1989

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INSURER, INSURER-RETAINED COUNSEL, INSURED: A REEXAMINATION OF CONFLICTS OF INTEREST IN THE TRIPARTITE RELATIONSHIP

Michael A. Berch* 
and Rebecca White Berch**

I. Introduction

LAST YEAR A crash at the Dallas/Fort Worth International Airport prompted concern about the ethical propriety of attorneys soliciting prospective clients.1 While the media focused on this issue, we reflected on the ethi-

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An additional ethical problem may arise in attempting to represent multiple plaintiffs whose interests differ. For example, if there is an inadequate fund to recompense all plaintiffs, the lawyer may have a conflict of interests. See Model Code EC 5-14 to 5-17 and DR 5-106; Texas Code EC 5-14 to 5-17 and DR 5-106. These conflicts, though, are not the focus of this article.
cal problems that confront an attorney selected by the insurer to represent the prospective defendants, which often include the manufacturer of the airplane, the airline, and the airline's agents and employees. The interests of the potential defendants, their insurers and insurer-selected counsel may actually or potentially conflict. How to accommodate these differing interests in the burgeoning field of tort litigation is the subject of this article.

The article focuses upon the need to establish a uniform rule to alleviate conflicts of interest between insurer and insured—conflicts that divide the loyalties of attorneys retained by insurers to represent insureds. After reviewing the background of the conflict and the applicable rules of professional responsibility, we will analyze Texas law and propose a rule that will reduce the conflict burden on the insurer, insured, and counsel.

II. BACKGROUND

Liability policies contain various types of clauses, including clauses identifying the insured event and exclu-

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In reviewing more than three hundred cases in the bad faith area, the author has discerned that one of the overriding, though frequently and insufficiently articulated, concerns expressed by the courts (and almost universally recognized by juries) is the problem of conflicting interests between the insurer and the insured. These conflicts may be heightened by the added conflict between the lawyer hired by the insurer for the insured and the interests of the hiring insurer. The greatest conflict of interest area lies with the representation by attorneys who insufficiently disclose these conflicting interests to their clients—the insured. Perhaps the most common conflict of interest situation involves a claim in which there is both a claim that comes within coverage and other asserted claims that are outside coverage.

Id. at 925-26.

3 Some aircraft insurance policies have been characterized as "manuscript" policies because the terms are negotiated between the insureds and the insurers. Because each of the parties to the negotiations has enormous bargaining power, several rules and doctrines formulated to aid the courts in construing and interpreting customary adhesion contracts have little relevance. Moreover, negotiated policies necessarily result in greater variation of terms. Nevertheless, basic doctrines, principles, and practices of insurance law still pertain.
sions therefrom, clauses imposing conditions and obligations on the insured (both before and after the event), clauses providing the insured with indemnity for amounts paid for covered losses and payment for the costs of defending against any claims, and clauses reserving to the insurer the duty and right to control the defense of actions brought against its insureds. Insurers generally exercise this control by selecting counsel to represent their insureds.

Assume that immediately after the crash, X Company, insurer of the airline, contacts Attorney Y about defending the interests of the insured and the insurer in any forthcoming suit. X should retain an attorney immediately, for no one can effectively replicate or recapture the advantages of contemporaneous investigation.

The lawyer selected by the insurer to represent the airline faces several ethical problems. In her attempts to ac-

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4 The insurer has a duty to defend the initial lawsuit. For conflicting opinions regarding whether the duty to defend extends to post-trial remedies, including appeals, compare Cathay Mortuary (Wah Sing), Inc. v. United Pac. Ins. Co., 582 F. Supp. 650, 657 (N.D. Cal. 1984) (the duty to defend extends to post-trial remedies) with General Casualty Co. v. Whipple, 328 F.2d 353, 357 (7th Cir. 1964) (the duty to defend does not necessarily extend to an appeal).

5 A few policies give the insurer an election whether to defend the action brought against the insured. See Continental Sav. Ass'n v. United States Fidelity & Guar. Co., 762 F.2d 1239, 1244 (5th Cir. 1985) (applying Texas law).

6 Y may begin the defense with a visit to the hospital to interview the pilot. A few ethical problems immediately emerge. First, may Y represent the pilot? Is the pilot an insured within the terms of the policy? Assuming the pilot is an insured, may the same attorney ethically represent the pilot and the airline in prospective litigation? What are the actual and potential conflicts between the pilot and the airline? May the attorney handle the matter despite potential conflicts? Does the union contract contain any provisions regarding pilot representation in the event of lawsuits? If Y does not represent the pilot, what should she tell the pilot before commencing the interview? These questions implicate ethical norms that are beyond the scope of this article. See supra note 1.

7 A Dallas newspaper reported that within days of the crash, a lawsuit was filed naming the airline as one of the defendants. The Rule 11 implications of instituting a suit so soon after the accident are beyond the scope of this article. See Fed. R. Civ. P. 11. The immediate filing of lawsuits highlights the need for the insurer to prepare its defense at the earliest possible time.

8 Indeed, contemporaneous investigative reports are so difficult to replicate that courts ordinarily permit discovery of these reports as an exception to the work product rule. See generally Fed. R. Civ. P. 26(b); Hickman v. Taylor, 329 U.S. 495, 511 (1947) (forging the work product rule).
commodate the insurer's interest in reducing monetary exposure with the insured's interest in reducing potential exposure, monetary and otherwise, the lawyer may encounter difficult choices. In cases in which a conflict arises, the lawyer's economic interest may favor siding with the insurer to the detriment of the insured.

In a bygone era, the insurance industry condoned divided loyalty. Later pronouncements by the industry waffle somewhat by adopting and then rescinding the Guiding Principles to govern insurer-retained counsel's conduct. The Texas Code of Professional Responsibility is much more resolute. It mandates that the lawyer's first

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9 Note that insureds may principally be interested in avoiding findings or inferences of culpability, which may include fraud or negligence. This is particularly true in the malpractice area. Recognizing this desire, many malpractice carriers give the insured an absolute right to reject any settlement.


The Texas Code of Professional Responsibility cautions that an attorney employed by one to represent another may "feel a sense of responsibility to someone other than his client" and "must constantly guard against erosion of his professional freedom." TEXAS CODE, EC 5-22, 5-23 (1984).

11 As recently as 1973, the Texas Supreme Court stated that it did not question that an insurer-retained attorney's conduct — providing the insurer with evidence to establish that the insured violated the notice provision of the policy — was "representative of the customary conduct of counsel employed by insurance companies in similar situations." Employers Casualty Co. v. Tilley, 496 S.W.2d 552, 558 (Tex. 1973). The court later acknowledged that insurer-retained counsel should display more loyalty toward the insured. Id. at 560. This deplorable state of affairs is not confined to Texas. See Parsons v. Continental Nat'l Am. Group, 113 Ariz. 223, 550 P.2d 94 (1976).

12 The insurance industry created its own set of rules, the Guiding Principles, to govern conflicts between insurers and insureds. The Principles proposed that once the attorney ascertained a conflict, she should notify the insurer and the insured in writing, and the insurer or the attorney should invite the insured, at his own expense, to obtain counsel. American Bar Association National Conference of Lawyers & Liability Insurers, Guiding Principles, 20 FED'N OF INS. COUNS. Q. 95, 96 (1970). Insureds rarely took advantage of the opportunity to retain and pay for counsel, so under this proposal, insurers remained in control of the defense.

