TABLE OF CONTENTS

Articles »
Ethical Obligations of Independent Defense Counsel
By William T. Barker and Charles Silver
Independent counsel representing policyholders have their own special ethical issues that deserve our attention.

When a Broker's Presence Breaks the "Cone of Silence" Surrounding Attorney-Client Communications
By Louis A. Chiafullo and Stephanie Platzman-Diamant
Policyholders often believe that their communications with the broker on issues related to a claim are protected by both the attorney-client privilege and the work-product doctrine—but some courts have disagreed.

Courts Are Now Rejecting Insurers' Reimbursement for Defending Non-covered Claims
By Benjamin D. Morgan
Several jurisdictions haven't decided whether a commercial general liability policy providing an insurer with the duty and right to defend its insured against third-party claims also authorizes that insurer to be reimbursed for defense costs related to claims that are later determined to be beyond the policy’s grant of coverage

Bankruptcy Treatment of Self-Insured Retentions and Deductibles
By Erin L. Webb
A brief overview of the key cases that have addressed this type of coverage to date.

FROM THE CHAIRS »
Fabulous Content Coming
This year, the ABA and the ICLC will be focusing on tangible deliverables to members, something the ICLC has never been short on.

EDITOR'S NOTE »
Kudos to Outgoing Cochair Mary Craig Calkins
Ethical Obligations of Independent Defense Counsel

By William T. Barker and Charles Silver

A vast literature exists on the ethical obligations and problems of lawyers defending policyholders on behalf of insurers. A smaller, but still substantial, literature deals with whether and when a policyholder is entitled to independent defense counsel at insurer expense. Very little published writing addresses the ethical obligations and problems of lawyers serving as independent counsel for policyholders. Of course, those duties include all of the usual duties of a lawyer retained by the policyholder to defend a suit. But independent counsel do have their own special ethical issues, which deserve our attention.

As used here, the term “independent defense counsel” means counsel who defends a suit in discharge of an insurer’s duty to defend under a liability insurance policy, where a coverage issue or other conflict has divested the insurer of its usual contractual right to control the defense. Although counsel are independent, insurers do have some rights in dealing with them. The existence of those rights helps define the scope of counsel’s ethical duties.

Rights of Insurers When Dealing with Independent Counsel

Once counsel has been selected, “[t]he Cumis rule requires complete independence of counsel.” “Cumis counsel represents solely the insured.” The insurance contract does not govern the relationship between the insurer and defense counsel. But counsel who represents a policyholder and therefore speaks for a policyholder could injure a policyholder’s coverage by failing to act in accordance with the policyholder’s duties under a liability policy. This is so because a lawyer’s conduct is often attributable to a client, meaning that the law often treats a lawyer’s actions as having been taken by a client. Because independent counsel acts solely on a policyholder’s behalf, actions by independent counsel that violate a policyholder’s duties could put the policyholder in breach of the insurance contract and endanger the policyholder’s coverage.

Communications is perhaps the area in which dangers to coverage are most likely to arise. Even when independent counsel represents the policyholder, the carrier is still entitled to information. For example, the carrier is entitled to know about settlement demands and to receive copies of court filings and other public documents, including items received or produced in discovery. At least as long as consulting with the insurer does not entail any substantial risk of harm to the policyholder, counsel’s duties to the policyholder require counsel to engage in such consultation (if requested by the insurer) to avoid any risk of injuring the policyholder’s coverage interests. Moreover, disclosure to the insurer of information relating to the representation is impliedly authorized to the extent necessary to avoid the risk of breaching the insurance policy, as long as disclosure does not endanger any policyholder interests and as long as the policyholder has not directed that such information be kept confidential.
California Civil Code § 2860 codifies some of these obligations and imposes them directly on defense counsel:

(d) When independent counsel has been selected by the insured, it shall be the duty of that counsel and the insured to disclose to the insurer all information concerning the action except privileged materials relevant to coverage disputes, and timely to inform and consult with the insurer on all matters relating to the action . . . .

These duties to disclose relevant information and to consult with the insurer seem especially well founded in the insurance contract. Although a conflict of interest denies the insurer the right to direct counsel, [6] to receive information prejudicial to the policyholder on the subject of the conflict, and to impede actions beneficial to the policyholder on that issue, it does not eliminate the insurer’s interest in the defense. The insurer still desires the most effective and efficient defense, as the insurer is still obliged to pay defense costs and may be required to pay any judgment or settlement. The policyholder is still bound by the contractual duty of cooperation except insofar as that duty is excused by the conflict. Moreover, the insurer retains the right to settle at its own expense and the right to deny payment of any settlement not approved by it. Exercise of these rights requires full and timely information, so the insurer can consider settlement opportunities and actions that may be necessary to fulfill any duty to the policyholder to accept reasonable settlement demands.

