TWENTY YEARS OF *DAVALOS*

THE EVER-EVOLVING RIGHT TO INDEPENDENT COUNSEL

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EXISTENCE OF DUTY TO DEFEND

Duty to Defend

- Eight Corners Rule
- Defend whole lawsuit, including covered and uncovered claims

Duty to Indemnify

- Actual Proven Facts Rule
- Pay only damages covered under the policy

RESPONSE TO A REQUEST FOR A DEFENSE

Deny	• Deny the request for a defense
Unqualified	• Provide an unqualified defense
Reservation of Rights	• Provide a qualified defense pursuant to a reservation-of-rights letter.
Reserve and File Suit	• Send a Reservation of Rights and File a Declaratory Judgment Action

NATURE OF CONFLICT BETWEEN INSURER AND INSURED

Subject to the terms of the insurance policy, if the insurer has a duty to defend with respect to *any* aspect of the lawsuit, it has the duty to defend with regard to *every* aspect of the lawsuit.

Heyden Newport Chem. Ins. Co. v. Southern Gen'l Ins. Co., 387 S.W.2d 22, 26 (Tex. 1965).

LANDSCAPE IN TEXAS BEFORE *DAVALOS*

Rhodes v. Chicago Ins. Co., a Div. of Interstate Nat. Corp

- In Rhodes, where an insurer's offer to defend came with a reservation of rights, "the insured may properly refuse the tender of defense and pursue his own defense."
- The insurer remains liable for attorneys' fees incurred by the insured and may not insist on conducting the defense.
- "When the insurer is denying coverage, ... and where coverage, vel non, will depend upon the finding of the trier of facts as to certain issues in the main case, ... the insurer is not in a position to defend the insured."
- In these cases, despite offering to defend, the insurer was also barred from enforcing other conditions like the voluntary assumption of liability and no action clauses.

719 F.2d 116, 120–21 (5th Cir. 1983)

NORTHERN COUNTY MUT. INS. CO. V. DAVALOS

- Davalos (a resident of Matagorda County) was involved in a car accident in Dallas County.

- Davalos brought suit in Matagorda County. The other driver brought suit against Davalos in Dallas County. Davalos moved to transfer venue to Matagorda County.

140 S.W.3d 685 (Tex.2004).

NORTHERN COUNTY MUTUAL INS. CO. V. DAVALOS

- Northern's letter stated that if Davalos' personal attorneys:

  . . . continue to defend you in the Dallas County lawsuit and continue to pursue the motion to transfer venue, we will take the position that there is no liability protection under the [policy], and the outcome of the Dallas County case will be your personal responsibility.

NORTHERN COUNTY MUT. INS. CO. V. DAVALOS

- Trial Court's
  - Final judgment rendered in Davalos' favor for breach of contract and violation of article 21.55 of the insurance code.
- Court of Appeals' Affirmed:
  - In determining an Insurer's responsibilities under the standard form Texas personal auto policy, the Texas Supreme Court held that: "The insurer's control of the insured's defense under this policy thus includes authority to accept or reject settlement offers and, ***where no conflict of interest exists***, to make other decisions that would normally be vested in the client, here the insured." *State Farm Mutual Ins. Co. v. Traver*, 980 S.W.2d 625, 627 (Tex. 1998)

STATE FARM MUTUAL INS. CO. V. TRAVER

- Traver's Estate was sued by a party injured in an auto accident.
- State Farm hired counsel to represent Traver.
- Case went to trial – 100% fault attributed to Traver resulting in judgment in excess of policy limits.
- Estate sued State Farm for breach of the duty to defend, alleging counsel committed malpractice.

980 S.W.2d 625, 627 (Tex. 1998)

STATE FARM MUTUAL INS. CO. V. TRAVER, 980 S.W.2D 625, 627 (TEX. 1998)

"We have recognized that a liability policy may grant the insurer the right to take complete and exclusive control" of the insured's defense…Here, the standard form Texas Personal Auto Policy provides that the insurer "will settle or defend, as [it] consider[s] appropriate, any [covered] claim or suit …" The insurer's control of the insured's defense under this policy thus includes authority to accept or reject settlement offers and, where no conflict of interest exists, to make other decisions that would normally be vested in the client, here the insured. *However, even assuming that the insurer possesses a level of control comparable to that of a client, this does not meet the requisite for vicarious liability*."