The ABA House of Delegates rescinded the Guiding Principles in August, 1980. See infra notes 123-125 and accompanying text.
and foremost duty is to her client.\(^\text{13}\) It provides: "Except with the consent of [her] client after full disclosure, a lawyer shall not accept employment if the exercise of [her] professional judgment on behalf of [her] client will be or reasonably may be affected by [her] own financial, business, property, or personal interests."\(^\text{14}\) The notes to the Code and prevailing case law establish the insured as the lawyer's client.\(^\text{15}\)

For analytical purposes, it is important to appreciate that there are several points at which conflicts of interest between insurer and insured may arise, if indeed they arise at all. The most common conflicts scenarios are the following:

1. Cases in which the interests of the insured and insurer are harmonious throughout the relationship. Simply put, no conflict of interest arises. As demonstrated later in the article, these cases are rarer than one might assume upon cursory analysis;\(^\text{16}\)

2. Cases in which the interests of the insured and insurer are aligned at the inception of the relationship but diverge later in the proceedings;

3. Cases in which the interests of the insured and insurer diverge at the inception of the relationship. This recurring conflict of interest scenario may arise when factual issues raise a question whether the insured's conduct is covered or excluded by the policy.\(^\text{17}\) A common exam-

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\(^{14}\) Model Code DR 5-101(A); Texas Code DR 5-101(A).

\(^{15}\) See, e.g., Tilley, 496 S.W.2d at 558-59 (setting forth the duty of insurer-retained attorney to the insured).

\(^{16}\) Cf. R. Keeton & A. Widiss, Insurance Law § 7.6, 808 (1988). "In most situations, there is an accord, reached either explicitly or implicitly, between the insurer and the insured as to an appropriate course of action to be pursued in response to the tort claim." Id. at 808. However, Keeton and Widiss follow this statement with an extensive discussion of insurer-insured conflicts of interest. Id.

\(^{17}\) By inception of the relationship, we refer to the period beginning with the transaction or occurrence for which claims may be asserted against the insured.

\(^{18}\) Typical exclusions from airline policies include the following situations, each
ple of this type of conflict is the case in which the insured's conduct could be viewed as either negligent or intentional, but the policy indemnifies only for negligent conduct.\(^\text{19}\)

But conflicts arise in many other situations not implicating the insured's conduct in causing the incident that gives rise to the claim. The following are among the most prominent of such situations giving rise to conflicts of interest between the insurer and insured:\(^\text{20}\)

1. when claims exceed policy limits;
2. when the insured must decide whether to accede to reservation-of-rights or nonwaiver agreements;
3. when the insured allegedly fails to comply with post-loss policy provisions;
4. when the insured's desires concerning the manner of defending the case differ from the insurer's;
5. when the insured's desires respecting settlement differ from the insurer's;
6. when the time comes to decide whether to seek appellate review;\(^\text{21}\) and
7. when the insurer decides whether to provide a defense after policy limits have been exhausted.\(^\text{22}\)

Conflicts so typically arise in the insurer-insured rela-

of which may give rise to conflicts of interest between the insurer and the insured: (a) illegal purposes exclusions, (b) unauthorized pilot exclusions, (c) maximum passenger exclusions, and (d) non-approved landing site exclusions.

In addition to policy exclusions, most airline policies contain comprehensive lists of preconditions to coverage. Most common among the preconditions are that the plane meet approved specifications, that the plane be serviced according to preapproved schedules, that the plane be flown only by those (generally preapproved) pilots holding current and valid certification, that the plane be flown according to preapproved flight plans, and so forth. Each exclusion and precondition presents an opportunity for a conflict of interest between the insurer and its insured.

\(^1\) This fact pattern frequently gives rise to claims by third parties for punitive damages, another common conflict-generating scenario. See Nandorf, Inc. v. CNA Ins. Co., 134 Ill. App. 3d 134, 479 N.E.2d 988 (1985).


\(^3\) See supra note 4 discussing whether the duty to defend extends to post-trial relief.

\(^4\) New conflicts patterns will arise. For example, in one airline policy we examined while preparing this article, the insurer purported to limit its liability for
tionship that, in addition to local rules of professional responsibility that govern attorneys’ conduct, most jurisdictions have developed case law specifically defining insurers’ and insurer-retained attorneys’ obligations to insureds. Until fairly recently, most courts assumed that insurer-retained counsel could adequately represent insureds, once potential conflicts of interest were revealed to the insured.25

Then in 1984, a California case sent shock waves through the insurance industry. In San Diego Navy Federal Credit Union v. Cumis Insurance Society, Inc.,24 an intermediate California state court examined a case in which the interests of the insured and insurer diverged from the outset of the suit, and, under the facts and circumstances of that case, held that the insured has a right to select his own attorney at the insurer’s expense.25 We suggest that Texas should adopt the Cumis rule26 to fully protect Texas insureds.

III. Cumis27

A. The Facts

Magdaline Eisenmann sued San Diego Navy Federal Credit Union for bad faith refusal to defend. As insurers attempt to limit their exposure, new conflicts will surface.

24 See, e.g., Tilley, 496 S.W.2d at 552.
25 Id. at 375, 208 Cal. Rptr. at 506. Reaction to Cumis was immediate and mainly hostile. See, e.g., Comment, Reexamining Conflicts of Interest: When is Private Counsel Necessary?, 17 PAC. L.J. 1421, 1422 (1986); Note, The Cumis Decision — What Has it Done to Insurance Policies?, 23 CAL. W.L. REV. 125, 148 (1986).

The California legislature bowed to pressure from the insurance industry. In 1987, the legislature incorporated many safeguards for insurers and insureds into an Act, that according to one California court, “implements” the Cumis decision. See CAL. CIVIL CODE § 2860 (West Supp. 1987).

26 Cumis may be interpreted many ways. See infra notes 58-59, 143 and accompanying text. We propose to steer a middle course. Thus we suggest that Cumis should control whenever the insurer reserves its right to contest coverage. See infra note 143. We will call this the Cumis Rule.

27 The authors have written other articles discussing insurer-insured conflicts of interest. See R. Berch, Insurer-Insured Conflicts: Can Insurer-Retained Counsel be True to the Insured?, 23 LAND & WATER L. REV. 185 (1988); Berch & Berch, Will the Real Counsel for the Insured Please Rise?, 19 ARIZ. ST. L.J. 27 (1987). The authors
Credit Union (Credit Union) and others, seeking $750,000 in compensatory damages and $6.5 million in punitive damages for wrongful discharge and for breaches of several contractual obligations. Pursuant to policy terms, the Credit Union requested that its insurer, Cumis Insurance Society, Inc. (Cumis), defend the lawsuit. In-house counsel for Cumis concluded that Cumis had a duty to defend its policyholders and retained a law firm (G & M) to represent the insureds on all claims. House counsel sent G & M copies of the insurance policies and forwarded letters to the insureds agreeing to defend the lawsuit, but reserving Cumis' right to contest coverage.

gratefully acknowledge permission from the Land and Water Law Review and the Arizona State Law Journal to adapt material from those articles for section III herein.

Cumis, 162 Cal. App. 3d at 361, 208 Cal. Rptr. at 496.

Id.

Id.

Id. at 361-62, 208 Cal. Rptr. at 496.

Id. at 362 n.2, 208 Cal. Rptr. at 496-97 n.2. Many factors may alert an insurance company to coverage problems. In Cumis, the complaint asserted alternative bases of liability, which indicated coverage questions. Id. at 361-62, 208 Cal. Rptr. at 496. At times, the insurance company may receive notice of coverage problems through statements in proofs of loss submitted by insureds. At other times, the insurer may discover through independent investigation facts giving rise to coverage questions. Regrettably, it has not been unknown for insured's counsel to inform the insurer of coverage problems. See, e.g., Parsons v. Continental Nat'l Am. Group, 113 Ariz. 223, 550 P.2d 94 (1976); Employers Casualty Co. v. Tilley, 496 S.W.2d 552 (Tex. 1973). For a discussion of Tilley, see infra notes 115-130 and accompanying text.

