

INDEPENDENT COUNSEL AFTER *DAVALOS*

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EXISTENCE OF DUTY TO DEFEND

- Background and Basis of the Duty to Defend
 - Duty to Defend – Eight Corners Rule.
 - Duty to Indemnify – Actual Facts Rule.

RESPONSE TO A REQUEST FOR A DEFENSE

- Insurer has three options:
 - Deny the request for a defense;
 - Provide an unqualified defense;
 - Provide an unqualified defense pursuant to a reservation-of-rights letter.
- Can Also 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)

Northern County Mut. Ins. Co. v. Davalos

- Facts:

Davalos (a resident of Matagorta County) was involved in a car accident in Dallas County. Davalos brought suit in Matagorta County. The other driver brought suit against Davalos in Dallas County. Davalos moved to transfer venue to Matagorta County.

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 Holding:
 - Final judgment rendered in Davalos' favor for breach of contract and violation of article 21.55 of the insurance code.

Northern County Mut. Ins. Co. v. Davalos

- 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)

Northern County Mut. Ins. Co. v. Davalos

- Northern County's Position in the Supreme Court:
 - 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

- Northern County's Position in the Supreme Court:
 - 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.

State Farm Mutual Ins. Co. v. Traver, 980 S.W.2d 625, 627 (Tex. 1998)

- Facts:
 - 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.

State Farm Mutual Ins. Co. v. Traver, 980 S.W.2d 625, 627 (Tex. 1998)

- Supreme Court's Holding:

"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

- Northern County's Position in the Supreme Court:

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 exists*, to make other decisions that would normally be vested in the client, here the insured.

Davalos, 84 S.W.3d at 318 (citing *State Farm Mutual Ins. Co. v. Traver*, 980 S.W.2d 625, 627 (Tex. 1998) (emphasis in original)). Under the majority's reading of *Traver*, a conflict occurs anytime the insured disagrees with the insurer's tactical defense decisions.

Northern County Mut. Ins. Co. v. Davalos

- **Davalos' Position in the Supreme Court:**
 - **"The first thing that an insurer with a duty to defend must determine . . . is whether there is a conflict of interest between it and the insured *with regard to how the lawsuit should be defended.*" Windt, *Insurance Claims and Disputes* § 4.20, p. 218 (1995). *Emphasis added.***
 - **A conflict exists between an insured and his insurer where the insured has sued his insurer over the same claim and where the insured seeks a defense from the same insurer involved in that claim.**
 - **The conflict persisted because Northern County sought coverage advice from the very lawyer it selected to defend Davalos. Specifically, Steven W. Drinnon, Northern County's choice of counsel, provided advice on "coverage" solicited by Northern County.**

Northern County Mut. Ins. Co. v. Davalos

- Davalos' Position in the Supreme Court:
 - Northern County forfeited its right to control the defense not only by attempting to impose a condition not mandated by its policy with Davalos, but by acting directly contrary to ethical considerations and duties to its insured.
 - An insurer is not entitled, by virtue of its insurance policy with its insured, to compromise an insured's affirmative claims against a third party including a claim against the insurer. *See Hurley v. McMillan*, 268 S.W.2d 229, 234 (Tex.Civ.App.—Galveston 1954, _____). Northern County's demands seeks to do just that.
 - Since Northern breached the duty to defend, Davalos was entitled to assume control over his own defense.

Northern County Mut. Ins. Co. v. Davalos

- Davalos' Position in the Supreme Court:

There was no conditional tender to Northern County by Davalos of Davalos' defense. Davalos ceded control of the defense to Northern County with his request that venue be maintained in Matagorda County since Davalos' lawsuit against Weinberg and his insurer were filed there first and that was the county of Davalos' residence. Issues of collateral estoppel and res judicata were clearly an issue. Absent a joinder of the two lawsuits or abatement, it would simply be a race to trial with loser facing collateral estoppel and res judicata, especially with regard to determinations of liability. Instead of assuming the defense, Northern County demanded Davalos waive venue (no discussion of abatement) and that Northern County would not defend Davalos until he did so.

Northern County Mut. Ins. Co. v. Davalos

- Holdings of the Supreme Court:
- First, the supreme court held that the right to conduct the defense by the insurer is a matter of contract. Under most policies, the right to conduct the defense includes the authority to select the attorney who will defend the claim and make other decisions that would normally be vested in the insured as the named party in the case.