NORTHERN COUNTY MUT. INS. CO. V. DAVALOS

North County's Position

- A dispute as to the manner in which the defense should be conducted does not constitute a conflict in the sense of insurance coverage.

- A conflict exists only when an insurer questions whether an event is covered by an insurance policy.

- The Appellate Court's reliance upon *State Farm Mutual Ins. Co. v. Traver*, 980 S.W.2d 625, 627 (Tex. 1998) was misplaced.

NORTHERN COUNTY MUT. INS. CO. V. DAVALOS

North County's Position

- The "settle and defend" clause of a liability policy give the right to take exclusive control of the suit.
- These provisions give the insurer "absolute and complete control of the litigation, as a matter of law."
- An insured must cooperate with his insurer and turn the defense over to the insurer when the insurer tenders an unconditional defense.
- The insured's actions must not deprive the insurer of any valid defense.

NORTHERN COUNTY MUT. INS. CO. V. DAVALOS

Davalos Position

- An insurer may assume the control over the insured's defense only where no conflict of interest exists. A conflict of interest exists where there is a dispute between the insurer and the insured *with regard to how the lawsuit should be defended."*

- Northern County's venue choice was a conflict that would result in "race to trial" in the underlying matter.

NORTHERN COUNTY MUT. INS. CO. V. DAVALOS

Davalos Position

- Northern County forfeited its right to control the defense by attempting to impose a condition not mandated by its policy with Davalos, and acting directly contrary to ethical considerations and duties to its insured

- Northern County is not entitled, by virtue of its insurance policy, to compromise Davalos's affirmative claims against a third party including his claim against Northern County.

- Since Northern breached the duty to defend, Davalos was entitled to assume control over his own defense.

NORTHERN COUNTY MUT. INS. CO. V. DAVALOS

Holding of the Supreme Court

- The insurer's right to conduct the defense by the insurer is a matter of contract.
- The insurer has the right to make defense decisions as if it were the client "*where no conflict of interest exists*." *State Farm Mutual Automobile Ins. Co. v. Traver.*
- A disagreement about how the defense should be conducted is not a conflict of interest under *Traver.*
- Where there is a question regarding the existence of scope of coverage and the duty to indemnify the insured, there may be exist a right for disqualifying conflict. A disqualifying conflict exists when the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends.

NORTHERN COUNTY MUT. INS. CO. V. DAVALOS

Every disagreement about how the defense should be conducted cannot amount to a conflict of interest . . .If it did, the insured, not the insurer, could control the defense by merely disagreeing with the insurer's proposed actions.

N. Cnty. Mut. Ins. Co. v. Davalos, 140 S.W.3d 685, 689 (Tex. 2004).

NORTHERN COUNTY MUT. INS. CO. V. DAVALOS

In this case, Davalos chose to reject Northern's tender and conduct his own defense because he really did not want the case defended in Dallas County. That was his right. But **having rejected the insurer's defense** without a sufficient conflict, Davalos **lost his right to recover the costs of that defense**. Because Northern's offer to defend Davalos in Dallas County satisfied its obligation under the policy, Northern did not breach its duty to defend.

N. Cnty. Mut. Ins. Co. v. Davalos, 140 S.W.3d 685, 690 (Tex. 2004).

TYPES OF CONFLICTS THAT MAY JUSTIFY REJECTION

Complete Defense

- When the defense tendered "is not a complete defense under circumstances in which it should have been."

Unethical Attorney

- When the "attorney hired by the carrier acts unethically and, at the insurer's direction, advances the insurer's interest at the expense of the insured's."

Duty to Defend

- When "the defense would not, under the governing law, satisfy the insured's duty to defend," and