The insured need not allow the insurer to defend under a reservation of rights, but may require the insurer either to provide an unconditional defense or to seek to resolve the coverage question in a declaratory judgment action. See 7C J. Appleman, Insurance Law & Practice § 4694, at 346 (1979); YMCA v. Commercial Standard Ins. Co., 552 S.W.2d 497, 502 (Tex. Civ. App. 1977) (insured may demand and receive an unconditional defense unburdened by a reservation of rights or non-waiver agreement). The attorney selected by the insurer to defend the insured should advise the insured that he need not accept the conditional defense. See Ideal Mut. Ins. Co. v. Myers, 789 F.2d 1196, 1201-02 (5th Cir. 1986) (applying Texas Law) (conduct of attorney in not advising insured of potential conflict of interest did not prejudice insured who received a letter from insurer explaining potential conflict and advising insured of the right to seek independent counsel); Tilley, 496 S.W.2d at 552, 560 (non-waiver agreement does not relieve insurer of consequences of failure to notify insured of conflict of interest). Of course, the insurer also could refuse to defend, but that approach is fraught with dangers should the refusal be deemed wrongful. First, if the insurer breaches its duty to defend, the insured has the right to select counsel to represent him—and the in-
The reservation-of-rights letters specifically disclaimed responsibility for punitive damages or for compensatory damages resulting from willful conduct by the insureds.53

Fearing that G & M might not adequately protect its interests, the Credit Union retained SA & B as independent

surer may have to pay insured's counsel's fees. Ideal, 789 F.2d at 1200; Rhodes v. Chicago Ins. Co., 719 F.2d 116, 120 (5th Cir. 1983) (applying Texas law); Steel Erection Co. v. Travelers Indem. Co., 392 S.W.2d 715, 716 (Tex. Civ. App. 1965). Indeed, many courts hold that if an insurer wrongfully refuses to defend, the insured need not do anything in the main action to minimize the insurer's exposure. See, e.g., Western Casualty & Sur. Co. v. Herman, 405 F.2d 121, 124 (8th Cir. 1968) (under Missouri law, if the insurer wrongfully refuses to defend, the insured has no duty to hire an attorney to defend the action); cf. Employers Nat'l Ins. Corp. v. Zurich Am. Ins., 792 F.2d 517 (5th Cir. 1986) (applying Texas law) (finding insurer not liable for amounts in excess of policy limits).

Texas cases are clear that the duty to defend extends to cases in which the complaint contains allegations against the insured that state a claim falling within the policy plus additional or alternative allegations that, if established and made the basis for a judgment against the insured, would not be covered. See Rhodes, 719 F.2d at 119 (under Texas law, insurer has a duty to defend if one or more of the plaintiff's claims come within the terms of the policy); Colony Ins. Co. v. H.R.K., Inc., 728 S.W. 2d 848, 850 (Tex. Ct. App. 1987) (insurer is obligated to defend if complaint potentially creates a case within coverage of the policy). Indeed if there is any doubt whether the complaint is in part predicated upon acts or omissions falling within the policy, all doubts will be resolved in favor of the insured, casting upon the insurer the duty to defend. Green v. Aetna Ins. Co., 349 F.2d 919, 924 (5th Cir. 1965) (applying Texas law). Should the insurer or the insured bring a suit for a declaratory judgment regarding the duty to defend, the court may base its decision on all the facts developed at the trial and is not bound solely by the third party's complaint. Id.

53 Cumis, 162 Cal. App. 3d at 362 n.2, 208 Cal. Rptr. at 496-97 n.2. At this stage, the insurer has several options: (1) It may defend the case unconditionally. In that event, however, it must pay any judgment up to the ceiling of the policy, even if liability is predicated on acts outside the scope of the policy. (2) It may refuse to defend, thereby giving the insured the right to select his or her own attorney to conduct the defense. If the refusal is deemed wrongful, however, the insurer may be liable for additional consequential damages. See supra note 32. (3) Or it may, as in Cumis, elect to defend under a reservation of rights or nonwaiver agreement. State law determines the legality and consequences of each of these options. If, however, insurer-selected counsel assists in developing coverage defenses while purporting to represent the insured, the Texas courts may estop the insurer from denying coverage. See Employers Casualty Co. v. Tilley, 496 S.W.2d 552 (Tex. 1973) (insurer estopped from denying responsibility under the policy when insured's attorney developed late notice evidence against the insured at the insurer's request and without notifying the insured of the conflict). But cf. Texas Farmers Ins. Co. v. McGuire, 744 S.W.2d 601 (Tex. 1988) (insurer not estopped because no coverage ever existed for the particular accident involved). See infra notes 115-130 and accompanying text (discussing Tilley) and note 131 (discussing McGuire).
co-counsel. Cumis paid two of SA & B's invoices for services performed for the Credit Union before questioning whether the Credit Union's interests so conflicted with Cumis' interests as to entitle the Credit Union to separate counsel at Cumis' expense. Upon receiving G & M's opinion that no such conflict existed, Cumis notified SA & B that it would make no further payments.

At a settlement conference, the plaintiff offered to settle within the policy limits. Cumis authorized G & M to counteroffer. The case did not settle. Neither Cumis nor G & M notified the Credit Union about the settlement negotiations until after the conference. When finally notified of the settlement negotiations, the Credit Union wrote G & M expressing its strong desire to settle the lawsuit without trial. With the facts set forth and the conflict exposed, the court analyzed the case.

B. Analysis of Cumis

In Cumis, the court of appeals framed the issue as "whether an insurer is required to pay for independent counsel for an insured when the insurer provides its own counsel but reserves its right to assert noncoverage at a later date." The court concluded that "under these circumstances there is a conflict of interest between the insurer and the insured, and therefore the insured has a

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34 Cumis, 162 Cal. App. 3d at 362, 208 Cal. Rptr. at 497.
35 Id. at 363, 208 Cal. Rptr. at 497.
36 Id.
37 Id. It is difficult to imagine an attorney for the insured advising the insurer that it did not see a conflict of interest. Undivided loyalty to the client should militate against such cavalier treatment. Obviously, G & M was acting as the insurer's attorney both in rendering this opinion and in handling the settlement negotiations. See infra text accompanying notes 38-41 for a discussion of the settlement negotiations.
38 Cumis, 162 Cal. App. 3d at 363, 208 Cal. Rptr. at 497.
39 Id.
40 Id.
41 Id. at 365, 208 Cal. Rptr. at 499.
42 Id. at 361, 208 Cal. Rptr. at 496.
right to independent counsel paid for by the insurer."\(^4\)

The *Cumis* court's assertion that *any* reservation of rights by an insurer triggers a conflict of interest with its insured, thereby giving the insured the right to select an attorney at the insurer's expense, shocked the insurance industry.\(^4\) Yet the court followed traditional paths to arrive at this result. For example, the court acknowledged the proposition that an attorney retained by an insurer to represent an insured owes absolute allegiance to the insured.\(^4\) The court also affirmed the general rule that the insurer's interest in controlling the defense is subordinate to its duty to defend its insured.\(^4\) Therefore, when the interests of the insurer and the insured conflict, the insurer may not insist upon controlling the defense of the action against the insured. From these premises, the *Cumis* court reasoned that in a conflict-of-interest situation, the insured should have the right to select independent counsel at the insurer's expense.\(^4\) The court viewed

\(^{45}\) *Id.* at 364, 208 Cal. Rptr. at 497-98.

\(^{44}\) Although some commentators claim that this is the holding of *Cumis,* see Comment, *supra* note 25, at 1422; Note, *supra* note 25, at 125; see also McGee v. Superior Court, 176 Cal. App. 3d 221, 226, 221 Cal. Rptr. 421, 423 (1985) (criticizing the "language in the rather wordy *Cumis* opinion."), the facts of the case probably limit the holding to cases in which the reservation relates to the insured's conduct in causing the underlying claim. See *Cumis,* 162 Cal. App. 3d at 370, 208 Cal. Rptr. at 502; see also *supra* note 26 and accompanying text and infra notes 58-59, 143 and accompanying text.

\(^{46}\) *Cumis,* 162 Cal. App. 3d at 374, 208 Cal. Rptr. at 505 (citing Betts v. Allstate Ins. Co., 154 Cal. App. 3d 688, 715-16, 201 Cal. Rptr. 528, 544-45 (1984)).