Northern County Mut. Ins. Co. v. Davalos

- **Holdings of the Supreme Court:**
 - **The right to conduct the defense by the insurer is a matter of contract.**
 - **The right to conduct the defense is not without its limits. Rather, 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.***
 - **Generally, a disagreement about how the defense should be conducted would not amount to a conflict of interest under *Traver.***
 - **Where there is a question regarding the existence of scope of coverage, there may 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.**

Types of Conflicts That May Justify Rejection

- **When the defense tendered “is not a complete defense under circumstances in which it should have been.”**
- **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.”**
- **When “the defense would not, under the governing law, satisfy the insured’s duty to defend,” and**
- **When though the defense is otherwise proper, “the insurer attempts to obtain some type of concession from the insured before it will defend.”**

What Coverage Disputes Give Rise To Independent Counsel?

- Test Announced in *Davalos*

The existence of a reservation of rights does not automatically give rise to a conflict of interest between the insurer and the insured with regard to the conduct of the insured's defense. The only conflict of interest that necessarily arises when the insurer reserves its right later to deny coverage is a conflict of interest between the insurer and the insured with regard to the existence of a duty to indemnify. A conflict of interest exists only if the facts that will be adjudicated in the lawsuit against the insured are the same facts upon which the existence of coverage depends. A conflict of interest does not arise unless the outcome of the coverage issue can be controlled by counsel first retained by the insurer for the defense of the underlying claim.

Housing Authority of Dallas, Tex. V. Northland Ins. Co., 333 F.Supp.2d 595 (N.D. Tex. 2004)

Reservation of rights issued on “willful violation of statute” exclusion created disqualifying conflict in the face of allegations that the insured willfully violated U.S.C.S., Title VII.

Downhole Navigator, LLC v. Nautilus Ins. Co., 4:10-cv-0695 (S.D. Tex., May 9, 2011)

- 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.

Downhole Navigator, LLC v. Nautilus Ins. Co., 4:10-cv-0695 (S.D. Tex., May 9, 2011)

- 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 refused to pay Downhole's attorney's fees. Downhole sued.

Downhole Navigator, LLC v. Nautilus Ins. Co., 4:10-cv-0695 (S.D. Tex., May 9, 2011)

- Summary Judgment Granted (Nautilus):
 - 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).

Downhole Navigator, LLC v. Nautilus Ins. Co., 4:10-cv-0695 (S.D. Tex., May 9, 2011)

“Liability in the Sedona lawsuit [turned] on whether [Downhole] acted negligently...Nautilus invoked several coverage limitations, including the right to disclaim coverage for any damage to Downhole’s own property, for any expected or intended damage, and for any work that trigger[ed] the Testing Exclusion...Comparing the allegations in the *Sedona* complaint to Defendant’s reservation of rights, the ‘facts to be adjudicated’ in the *Sedona* suit are not the same facts upon which coverage depends...”

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, and the insurance policy does not provide coverage for intentional torts. The insurer, under those circumstances, 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 verses non-covered damages.

When Independent Counsel Is Not Required

- Coverage Issues Where Facts Will Not Be Decided in the Underlying Case

On this issue, Windt states the following:

A second situation in which a conflict of interest will not arise despite a reservation of rights is when the grounds on which the insurer reserves its right to deny coverage relate to a factual issue that will not be addressed in the lawsuit against the insured. For example, in *Murphy v. Clancy* a guest passenger in a bus who sustained injuries when the bus crashed brought suit against the driver of the bus, and the insured denied coverage on the ground that the driver had been using vehicle without permission. The court correctly held that there would have not been a conflict of interest between the insurer and the driver if the insurer had assumed the driver's defense.

Punitive Damages?

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

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

- California statute expressly states that:

If the provisions of a policy of insurance impose a duty to defend upon an insurer and a conflict of interest arises which creates a duty on the part of the insurer to provide independent counsel to the insured, the insurer shall provide independent counsel to represent the insured unless, at the time the insured is informed that a possible conflict may arise or does exist, the insured expressly waives, in writing, the right to independent counsel.

Advising Insured of Right to Independent Counsel

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

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):

This case does not present a *Tilley* problem because there is no allegation that Fidelity used the same attorneys to defend the defendants that it used to determine coverage issues. Furthermore, the reservation of rights letter in this case detailed specific coverage problems that the defendants might face, and informed them they had a 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):

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.

Actual Selection of Counsel

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