Moreover, the insurer should at least be entitled to make suggestions on defense options and decisions and to have the information necessary to do so. Although the policyholder and defense counsel are not bound by any such suggestions, they cannot be harmed and may be helped by receiving them. As Dean Syverud observed with respect to common defense counsel guidelines, “[t]he advance consultation by defense counsel contemplated in the Guidelines is as minimal a form of cooperation as one can imagine.”[7]

Consultation is valuable, in and of itself, in achieving an economical defense. Lawyers make money by delivering services. Their incentive is, therefore, to maximize service levels, which is antithetical to minimizing costs. “Even a lawyer who aims to provide only worthwhile defense efforts can subconsciously resolve doubts in favor of doing more, and so earning more.”[8]

Consultation, even without an approval requirement, tends to restrain inefficient efforts:

The lawyer’s evaluation is sharpened by responding to the adjuster’s comments and questions. Consultation also allows the claims staff to consider with counsel whether the effort proposed could safely be postponed, particularly when there is still a possibility of settlement.[9]

In short, consultation is valuable to the insurer and cannot be prejudicial to the policyholder (as long as any confidential information bearing on coverage is withheld.
from the insurer, as all agree it must be). Moreover, “[t]o the extent that such consultation avoids unnecessary discovery or motion practice, it also benefits the judicial system.”[10]

Even in a case that most severely restricted the insurer’s use of prior approval requirements, it was conceded that requirements of advance consultation are permissible. At oral argument in In re Rules of Professional Conduct & Insurer Imposed Billing Rules & Procedures, Justice Gray had the following exchange with one of the petitioners’ counsel, Robert James:

Mr. James: Rule 1.8 is fairly straightforward. A lawyer shall not accept compensation for representing a client from one other than the client unless there is no interference with the lawyer’s independence of professional judgment. Rule 5.4 is very similar. It essentially says the same thing. A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer’s professional judgment. When the billing rules say that we need pre-approval to hire experts to conduct research to file a motion, to file pleadings, to engage in trial preparation, or to decide how to staff a case, we simply can’t agree to do so. Why? Our position is that the plain and ordinary meaning of these ethical rules prohibit us from allowing an insurance company from directing and regulating our judgment to do so. It’s just that simple.

Justice Gray: Counsel, if the billing rules said “consult” instead of “approve,” would they still violate the rules?

Mr. James: No, I think that we consult with the insurance company all the time, with insurance adjusters, and tell them here’s what we think should be done. So I think that one of the things that the insurance companies can expect defense counsel to do is to consult with them and find out what our thinking is, why we are thinking [that], and in many cases an adjuster may say let me question you about that. Maybe this isn’t a good thing at this particular time and maybe you will agree or maybe you will disagree.[11]

Advance consultation on substantial expenses may also lead the insurer to settle to avoid that cost or to withdraw its reservation of rights to regain control of the defense. Either of these results would be beneficial to the policyholder.

Were the insurer unaware that independent counsel was representing only the insured, the provision of legal advice to the insurer could result in creation of an attorney-client relationship not intended by the lawyer[12] (and creating the very conflicts that the counsel’s independence was intended to avoid). But that could occur only if the insurer had a reasonable belief that the lawyer was acting on its behalf, and the process by which independent counsel was retained ordinarily should negate any such expectation.[13] Any communication or consultation between independent counsel and the insurer is purely informational.[14] If there is any doubt about the lawyer’s relationship with the insurer, the lawyer should clarify that the insurer is not a client. And, in some jurisdictions, the fact that the lawyer is independent counsel will automatically preclude the existence of
Insurers Can Challenge Defense Expenditures and Activities

Even where there is a conflict of interest, an insurance policy is not a blank check requiring payment by the insurer for whatever work defense counsel chooses to do. An insurer is entitled not to pay for services that are overpriced or inappropriate to the case. The provider of services is not the sole judge of their necessity. Insurers must also be able to review all legal bills, including those submitted by independent counsel, to protect against fraud. For example, they must be able to determine that all services billed were actually performed or that lawyers are not turning expense items into profit centers by tacking surcharges onto them.