\(^{47}\) *Id.* at 371, 208 Cal. Rptr. at 503 (citing Executive Aviation, Inc. v. National Ins. Underwriters, 16 Cal. App. 3d 799, 810, 94 Cal. Rptr. 347, 354 (1971)).

\(^{48}\) *Id.* at 369, 208 Cal. Rptr. at 501-02.
the insurer's obligation to pay the insured’s counsel as simply an extension of its duty to defend the insured.48

The *Cumis* court also followed accepted notions regarding the tripartite relationship among the insured, insurer, and insurer-retained counsel.49 The court noted that in the usual case, in which the insurer and insured share a single, common interest, "[d]ual representation by counsel is beneficial since the shared goal of minimizing or eliminating liability to a third party is the same."50 The court then distinguished the usual tripartite relationship case from the situation in which some or all of the allegations in the complaint fall outside the coverage of the policy.51 It noted that sending a reservation-of-rights letter to the insured indicates that the interests of the insured and the insurer differ.52 Although both the insured and insurer still desire a verdict for the defendant, their interests will diverge should the fact finder render a verdict for the plaintiff. The insured wants a verdict based on grounds covered by the policy; the insurer, excludable grounds.53

The court then attempted to provide predictability in

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48 Id.
49 Id. at 365, 208 Cal. Rptr. at 498.
50 Id.
51 Id.
52 Id.
53 Whether collateral estoppel of findings of fact in the main action may be asserted in the coverage dispute between the insured and the insurer is not free from doubt. For a general discussion of collateral estoppel in these and other situations, see M. Berch, *A Proposal to Permit Collateral Estoppel of Nonparties Seeking Affirmative Relief*, 1979 Ariz. St. L.J. 511.

If the insured proceeds to trial either under a nonwaiver agreement or under a reservation of rights, the insurer would not be bound, under the Restatement view, by any findings respecting coverage. Restatement (Second) of Judgments § 58 (1982). If the jurisdiction has rejected mutuality of estoppel, the insured may be bound by findings that demonstrate noncoverage, absent a showing of collusion between the insurer and the insured's attorney. See M. Berch, *A Proposal to Permit Collateral Estoppel of Nonparties Seeking Affirmative Relief*, 1979 Ariz. St. L.J. 511. In view of this possibility, the insured's attorney should consider advising the insured to implead the insurance company in the main proceeding. Then the same fact finder that decides the issues in the main case will decide coverage issues. Although the insurer may not like having the jury advised of the presence of insurance to satisfy any judgment, impleader minimizes the possibility of inconsis-
the volatile conflicts area by defining when a conflict exists. Reasoning that once the insurer sends a reservation-of-rights letter it no longer shares a commonality of interest with the insured, the court concluded that a conflict arises when the insurer takes the position that coverage is disputed. The court, however, limited its definition of conflicts to those occasions on which the insurer reserves its right to later contest coverage.

Thus, although shocking to the insurance industry, *Cumis* does not represent a radical departure from established law in the area of insurer-insured conflicts. Rather, it extends settled notions of when an insured should be able to select an attorney at the insurer's expense.

*Cumis* may be interpreted several ways. Narrowly interpreted, *Cumis* holds that, absent policy provisions to the contrary, the insurer may not insist on choosing the insured's attorney if the insurer (1) reserves its right to dispute coverage, and (2) premises that reservation on actually or potentially non-covered conduct by the insured. In such circumstances, the insured may select its own counsel, to be paid by the insurer. So restricted, the decision confirms and extends settled legal principles. But *Cumis* may also be read more broadly as mandating independent counsel at the insurer's expense whenever the insurer sends a reservation-of-rights letter or notice.

A "no action" clause in the insurance policy does not prevent insureds from impleading insurers. Colton v. Swain, 527 F.2d 296 (7th Cir. 1975).

For further discussion of collateral estoppel consequences in the insurer-insured context, see R. Berch, *supra* note 27, at 193.

*Cumis*, 162 Cal. App. 3d at 370, 208 Cal. Rptr. at 502.

*Id.* at 375, 208 Cal. Rptr. at 506.


*Cf.* R. Keeton & A. Widiss, *supra* note 16, § 7.6(a) at 818 (citing O'Morrow v. Borad, 27 Cal. 2d 794, 167 P.2d 483 (1946)).

See *supra* note 26 and *infra* note 143 and accompanying text.

*Cumis*, 162 Cal. App. 3d at 364, 208 Cal. Rptr. at 497-98.
Under the broadest interpretation, *Cumis* would require independent counsel every time an insurer is called upon to provide counsel for its insured to alleviate the inherent conflict of interest in the insurer-insured relationship. This reading would upset traditional views on insurer-insured relationships.

IV. ETHICAL RESPONSIBILITIES OF INSURED’S COUNSEL

The attorney chosen by the insurer to represent its insured owes undeviating allegiance to the insured and must not act in any way to prejudice the insured.60 The ethical concern that generated the *Cumis* rule is that once the insurer sends a reservation-of-rights letter, it no longer shares a commonality of interests61 with the insured. Rather, at that point, its interests may actually be antagonistic to the insured’s. The lawyer then faces the ethical dilemma of representing multiple clients with conflicting interests.62 The danger, of course, is that the attorney will not be able to exercise the independent judgment required by the code on behalf of both clients.63

The Ethical Considerations of the Model Code of Professional Responsibility provide aspirational guidelines for attorneys representing multiple clients, such as insurers and insureds.64 These guidelines caution lawyers against representing clients with conflicting interests; lawyers should decline cases in which they question whether a conflict exists.65 The ethical considerations further in-

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61 Cumis, 162 Cal. App. 3d at 358, 208 Cal. Rptr. at 494; see also Model Code EC 5-1, 5-2; Texas Code EC 5-1, 5-2.
62 See generally Model Code EC 5-14 to 5-20 and DR 5-101(a), 5-105 to 5-107; Texas Code EC 5-14 - 5-20, DR 5-101(A), 5-105 to 5-107.
63 Model Code DR 5-101 (1981). See also Model Rule 1.7 (1983) (Conflict of Interest: General Rule); Model Rule 1.8 (Conflict of Interest: Prohibited Transactions).
64 Model Code EC 5-14 to 5-20; Texas Code EC 5-14 to 5-20.
65 Model Code EC 5-17 n.23, provides in part:
When counsel, although paid by the casualty company, undertakes to represent the policyholder and files his notice of appearance, he
form that there are few litigation situations in which counsel would be justified in representing multiple clients whose interests even potentially differ.66

The foregoing ethical considerations appear to allow an attorney to represent an insurer and its insured in a few situations in which the conflicts between them are only potential and not actual. A close reading of the rules and ethical considerations, however, reveals that these circumstances are limited to cases in which the attorney can fully protect the insured's interests. If any question of conflict arises, the attorney owes undivided allegiance to the insured.67

The code recognizes that the insured-insurer dyad is a typically recurring situation involving potentially differing interests.68 Whether the code then permits the representation of the insured depends upon whether the lawyer's independent professional judgment will be impaired if she accepts payment from the insurer to represent the insured.69 In those circumstances in which the "chance of adverse effect upon [her] professional judgment is not unlikely," the lawyer should decline employment.70 If the lawyer accepts the employment, she must explain to the

owes to his client, the assured, an undeviating and single allegiance. His fealty embraces the requirement to produce in court all witnesses, fact and expert, who are available and necessary for the proper protection of the rights of his client . . . .


See also Model Rules Rule 1.7 (1983).

66 The considerations clearly state that a lawyer should never represent in litigation multiple clients whose interests actually differ. Model Code EC 5-14; Texas Code EC 5-14. These code sections then state that there are few situations in which a lawyer may represent multiple clients whose interests may potentially conflict. Model Code EC 5-15; Texas Code EC 5-15.

