nuances of insurance jurisprudence that interplay with the particular issue on appeal, but may not have the briefing or argumentative skills necessary to convince an appellate court within the constrained and concise structure allowed by the appellate process.

As with the trial model, it is possible to hire both types of lawyer so that the appellate specialist has the benefit of the coverage lawyer's substantive expertise. But better, if a single lawyer combines both skills so that nothing is lost in the argument.

The next article in our series will address What Relief to Seek