So, sooner or later, a representative of the insurer must decide whether particular services are appropriate and should be paid for. A preapproval requirement simply requires that question to be addressed before the services are rendered, instead of afterward.

In other words, the insurer is entitled to challenge defense activities and expenditures it regards as excessive or inappropriate, and to do so before they are executed, to the point of warning that it will not voluntarily pay for them. Accordingly, even where the policyholder is represented by independent counsel, insurers are still “entitled to apply billing Guidelines for purposes of obtaining the most effective, professional and efficient defense possible for their insureds.”

Of course, the insurer’s refusal to pay does not end the matter. The policyholder can direct counsel to execute the disputed recommendations for expenses or activities, and counsel will be obliged to do so. Either before or after that is done, the policyholder or counsel can seek to collect from the insurer for those expenses or services. If a court or arbitrator finds the expenses or services appropriate, the insurer will have to pay. Otherwise, the policyholder will have to pay, unless the inappropriateness of the expenses or services prevents counsel from collecting from anyone.

In short, neither party may sit as judge in its own case. If disputes cannot be compromised, they must be submitted to an outside adjudicator. Both sides must take account of the likely rulings of such an adjudicator on the facts presented, and disputes are unlikely to be pressed unless the parties have very different predictions about such a ruling.

Outright refusal to pay has significant risks for the insurer. If held to be incorrect, it is likely to be deemed a breach of the duty to defend, freeing the policyholder from policy restrictions on refusal to settle. To avoid these risks, an insurer may wish to advance the disputed funds, while reserving the right to seek to recoup them. But the ability to recoup may be illusory where the policyholder is impecunious, and counsel may have defenses to recoupment not available to the policyholder. If recoupment is to be sought, the insurer should either (1) obtain an agreement that the advances will be returned if the insurer prevails in later litigation or (2) seek prompt adjudication of the propriety of the
expenses or services in question. Failure to do one or the other may prevent recoupment even if the expenses or services might be found beyond the insurer’s obligations to pay.

Apart from the possibility of freeing the policyholder to settle, an unreasonable refusal to pay could be the basis of a bad faith claim, as defense costs are a form of first-party benefit. [21]

The Montana Supreme Court’s Rejection of Prior Approval Requirements
The Montana Supreme Court has held that any requirement of prior approval impermissibly interferes with a lawyer’s obligation to exercise independent judgment on behalf of the policyholder. [22] We believe the decision is poorly reasoned, for reasons explained elsewhere. But even one who agrees with the decision should recognize that the decision focused on ordinary defense counsel and that the concern that motivated it does not justify an extension of the holding to representations in which independent counsel represent policyholders.

This is so because independent counsel recommend options to policyholders and follow policyholders’ instructions. They do not follow insurers’ instructions and, therefore, are not subject to insurers’ prior approval. They may learn that an insurer will not willingly pay for a defense-related service they believe should be employed, but they are nonetheless entirely free to recommend the service to the policyholder, to perform it at the policyholder’s request, to bill for it, and to help the policyholder sue for reimbursement. And unlike conventional defense lawyers who work with carriers repeatedly, they have no ongoing relationships with the insurer that might make them hesitant to adopt an adversarial posture toward it. Independent counsel thus stands in the same position as any other lawyer whose client has arguable contractual rights against another party that the latter disputes.

The propriety of this conclusion is reinforced by the similarity of the procedure to that approved by the ABA Standing Committee on Ethics for cases in which counsel is not independent. [23] Its Opinion 01-421 assumes that the insurer has directed the lawyer to proceed in a particular way, rather than merely declining to pay for services the lawyer has recommended. Because actual direction of the lawyer creates no insurmountable problem, a mere threat to withhold payment can hardly do so.

Much of the ABA opinion addresses what the policyholder must be told about a representation in which the insurer expects to exercise a power to direct counsel. No such requirements apply to an independent counsel representation, so they need not be discussed here.