67 Model Code EC 5-1; 5-17; Texas Code EC 5-1, 5-17.

68 Model Code EC 5-17; Texas Code EC 5-17.

69 Model Code EC 5-17; Texas Code EC 5-17.

70 Model Code EC 5-17; Texas Code EC 5-17.
insured the potential conflict and its implications for the representation, and advise the insured to retain independent counsel if he wishes to do so.\textsuperscript{71}

The Ethical Considerations go one step further. They censure not only the potential impairment of the attorney’s independent professional judgment, but also emphasize that the insurer-retained counsel has a duty of exclusive loyalty to the insured.\textsuperscript{72}

What should the lawyer do when asked by an insurer to defend an insured in a third-party claim? At a minimum, the lawyer should resolve any doubts against the propriety of the representation.\textsuperscript{73} If she undertakes the representation, she must provide the insured adequate information from which he can evaluate the need for representation by independent counsel who is free of any potential conflict.\textsuperscript{74}

\textsuperscript{71} \textit{Model Code EC} 5-16, DR 5-105 to 5-107; \textit{Texas Code EC} 5-16, DR 5-105 to 5-107.

\textsuperscript{72} These are separate and distinct considerations. For example, EC 5-14 provides that the lawyer should not accept employment that will “adversely affect his judgment on behalf of or dilute his loyalty to a client.” \textit{Model Code EC} 5-15 demands that the lawyer “weigh carefully the possibility that his judgment may be impaired or his loyalty divided . . . .” \textit{Model Code EC} 5-15.

\textsuperscript{73} See \textit{Model Code EC} 5-15 (Representation of Multiple Clients Having Potentially Differing Interests); \textit{Texas Code EC} 5-15.

\textsuperscript{74} See \textit{Model Code EC} 5-16; \textit{Texas Code} 5-15. The analysis in the text is premised upon the ethical considerations dealing with multiple clients. That premise, of course, is debatable for two reasons. First, one could argue that the insured and the insurer are not multiple clients. They merely represent a “typically recurring situation involving potentially differing interests . . . .” See \textit{Model Code EC} 5-17; \textit{Texas Code EC} 5-17. This is the position taken by one observer, who then notes that because the insured does not exercise the control over litigation exercised by a typical client, the insured is owed an ever higher fiduciary duty by his insurer-retained lawyer. Note, \textit{Legal Ethics—If an Insurance Company Uses an Attorney Employed to Defend the Insured as an Investigator to Prepare a Policy Coverage Defense, It is Estopped from Asserting the Defense}, 52 Tex. L. Rev. 610, 618-19 (1974). We concur. We further believe, though, that not applying the code provisions relating to multiple clients is unduly restrictive and does not further the salutary aims of the code. Even if the position is correct, it does not mean that the same advice should not be given to the insured who may have a potentially differing interest from the insurer.

Second, one could argue that, by entering into the contract of insurance, the insured waived any future conflict. This view does not even represent good contract law. It certainly has been rejected in the domain of attorney ethical responsibility.
Although the code does not prohibit compensation from a source other than the client, it does recognize that such payment may cause the lawyer to feel a sense of responsibility to someone other than the client.\textsuperscript{75} The sentiment was perhaps best stated in \textit{United States Fidelity & Guaranty Co. v. Louis A. Roser Co.}:\textsuperscript{76} Even the most optimistic view of human nature requires us to realize that an attorney employed by the insurance company will slant his efforts, perhaps unconsciously, in the interests of his real client — the one who is paying his fee and from whom he hopes to receive future business — the insurance company.\textsuperscript{77} If the attorney feels she might owe a duty to the insurer she should decline the proffered employment.\textsuperscript{78} She must resolve all doubts against the propriety of the representation and should inform the insured of all the relevant facts.\textsuperscript{79} EC 5-14 of the Model Code of Professional Responsibility provides that the lawyer shall not represent clients with conflicting interests unless she reasonably believes that she can represent each client without adversely affecting the other.\textsuperscript{80} Although DR 5-105(C) does permit a lawyer to represent multiple clients, it does so only if it is "obvious" that the lawyer can adequately represent all clients, she fully discloses the possible effects of the poten-

\textsuperscript{75} \textit{Model Code} DR 5-107 requires full disclosure and the consent of all clients before an attorney may accept payment from one other than his client. \textit{Model Code} DR 5-107; \textit{Texas Code} DR 5-107. We question whether the bare assertion in the insurance contract that the insurer has the right to control the defense of any lawsuit against the insured satisfies that disclosure requirement.\textsuperscript{76} 585 F.2d 932 (8th Cir. 1978).\textsuperscript{77} \textit{Id.} at 938 n.5.\textsuperscript{78} \textit{Model Code} DR 5-101(A); \textit{Texas Code} DR 5-101(A); \textit{see also} \textit{Model Code} EC 5-15, which requires that even if the interests of the clients only \textit{potentially} differ, the attorney "should resolve all doubts against the propriety of the representation." \textit{Texas Code} EC 5-15.\textsuperscript{79} \textit{Model Code} EC 5-15, 5-16; \textit{Texas Code} EC 5-15, 5-16.\textsuperscript{80} \textit{Model Code} EC 5-14; \textit{Texas Code} EC 5-14. This requirement is made mandatory by DR 5-101(A), which states that a lawyer \textit{shall not} accept employment by multiple clients if her independent professional judgment "may be affected by [her] own \ldots financial \ldots or personal interests." \textit{Model Code} DR 5-101(A); \textit{Texas Code} DR 5-101(A).
tial conflict, and the client then consents to the continued representation. The model rules require that the disclosure include explanation of the advantages and risks of common representation. It is difficult to imagine that any attorney truly acting on the insured's behalf could counsel the insured to accept representation by insurer-selected counsel once any potential conflict of interests has been identified. Regrettably, however, members of the legal profession do not always fully disclose the risks of common representation, nor do they bestow absolute loyalty upon clients. Adopting the Cumis rule should alleviate many of the problems that inhere when insurer-retained attorneys attempt to represent both insurers and insureds, for under Cumis, the insured would select counsel whom he trusted, and counsel would presumably give full loyalty to the insured.

The Model and Texas Codes recognize that conflicts inhere whenever one party pays for legal services for another. Moreover, the comments to the Model Rules of Professional Conduct note that an attorney may not accept a payment from a source other than the client unless the arrangement assures the attorney's loyalty to the cli-

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81 Model Code DR 5-105(C); Texas Code DR 5-105(C).
82 Model Rules Rule 1.7; see also Model Code DR 5-105(C); Texas Code DR 5-105(C).
83 See, e.g., State Farm Mut. Auto. Ins. Co. v. Walker, 382 F.2d 548 (7th Cir. 1967), cert. denied, 389 U.S. 1045 (1968) (insured's counsel provided the insurer with insured's ex parte sworn statements, which counsel took after learning of the conflict); Parsons v. Continental Nat'l Am. Group, 113 Ariz. 223, 550 P.2d 94 (1976) (insured's counsel revealed privileged information to the insurer, who later used the information to the insured's detriment); Employers Casualty Co. v. Tilley, 496 S.W.2d 556 (Tex. 1973) (while purporting to represent the insured, insured's counsel helped the insurer develop facts to establish a policy exclusion).
84 See infra section V(C). The Code of Professional Responsibility does not require the adoption of Cumis. There are other ways to foster counsel's loyalty to the insured. For example, the Washington Supreme Court approved the practice whereby an insurer retained separate counsel to represent insured's interest, as distinct from company's interest. Tank v. State Farm Fire & Casualty Co., 105 Wash. 2d 381, 715 P.2d 1133 (1986). Adopting Cumis, however, serves the salutary goals of the Texas Code of Professional Responsibility and is the most direct way to assure loyalty to the insured.
85 Model Code EC 5-17; Texas Code EC 5-17.
The comments suggest that when the interests of the insurer and the insured conflict, the insurer must "provide special counsel" for the insured, and the arrangement should "assure the special counsel's professional independence." The comments fail, however, to specify who pays for the special counsel. We contend that the insurer should bear this expense.