Concession from Insurer

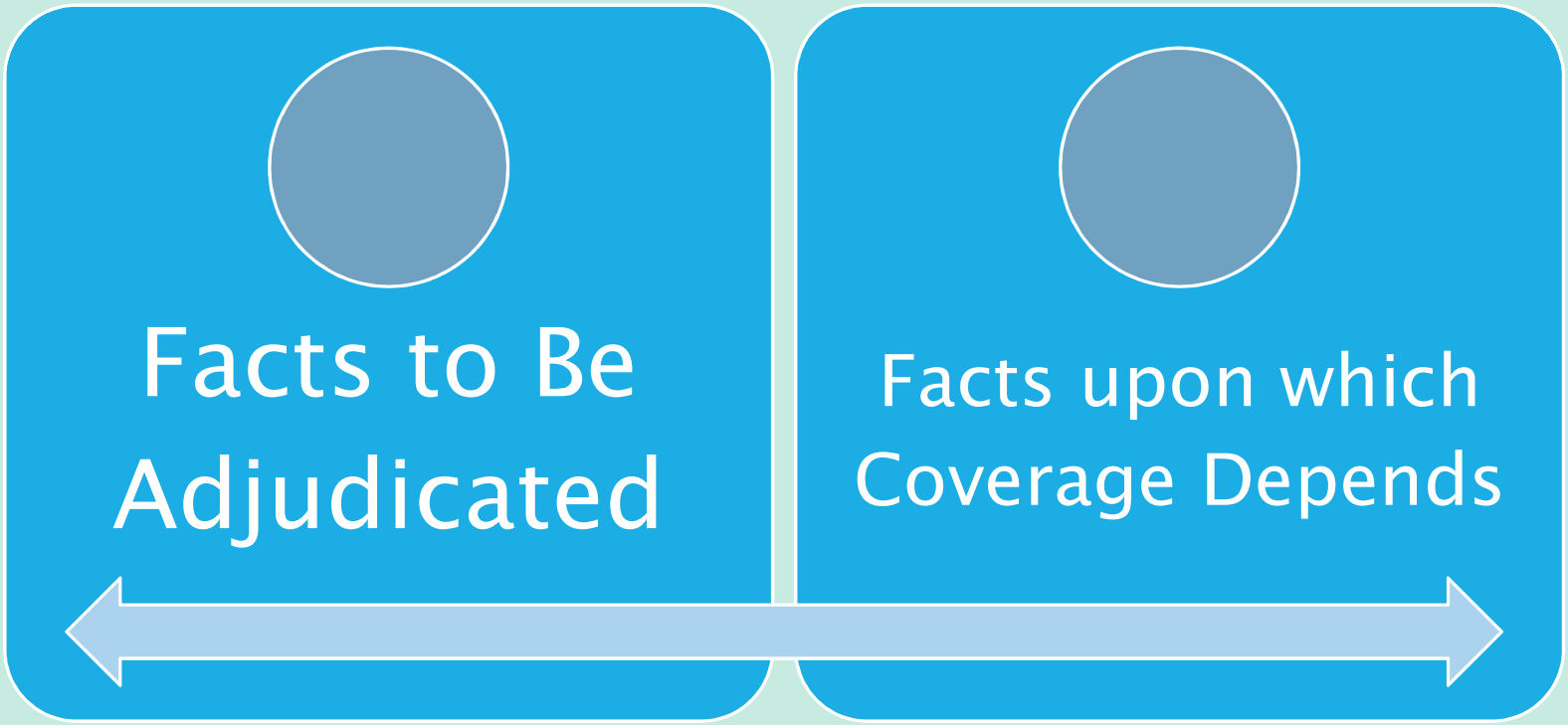
- When though the defense is otherwise proper, "the insurer attempts to obtain some type of concession from the insured before it will defend."

NORTHERN COUNTY MUT. INS. CO. V. DAVALOS

In the typical coverage dispute, an insurer will issue a reservation of rights letter, which creates a potential conflict of interest. And when 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.

N. Cnty. Mut. Ins. Co. v. Davalos, 140 S.W.3d 685, 690 (Tex. 2004).

NORTHERN COUNTY MUT. INS. CO. V. DAVALOS



HOUSING AUTHORITY OF DALLAS, TEX. V. NORTHLAND INS. CO.,

- Insured hired its own lawyers after its insurer agreed, subject to a reservation of rights, to tender a defense in the underlying Title VII lawsuit.
- To determine whether the insured had properly rejected the proffered defense, the court looked at the underlying complaint, in which "the plaintiff ... alleged violations of Title VII and characterized the [insured's] conduct as willful." Id.
- Because the insurer had "reserved its rights to disclaim coverage on ... a willful violation of a statute," the court found that it was "undisputed that the facts to be decided in the [underlying] lawsuit are the same facts upon which coverage depends."
- For that reason, it held that a "disqualifying conflict of interest" existed which entitled the insured to choose its own attorney.

333 F.Supp.2d 595 (N.D. Tex. 2004).

DOWNHOLE NAVIGATOR, LLC V. NAUTILUS INS. CO.