If counsel believes that an insurer decision poses a substantial risk to the policyholder, counsel should point that out to the insurer and request reconsideration. If the insurer will not reconsider, then counsel must inform the policyholder, fully describe the risks and benefits, and inquire whether the policyholder will consent to having counsel proceed on the basis the insurer requests. The Tennessee Bar describes such a consultation as follows:
Counsel should describe the decision and its risks and benefits from the standpoint of the insured. Of course, these will include whatever risks to the insured that counsel believes might result from the compliance. But objection to the insurer’s directive would also have risks and therefore, where appropriate, counsel should point out that the insurer might take the position that any unjustified refusal to permit counsel to follow its direction would breach the insurance contract. If the insurer were correct in so contending an objection would endanger the insured’s coverage. On the other hand, if the insured permits counsel to follow the insurer’s directive, the insured could also reserve the right to hold the insurer responsible for any resulting damage to the insured. (The insurer would be liable if the directive were found to breach its duties under the insurance policy.) The insured should be advised of the utility of obtaining independent counsel, at the insured’s own expense, in considering whether to acquiesce in the insurer’s directive (perhaps under protest). If the insured acquiesces, after being properly advised, counsel may comply with the insurer’s directive.[24]

If the policyholder gives informed consent (perhaps coupled with a declaration of intent to hold the insurer responsible for any resulting injury), then counsel may comply with the insurer’s direction. If the policyholder refuses to consent, then counsel cannot proceed in the way the insurer requests. If the insurer will not rescind the disputed decision, counsel must then withdraw. (A request to withdraw will necessarily involve the court, which may resolve any dispute between insurer and policyholder.)

In an independent counsel situation, there will be no possible need for withdrawal and no need to get the insurer’s consent for proposed activities or expenses. The lawyer and the policyholder need only discuss whether to assume the risk of nonpayment and the burden of litigating for payment. If the policyholder is willing to advance the necessary funds or if the lawyer is willing to extend credit (possibly on a nonrecourse basis), they may proceed and pursue the insurer later. In the meantime, the insurer remains obligated to continue funding agreed expenses and activities.

Although the Montana Supreme Court presumably would reject the ABA analysis, its opinion is distinguishable when the problem is presented in an independent counsel context and should be rejected by other courts even where it is not distinguishable.[25]

**Insurers Are Entitled to Pay No More Than Market Rates**

In a few states, statutes regulate the fees that insurers must pay independent counsel. Thus, in California,

> [t]he insurer’s obligation to pay fees to the independent counsel selected by the insured is limited to the rates which are actually paid by the insurer to attorneys retained by it in the ordinary course of business in the defense of similar actions in the community where the claim arose or is being defended . . . [26]
Absent such a statute, lawyers are still limited to charging fees permissible under the applicable Rules of Professional Conduct. Most such rules are based on ABA Model Rule 1.5:

(a) A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses. The factors to be considered in determining the reasonableness of a fee include the following:

1. the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;
2. the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer;
3. the fee customarily charged in the locality for similar legal services;
4. the amount involved and the results obtained;
5. the time limitations imposed by the client or by the circumstances;
6. the nature and length of the professional relationship with the client;
7. the experience, reputation, and ability of the lawyer or lawyers performing the services; and
8. whether the fee is fixed or contingent.[27]

Insurers are likely to argue that a reasonable fee for defense services is established by the rates charged by lawyers from whom the insurers regularly purchase similar services. In their view, the cost of defending the insured ought not to be increased by the fortuitous existence of circumstances entitling the insured to independent counsel.

But lawyers not regularly retained by the insurer obliged to pay for independent counsel may resist accepting payment at the rates that the insurer normally pays for similar services. Insurers are able to provide their regular counsel with a volume of work warranting a significant discount in the rates charged for that work. Independent counsel do not receive a similar volume of work. If they have adequate business at rates not affected by such a discount, they have no incentive to accept the discounted rates charged by firms the insurer regularly retains.

If the insurer were obliged to pay no more than its customary discounted rates, a policyholder seeking independent counsel might find it necessary to supplement the insurer’s payments to obtain comparable counsel or accept the services of less able (and therefore less expensive) counsel than would normally be retained for the particular case. Accordingly, policyholders would argue that the insurer’s customary discounted rates are not adequate or reasonable for independent counsel.

One argument sometimes made in support of limiting the insurer’s obligation to payment of its customary rates is that providing a defense by independent counsel is a form of substitute performance where a conflict of interest has rendered the performance contemplated by the contract partially impracticable.[28] One commentator summarizes this argument as follows:
[B]ecause the conflict does not excuse the insurer’s duty to defend, the doctrine of substitute performance should be understood to effectuate the terms of the contract, i.e., the insurance policy, without conferring an advantage on either party. “Substitute performance” should therefore be a minimal variation from the performance originally contemplated. This approach is said to track courts’ general recognition that a party injured by a contract breach should receive the benefit of its bargain but never a windfall.