V. Texas Law

Texas courts have had several occasions to scrutinize the relationship among the insurer, its insured, and insurer-selected counsel. Section A analyzes the landmark case, G.A. Stowers Furniture Co. v. American Indemnity Co., which explores the relationship in the context of the duty of the insurer to settle within policy limits. Section B analyzes Texas law regarding the obligations of counsel selected by the insurer to defend the insured. Finally, although the area is not free from doubt, Section C concludes that Texas courts have already embraced the principle of protecting insureds' interests, and by accepting that principle have laid the foundation for adopting the Cumis rule.

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86 Model Rules Rule 1.7 comment. "A lawyer may be paid from a source other than the client if the client is informed of that fact and consents and the arrangement does not compromise the lawyer's duty of loyalty to the client." Id.

87 Id.


89 15 S.W.2d 544 (Tex. Comm'n App. 1929, holding approved).
A. Liability of Insurer for Failure to Settle Within Policy Limits

As early as 1929, Texas recognized an insurer's liability to its insured for damages resulting from its negligent failure to settle within policy limits.90 Texas courts have stalwartly defended insured's interests ever since.

In Stowers, the insurer, pursuant to policy provisions reserving the right to defend third-party claims, provided counsel to defend its insured in a case seeking $20,000 damages.91 During the pretrial stages of the litigation, the plaintiff offered to settle for $4,000, $1,000 below the maximum coverage.92 The insurer refused to settle for more than $2,500, allegedly in accordance with a practice never to settle for more than one-half the amount of the policy.93 The insured charged:

that [plaintiff in the third-party action] was likely to get a judgment for far more than $5,000, and that a person of ordinary prudence would have settled said cause for said sum of $4,000; that defendant admitted that said offer of settlement was a good one and should be accepted; that it willfully and negligently refused to make such settlement, knowing at the time it did so that it was jeopardizing the interests of this plaintiff in a very large amount; . . . and that by reason of such conduct of said indemnity company the [insured] had been compelled to pay the said sum of more than $14,000.94

Earlier cases had recognized liability for fraudulent conduct or lack of good faith in refusing to settle,95 and none had set forth any reasoning that would preclude imposing liability for negligent conduct.96 Therefore, noting that an insurer should not be permitted to assume a contrac-
tual duty to protect the insured’s interest and then disre- 
gard that interest, the commission reversed the Court of 
Appeals’ judgment for the insurer, and held that the com-
plaint stated a cause of action in negligence.97

Stowers liability is premised upon the principle that by 
the act of reserving the absolute right to control the de-
fense of the lawsuit against its insured, the insurer “as-
sumed the responsibility to act as exclusive and absolute 
agent of the assured . . .”98 The court held that, as agent 
for the insured, the insurer “ought to be held to that de-
gree of care and diligence which an ordinarily prudent 
person would exercise in the management of his own busi-
ness . . . as viewed from the standpoint of the assured 
. . .”99 The Texas Court has consistently followed the 
Stowers principle.100 In fact, in 1987 it extended the Stow-
ers reasoning to further protect Texas insureds.

Ranger County Mutual Insurance Co. v. Guin101 raised the 
question whether to impose liability on an insurance com-
pany for negligent handling of a claim against its in-
sured.102 In Ranger, the insureds alleged that the insurer-
selected attorney neither advised them of settlement of-
fers nor offered policy limits to a third-party claimant, de-
spite knowledge that “the liability factors were adverse to 
the insureds” and that there was a “high probability” that a 
“jury verdict would exceed policy limits.”103 Despite the

97 Id. at 546-47.
98 Id. at 547.
99 Id. (emphasis added).
100 The Texas State Bar Committee was asked to issue an advisory opinion on 
two issues: (1) whether an insurer-retained attorney must comply with the ethical 
duty “to fully inform” the insured of potential conflicts of interest, and (2) 
whether, in complying with that duty, he had to inform the insured of the Stowers 
holding imposing liability in excess of policy limits for negligent failure to settle. 
Not only did the committee answer both questions in the affirmative, it opined 
that the failure to make the required disclosures was a violation of the canons of 
ethics. It warned that attorneys and insurers who failed to make the required dis-
closures faced potential excess liability. See State Bar of Texas, Committee on 
B.J. 593 (1958); see infra text accompanying notes 113-114.
101 723 S.W.2d 656 (Tex. 1987).
102 Id. at 657.
103 Id. at 659.
lawyer's testimony to the contrary, the jury found that he had not offered to settle within policy limits. The court held that failure to advise the insureds of a third party's conditional settlement offer and failure to offer policy limits would support a finding of negligence. Indeed, such negligence would support an independent action for exemplary damages. Rangers extends Stowers beyond mere negligent failure to settle to include any negligence in investigating and handling lawsuits.

Justice Gonzalez's dissent shows that the court's extension of Stowers to the full range of representation of the insured was no mere happenstance. He stated that the court misapplied Stowers. He would have restricted Stowers to cases in which the plaintiff made an unconditional offer to settle. The majority opinion, however, extends Stowers protection to all aspects of the insured/insured-counsel relationship, thereby fully protecting the insured.

B. The Role of Counsel

Stowers and Ranger impose upon an insurer in handling all aspects of a claim against its insured the duty to exercise that degree of care and diligence that an ordinarily prudent person would exercise in the management of his own affairs. Ranger's effects, however, are even more far-reaching, as it enters the domain of the tripartite relationship among the insurer, the insured, and the attorney.

104 Id.
105 Id. at 660.
106 Id.
107 An insurer's duty to the insured extends to "the full range of the agency relationship." Id. at 659.
108 Id. at 663.
109 Id.
110 Although we approve the extension of Stowers, Ranger can, and even arguably should, be read more restrictively. The issue before the court was whether the failure to accept a conditional settlement offer not releasing all insureds renders an insurer negligent. The court's language purportedly extending Stowers liability to "the full range" of the insurer-insured relationship, from investigation through trial, is dicta. See id. at 659.
111 Id.; Stowers, 15 S.W.2d at 548.
The court in *Ranger* not only makes the insurer an agent of the insured, but extends the agency relationship to the insurer-selected attorney.\(^{112}\) Thus, negligence on the part of the attorney may render her liable to the insured.

The *Stowers/Ranger* doctrine and the ethical rules and considerations governing lawyers’ duties to clients should caution insurer-selected lawyers against readily agreeing to accepting the insured’s defense. At a minimum, any lawyer should reflect upon these matters before accepting an insurer’s request to represent its insured.

Thirty years ago, the Texas State Bar Committee on Interpretation of Canons of Ethics considered whether the insurer-selected attorney had an obligation to inform the insured of the *Stowers* holding. The Committee rendered the opinion that the attorney has the obligation to inform the insured that the company may be liable in excess of policy limits for negligent failure to settle.\(^{113}\)

The lack of more explicit disclosure may not be significant in those cases in which the insured employs independent counsel. But if the insured is not fully aware of this conflict and does not employ independent counsel, the failure of the attorney to make the more explicit disclosure suggested in the Texas opinion is not only a probable violation of canons of ethics but also a potential source of liability for the attorney and the company for loss resulting to the insured from a tort judgment against the in-

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\(^{112}\) *Ranger*, 723 S.W.2d at 659. *Ranger* and *Stowers* apply agency terminology to the insurer-insured relationship. *Id.; Stowers*, 15 S.W.2d at 458. In *Ranger*, however, the Texas Supreme Court extends the agency analogy, designating the insurer the agent of the insured and the insurer-retained attorney the sub-agent. *Ranger*, 723 S.W.2d at 659. As the dissent correctly notes, the agency analogy imperfectly fits the insurer-insured context because the principal (the insured) lacks full control over its agents (the insurer and insurer-retained counsel). *See id.* at 663 (Gonzales, J., dissenting) (citing Keeton, *Liability Insurance and Reciprocal Claims from a Single Accident*, 10 Sw. L.J. 1, 9 (1956)); *see also* R. KEETON & A. WIDISS, supra note 16 § 7.5, 807-08 (1988).