- Nautilus insured Downhole under a CGL policy;
- Downhole was sued by Sedona for damage to oil well sustained while Downhole was engaged to redirect the well (deviation);
- Sedona sued for loss profits, damage to the well, loss of business opportunity, loss of value in lease, loss of minerals, costs of delay, exemplary damages and attorney's fees.

686 F.2d 325 (5th Cir. 2012)

DOWNHOLE NAVIGATOR, LLC V. NAUTILUS INS. CO.

- Nautilus reserved its rights under professional liability and testing exclusions, as well as a data processing exclusion
- Downhole attempted to reject, citing a disqualifying conflict of interest between Downhole and Nautilus;
- Nautilus responded that it had "reserved [its] rights while investigating the matter," and insisted that "[u]ntil or unless a coverage issue develops, Downhole is not entitled to separate counsel."
- Nautilus refused to pay Downhole's attorney's fees. Downhole sued.

DOWNHOLE NAVIGATOR, LLC V. NAUTILUS INS. CO.,

After granting of Summary Judgment for Nautilus, the Fifth Circuit held:

- Under *Davalos*, a disqualifying interest exists "when the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends."

- A conflict 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 suit. *Rx.com, Inc. v. Hartford Fire Ins. Co.*, 426 F.Supp. 546 (S.D. Tex 2006).

ALLSTATE COUNTY MUTUAL INS. CO. V. WOOTTON, 494 S.W.3D 825 (TEX. APP. – HOUSTON [14TH DIST.] 2016)

Post-Downhole Navigator application

Insureds contended that they had a right to independent counsel because of a conflict of interest because of the underlying plaintiffs allegations of vicarious liability, that if proven, would show that the insured was acting in the course and scope of employment, which would bring the claim into a coverage exclusion

Trial court granted declaratory judgment that Allstate had to provide independent counsel

ALLSTATE COUNTY MUTUAL INS. CO. V. WOOTTON, 494 S.W.3D 825 (TEX. APP. – HOUSTON [14TH DIST.] 2016)

On appeal, the 14th Court of Appeals reversed based upon *Downhole Navigator*.

Whether that fact could be proven presented a "potential conflict of interest."

"The Woottons are not entitled to independent counsel simply because there is a potential conflict of interest."

WHEN INDEPENDENT COUNSEL IS REQUIRED

Example (Covered Verses Non-Covered *Claims*):

- Assume that a plaintiff alleges that a defendant-insured is guilty of either negligence or an intentional tort because of his wrong doing
- The insurance policy does not provide coverage for intentional torts.
- The insurer would be benefited, at the expense of the insured, if the insured's counsel shaped the defense so that, in the event he was unable to prove that the insured was not liable, the insured would be found guilty of an intentional tort.
- A conflict of interest, therefore, does exist in that situation.

WHEN INDEPENDENT COUNSEL IS NOT REQUIRED

- Claim Against Multiple Insureds;
- Insured Suit Against Other Insureds;
- Suit for money in excess of policy limits;
- Person insured;
- Property insured;
- Policy period;
- Covered vs. non-covered damages.

GRAPER V. MID- CONTINENT

- Copyright infringement case where Mid-Continent agreed to defend, subject to reservation of rights
- Mid-Continent reserved rights based on possibility that alleged injury occurred outside of policy period
- Also reserved rights as to intentional or willful conduct of insured
- Insured asserted it had right to independent counsel due to conflict of interest

756 S.W.3d 388 (5th. Cir. 2014)

GRAPER V. MID- CONTINENT

- Insured alleged a statute of limitations defense in Underlying Action
- Insured argued that timing relating to coverage and timing relating to accrual of the claims for statute of limitations run on same factual track, so conflict of interest existed.
- Court rejected the argument, noting distinction between adjudicating when a claim accrued (for SOL purposes) and when acts of infringement occurred (for coverage purposes).
- Occurrence determines date of actual injury
- Accrual determines the date of the discovery of injury

756 S.W.3d 388 (5th. Cir. 2014)

GRAPER V. MID- CONTINENT

- Insured argued that issue of "willingness of insured's conduct" created a conflict of interest because statutory damages for copyright infringement under 17 U.S.C. Sec. 504(c) can be increased if the infringement was willful.
- Court rejected, noting that policy requires a knowing violation of another.
- Statute requires infringement to be committed willfully, but does not require proof of knowing conduct (as the policy does).
- Jury could find willful copyright infringement, without a finding of knowing infringement.