We agree that despite the agency analogy’s usefulness in illustrating the insurer’s duty to the insured, the analogy does not work well in the insurer-insured context. Applying agency concepts may give observers the inaccurate impression that the insured exercises full decision-making authority over the insurer and insurer-retained counsel.

\(^{113}\) *See supra* note 100.
sured in excess of policy limits. The present Code requires no less.

Recent Texas cases are likewise explicit concerning the attorney's duty to the insured, and the consequences for breach of that duty. In *Employers Casualty Co. v. Tilley*, the insurer requested a declaration that the insured's late notice had violated a policy condition, thereby relieving the insurer of any obligation to defend or to indemnify the insured. The insurer had secured a standard non-waiver agreement and had retained an attorney who represented the insured for eighteen months before the insurer instituted the declaratory judgment action. At no time did the insurer-retained attorney advise the insured of any conflict between the interests of the insurer and the insured. Indeed, the attorney actively worked against the insured by developing for the insurer evidence of the facts and circumstances surrounding the insurer's defense of late notice. The Supreme Court of Texas noted that the case presented "serious questions involving legal ethics and public policy with which this Court has not dealt under like circumstances." Although the court did not impugn the integrity of the attorney, it stated that "custom, reputation, and honesty of intention and motive are not the tests for determining the guidelines which an attorney must follow when confronted with a conflict between the insurer who pays his fee and the insured who is entitled to his undivided loyalty as his attorney of record." The court held that as soon as a conflict of interest between the insurer and insured develops, the attorney re-

114 R. Keeton & A. Widiss, supra note 16, § 7.6(c), 891 n.7.
115 496 S.W.2d 552, 554 (Tex. 1973).
116 Id. at 554-55.
117 Id. at 554.
118 Id.
119 Id.
120 Id. at 557.
121 Id. at 558 (emphasis added) (citing Hammett v. McIntyre, 114 Cal. App. 2d 148, 249 P.2d 885, 889 (1952); Van Dyke v. White, 55 Wash. 2d 601, 349 P.2d 430, 437 (1960)).
tained by the insurer to represent the insured owes a duty to the insured to immediately advise him of the conflict.\footnote{122}{Id. (citing Automobile Underwriters' Ins. Co. v. Long, 63 S.W.2d 356 (Tex. Civ. App. 1933)).}

The court approved certain passages in the \textit{Guiding Principles};\footnote{123}{\textit{Id.} at 559 (approving the American Bar Association National Conference of Lawyers and Liability Insurers \textit{Guiding Principles}, 20 Fed'n of Ins. Couns. Q. 95 (1970)). For further discussion of the \textit{Guiding Principles}, see \textit{supra} note 12 and accompanying text.} in particular, it sanctioned those provisions imposing on the insurer-retained counsel the duty to inform both the insured and the insurer of the nature and extent of the conflict, and requiring that the insurer-retained counsel withdraw from further representation of the insured unless the insured acquiesces in the continuation of the defense.\footnote{124}{\textit{Tilley}, 496 S.W.2d at 559.} The court neither approved nor disapproved the particular passage in the \textit{Guiding Principles} that required the insured to retain counsel at his own expense.\footnote{125}{\textit{Id.} at 561.}

The court also addressed the relevance of the non-waiver agreement to the attorney's conduct. It specifically held that standard nonwaiver agreements cannot relieve the attorney of the consequences of the failure to notify the insured of the conflict of interest.\footnote{126}{\textit{Id.} at 562-64 (Johnson, J., concurring).} Disapproving of the attorney's violation of public policy in assisting the insurer while purportedly representing the insured, the court estopped the insurer from using against the insured the damaging information gained by the insured's attorney during the course of the representation.\footnote{127}{\textit{Id.} at 562-64 (Johnson, J., concurring).}

Justice Johnson's concurring opinion concentrated on the ethical considerations involved in the attorney client relationship.\footnote{128}{\textit{Id.} at 562.} According to Justice Johnson, the attorney's sole client is the insured, and she should act solely for his benefit.\footnote{129}{\textit{Id.} at 562.}

\begin{footnotesize}
\begin{enumerate}
\item Id. (citing Automobile Underwriters' Ins. Co. v. Long, 63 S.W.2d 356 (Tex. Civ. App. 1933)).
\item Id. at 559 (approving the American Bar Association National Conference of Lawyers and Liability Insurers \textit{Guiding Principles}, 20 Fed'n of Ins. Couns. Q. 95 (1970)). For further discussion of the \textit{Guiding Principles}, see \textit{supra} note 12 and accompanying text.
\item Tilley, 496 S.W.2d at 559.
\item \textit{Guiding Principles}, \textit{supra} note 12 at ¶ IV.
\item Tilley, 496 S.W.2d at 599 (citing \textit{Guiding Principles}, \textit{supra} note 12).
\item Id. at 561.
\item Id. at 562-64 (Johnson, J., concurring).
\item Id. at 562.
\end{enumerate}
\end{footnotesize}
ance company's ethical obligation, but on the attorney’s. 130 Once again in Tilley, the Texas Supreme Court expressed concern that attorneys who represent insureds must truly be loyal to the insureds. The court places the burden of managing the conflict squarely upon the shoulders of the attorney.

One recent case construing Texas law seems to go against the tide of cases protecting Texas insureds. 131 In Ideal Mutual Ins. Co. v. Myers, 132 the Fifth Circuit refused to censure an insurer and an insurer-selected attorney for allegedly failing to advise the insured of its right to secure independent counsel when a conflict of interest arose. The court, however, recognized the duty Tilley places upon insurer-retained attorneys. 133 Nevertheless, it found that the insured had not been prejudiced by the attorney’s inaction because the insured received notice of the conflict and had been advised, by a reservation-of-rights letter, of its option to seek independent counsel. 134 Further, the court found that the insurer-retained attorney had not worked against the insured’s interest, nor had he previ-

130 “This court should not be considering the ethical obligation, whatever it may be, which is required of a commercial enterprise to its customer; this court should be considering the fiduciary relationship inherent in the attorney-client relationship and the effect of its transgression upon the rights of the parties thereto.” Id. at 564.

131 One other case diverging from the otherwise consistent line of cases protecting insureds’ rights is Texas Farmers Ins. Co. v. McGuire, 744 S.W.2d 601 (Tex. 1988). That case, however, focused upon the conduct of a claims representative rather than on the conduct of a lawyer. Indeed, there appears to have been no insurer-retained attorney involved in the case. This article focuses upon the tension between the attorney’s attempt to accommodate the sometimes conflicting interests of the insurer and insured and complying with the Rules of Professional Responsibility. We know of no corresponding ethical constraints on claims representatives.

Although McGuire does diverge from the main line by not scrupulously protecting the insured’s interests, we suspect that the Texas Supreme Court was influenced by insured’s less-than-exemplary conduct in attempting to maneuver the insurer into paying for an accident that it had no contractual duty to cover. The court held that “estoppel cannot be used to create insurance coverage when none exists by the terms of the policy.” Id. at 602-03.

132 789 F.2d 1196 (5th Cir. 1986).
133 Id. at 1202.
134 Id.
ously or subsequently worked for the insurer. Thus, although the interests of the insurer and insured conflicted, there was no evidence that the insured’s attorney did not fully represent the insured. Indeed although the opinion does not disclose who negotiated the settlement, the insured entered into the settlement that called for liability seven and one-half times policy limits, coupled with an assignment of all claims against the insurer and a covenant not to execute against the insured. Clearly the insured could not establish any prejudice to his interests. So although the holding may at first glance seem to dilute the protection offered to the insured, the insured’s rights seem to have been fully protected.

C. Adoption of the Cumis Rule

Texas is in the forefront of jurisdictions giving maximum protection to insureds. Texas courts recognize the broad principle that the attorney an insurer retains to represent its insured is responsible to the insured for negligence in the investigation and processing of claims. Texas case law and the Texas Code of Professional Re-

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135 Id.
136 Id. at 1198 n.5.
137 In Ideal, the Fifth Circuit does sow one dangerous seed. The court states that the Myers Estate “did not object to Ideal’s offer of a conditional defense, and therefore, by its silence, constructively consented to Ideal's legal representation.” Id. at 1200-01. This statement improperly shifts the burden from the attorney, to fully disclose and to obtain the insured’s consent, to the insured to object to the conditional offer of defense. See MODEL CODE DR 5-101(A), 5-105(C), 5-107. This shift is less troubling if the Myers Estate was represented by its own attorney, as indeed the generous settlement indicates that it may have been. See Ideal, 789 F.2d at 1198. This issue is never made clear in the opinion. The holding in Allstate Ins. v. Kelly, 680 S.W.2d 595, 608-09 (Tex. Ct. App. 1984), is similar to the holding in Ideal. In Kelly, the court refused to find the insurer liable under the Deceptive Trade Practices Act for advising the insureds “that it was not necessary for them to hire a lawyer (in the personal injury suit).” In Kelly, there was neither a reservation of rights nor a nonwaiver of rights agreement. The court specifically found no evidence that insurer-selected counsel failed to provide the insured with competent legal services in defense of the third-party action. Indeed the attorney advised the insurer to settle within the policy limits. More fealty to the insured cannot be commanded. Contrast Cumis, in which the attorney neither advised the insured of settlement offers nor sought his position on such matters.

138 See, e.g., Stowers, 15 S.W.2d at 544; Ranger, 723 S.W.2d at 656.
sponsibility place a high obligation upon the attorney to give undivided loyalty to the insured. This is the way it should be.

When a conflict between the interests of the insurer and its insured arises, insurer-selected attorneys must fully inform the insured of the differing interests between the insurer and insured and the potential prejudicial consequences to the insured of the continuing relationship with the insurer-selected attorney. The attorney must also advise the insured of their right to retain counsel of their own choosing.

In short, Texas now requires every disclosure that Cumis requires. Indeed, Texas goes one step further in requiring that insurer-selected attorneys make a Stowers disclosure, telling the insureds that if the insurer negligently fails to settle within policy limits, the insured may be able to recover in excess of policy limits. Texas stops short of Cumis, however, in that it has not attempted to define when a conflict of interest between insurer and insured exists. Cumis defines that point as occurring whenever the insurer reserves the right to contest coverage.

Nor has Texas yet determined who should pay for independent counsel for the insured once a conflict requiring such protection arises. The insurer-drafted Guiding Principles invite the insured to retain counsel at his own

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139 See supra notes 60-87 and accompanying text.
140 Id.
141 MODEL CODE EC 5-16 (1981); TEXAS CODE EC 5-16 (1984).
142 See supra note 100 and text accompanying notes 113-114.
143 Cumis, 162 Cal. App. 3d at 358, 208 Cal. Rptr. at 494. As set forth in supra notes 42-59 and accompanying text, Cumis may be read to define conflicts as occurring at any of three points: (1) whenever an insurer reserves its right to contest coverage and premises that reservation upon the insured's conduct in causing the claim, (2) whenever the insurer reserves the right to contest coverage for any reason, or (3) whenever an insurer is called upon to represent an insured. We suggest that the second option represents the most reasonable interpretation of Cumis and provides the most workable definition of conflicts of interest.
144 If the insurer wrongfully refuses to defend, the insurer may be required to pay the insured's attorney. Ideal, 789 F.2d at 1200; Rhodes v. Chicago Ins. Co., 719 F.2d 116, 120 (5th Cir. 1983) (applying Texas law); Steel Erection Co. v. Travelers Indem. Co., 392 S.W.2d 713, 716 (Tex. Civ. App. 1965).
expense.\textsuperscript{145} We would guess that few insureds would forego free representation for the opportunity to hire and pay independent counsel, even when doing so might more fully protect their interests.

This state of affairs burdens not only insureds, but insurers.\textsuperscript{146} Failure to satisfactorily represent insureds now subjects insurers not only to excess liability, but also to exposure for punitive damages.\textsuperscript{147} We suggest that Texas courts lift this burden by providing that once a conflict of interest arises, the insured be permitted to select counsel of his own choosing at the insurer's expense—the Cumis rule.

We do not suggest that the insurer need be bound by any selection that the insured makes. Indeed we suggest that insurers draft appropriate language to protect themselves. The insurer is "under a duty to provide an impartial defense—not to sacrifice its own interests."\textsuperscript{148}

Note too that this solution, although concededly intended to protect insureds from conflicts of interest, does carry one negative consequence for the insured. Having selected his own attorney, he will not then be able to subject the insurer to liability if the representation he receives is less than adequate. Having made his selection, he should be bound by it.

Cumis is a desirable method for implementing the Texas

\textsuperscript{145} Guiding Principles, supra note 12, at \S IV.

\textsuperscript{146} Recognize that the fiduciary duty to the insured is in addition to the insurer's contractual obligation to the insurer to deal fairly and in good faith. See R. Kee- ton & A. Widiss, supra note 16, § 7.6(b).

\textsuperscript{147} See Ranger, 723 S.W.2d at 660-61.

\textsuperscript{148} New York Urban Dev. Corp. v. VSL Corp., 563 F. Supp. 187, 190 n.1 (S.D.N.Y. 1983). The Second Circuit affirmed a district court opinion permitting an insurer to participate in selecting counsel once a conflict arises, where the policy provided for such participation. Id. at 190; see also Employers' Fire Ins. Co. v. Beals, 103 R.I. 623, 240 A.2d 397, 404 (1968). Thus, amending policy language is one way insurers may mitigate any perceived burden of Cumis-type rules.

For other ways insurers might respond to a Cumis-type rule, see Berch & Berch, supra note 27; Lower, The Cumis Triangle, CAL. LAW., May 1986 at 46-47, 63; see supra note 25 (setting forth the response of the California legislature).

Contrary to most insurers' reactions to Cumis, it is our position that the industry should welcome the opportunity and impetus to draft policy language that will benefit the insurance industry and its insureds and alleviate many conflicts of interest that have plagued the profession.
policy of protecting insureds. Insurers would benefit from allowing the insured to select his own counsel, even at the insurer’s expense, because insurers would then be relieved of some exposure for excess judgments and punitive damages that now stem from the insurer-retained attorney’s attempts to balance insurer-insured conflicts of interest. The insurer’s legitimate interest in reducing monetary exposure through a vigorous and adequate defense can be satisfied, with fewer risks, by giving the insurer the right to participate in the selection of [her] attorney. Insureds would benefit because their interests would be protected by attorneys whom they have selected and whose loyalty they do not question.

D. Conclusion

It is inevitable that conflicts of interest will arise between insureds, who desire their insurers to bear the financial burden of negligence lawsuits, and insurers, who seek to limit their exposure in such cases. The attorney retained by the insurer to represent the insured is caught in the middle of this tug-of-war. She is further constrained by the rules of professional responsibility.

Insurers and counsel need guidance in their appropriate functions in representing insureds. Cumis provides this guidance by defining when a conflict of interest arises — that is, when the insurer reserves its right to contest coverage. It then provides that when such a conflict exists, the insured should be permitted to select his own attorney, at the insurer’s expense.

The Cumis rule provides a systematic, easily-applied standard for guiding parties through the murky conflicts area. Texas courts have repeatedly shown their desire to protect Texas insureds. This rule protects those interests without unduly burdening Texas insurers. The rule has

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149 Cumis, 162 Cal. App. 3d at 358, 208 Cal. Rptr. at 494. In our opinion, this definition should be expanded to include nonwaiver agreements. See infra note 143.

150 Cumis, 162 Cal. App. 3d at 375, 208 Cal. Rptr. at 506.
the added benefit of making counsel independent of the insurer and thus more fully able to represent her true client—the insured.