GRAPER V. MID- CONTINENT

- Court applied the "same facts" analysis in *Davalos* and *Downhole Navigator* to allegations of "willful conduct" for alleged violations of the Copyright Act in a claim where Mid-Continent reserved rights based upon coverage exclusions for intentional acts
- Court held that despite the fact that the Court would be determining whether or not the insureds conduct was willful, it would not violate the "same facts" because "willful" does not necessarily imply "knowing", which is required under the policy exclusion
- Demonstrates that it will take a rare case to meet the "same facts" standard

BREACH OF THE DUTY TO DEFEND

- When the insurer breaches its duty to defend, the insured may engage their own counsel and either litigate or settle as the insured chooses

- "An additional consequence of a breach of the duty to defend is the inability to enforce against the insured any conditions in the policy[.]"

- As the right to control the defense is a condition of the policy, the insurer loses that right when the duty to defend is breached

Yowell v. Seneca Specialty Ins. Co., 117 F. Supp. 3d 904, 908–09 (E.D. Tex. 2015)

PUNITIVE DAMAGES?

- Whether the plain language excludes coverage for punitive damages;

- If the policy provides coverage, does Texas law allow or prohibits coverage in the circumstances of the underlying suit.

- In determining policy, a central concern exists when shifting the risk from the insured to the insurer in cases where "extreme and avoidable conduct that causes injury" may warrant consideration. *See also American Int'l Sp. Lines Ins. Co. v. Res Care,* 529 F.3d 649 (5th Cir. 2008).

Fairfield Ins. Co. v. Stephens Martin Paving, LP, 246 S.W.3d 653 (Tex. 2008).

WHAT ABOUT LIMITATIONS?

Gilbert Texas Constr., L.P. v. Underwriters at Lloyd's London, 327 S.W.3d 118 (Tex. 2010)

- Holding: Exclusion 2(b) applies when liability is based upon breach of contract or other contract theory.
- Conflict: Filing a Motion for Summary Judgment on Limitations for Negligence Claims.

ADVISING INSURED OF RIGHT TO INDEPENDENT COUNSEL

Ideal Mutual Ins. Co. v. Myers, 789 F.2d 1196 (5th Cir. 1986):

- The letter said: "You are at liberty to secure counsel of your own choice, at your expense, to represent you in regard to the amount [sued] which is in excess of your insurance coverage. . . ."

ADVISING INSURED OF RIGHT TO INDEPENDENT COUNSEL

Ideal Mutual Ins. Co. v. Myers, 789 F.2d 1196 (5th Cir. 1986):

- The defendants do not show how the reservation of rights letter from Charles England of Aero Adjust Bureau was defective. On the contrary, the letter adequately apprised the buyers' estate of Ideal's position and the estate's rights. The letter specifically identified the policy in question; and informed the estate that McElhaney had been retained to defend the Rockwall action and apprise the estate of the initial results of Ideal's investigation and of Ideal's reservation of rights under the policy, including the right to withdraw from the defense of the Rockwall action.

ADVISING INSURED OF RIGHT TO INDEPENDENT COUNSEL

***J.E.M. v. Fidelity and Casualty Co. of New York*, 928 S.W.2d 668 (Tex.App.—Houston [1st Dist.] 1996, no writ):**

- Plaintiffs argue that the reservation letter did not adequately advise the defendants of the potential conflict of interest between themselves and the carrier.

- The Court found that this case did not present a Tilley problem because there is no allegation that the insurer used the same attorneys to defend the defendants that it used to determine coverage issues.

- Additionally, the reservation of rights letter in this case detailed specific coverage problems that the defendants might face, and informed them they had the right to seek outside counsel.

ADVISING INSURED OF RIGHT TO INDEPENDENT COUNSEL

***J.E.M. v. Fidelity and Casualty Co. of New York*, 928 S.W.2d 668 (Tex.App.—Houston [1st Dist.] 1996, no writ):**

- The letter said: "We therefore wish to advise you that you may, at your own expense, retain outside counsel to oversee you in this litigation. We are not suggesting that you do so but merely advising you of your right."

- The Court noted: "Although the words "conflict of interest" do not appear in the letter, the letter makes clear the possibility that Fidelity may have an adverse position to the defendants on the issue of coverage."

ACTUAL SELECTION OF COUNSEL

- Qualifications
- Fees
- Scope of Representation
- Reporting
- Record Keeping

31ST ANNUAL INSURANCE LAW SYMPOSIUM

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