Continuing, substitute performance advocates theorize that courts that allow an insured to select defense counsel and control the defense because of a conflict of interest rendering the insurer’s duty to defend impractical are supplying a substitute for the carrier’s performance so as to preserve the carrier’s remaining contractual obligations. As a substitute for the carrier’s duty to defend, it follows that the alternative performance must conform to the original. The insured’s defense should not be funded at a level substantially lower than the defense the carrier otherwise would have provided so that the insured receives the benefit of its bargain, but nor should the insured’s defense costs substantially exceed those which the carrier would have paid were it in control lest the insured be unjustly enriched. Therefore, the carrier cannot be obligated to pay independent counsel hourly rates greater than those it would pay panel counsel.[29]

This argument has a number of flaws. Most fundamentally, the doctrine of impracticability applies to excuse performance only where “a party’s performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made.”[30] Nonoccurrence of a conflict of interest can hardly have been a basic assumption by the insurer: The existence of conflicts in a significant number of cases and the need to provide a defense despite them is well known to insurers. Moreover, increased expense in performance generally is not considered to render performance even partially impracticable.[31] An insurer drafts the policy, and it could contractually specify limits on the rates payable to independent counsel. If the insurer has failed to include such language, it can hardly claim surprise when it is called upon to pay more than its customary rates to retain independent counsel appropriate to the case. And the insurer is still protected by the limitation of the fees payable to a reasonable amount.[32]

Putting the matter succinctly, “while the substitute performance approach is superficially appealing, it quickly unravels when closely scrutinized.”[33]

The policy promises the policyholder an adequate and appropriate defense to any suit seeking any relief that, if established, would be covered.[34] This is promised at no cost to the policyholder. To fulfill this promise, the insurer must be obliged to pay independent counsel fees equal to “the prevailing market rates in the relevant community” for the type and quality of services reasonably necessary for the defense of the particular lawsuit.[35] The market rate will typically reflect the factors enumerated in Model Rule 1.5.
The market rate may or may not be the customary rate charged by the lawyer(s) the insured has chosen to retain, depending on whether the caliber of lawyer chosen is appropriate to the case:

[N]ot all cases are alike. The “novelty and difficulty” of a matter may be either factual or legal. A catastrophic injury, wrongful death, or professional liability case, for instance, is much different from a slip-and-fall or automobile case involving minor injuries. Insurers obligated to engage independent counsel chosen by an insured must acknowledge that the defense of difficult matters generally requires experienced and skilled lawyers and that such lawyers can command greater rates than lawyers who handle relatively minor or simple cases. Fortunately for all concerned, liability insurers, as professional litigants, understand this quite well. Most insurers factor the nature of a case into their defense assignments and they typically have strata of law firms on their panels. Thus, and by way of example, although Firms A and B on an insurer’s panel may receive simple cases to defend at very low hourly rates, Firms C and D are assigned complex matters or large losses, and are compensated at higher hourly rates.[36]

If a policyholder chooses to use more capable attorneys than the case requires, the policyholder may have to pay the extra cost beyond what would be required for less capable, but adequate, attorneys. And disputes regarding the required level of capability (and the corresponding reasonable rate) may need to be adjudicated. Pending adjudication, insurer, policyholder, and lawyers need to have some agreement on payment of fees as the litigation proceeds.

**Ethical Obligations of Independent Defense Counsel**

Some issues affecting independent counsel, notably those just discussed, require particular attention to the interaction of the lawyer’s duties and the insurance law duties of the policyholder. Insurance law has a primary role in those issues, with lawyer duties a secondary consideration. This section addresses issues in which lawyer duties come to the fore and insurance law plays a secondary role.

A key feature of independent counsel is that the lawyer is paid by the insurer, even though the policyholder is the lawyer’s sole client. Such third-party payment implicates Model Rule 1.8(f):

A lawyer shall not accept compensation for representing a client from one other than the client unless:
(1) the client gives informed consent;
(2) there is no interference with the lawyer’s independence of professional judgment or with the client-lawyer relationship; and
(3) information relating to representation of a client is protected as required by Rule 1.6.[37]

Looking first to the requirement of “informed consent,” the Model Rules define that as “the agreement by a person to a proposed course of conduct after the lawyer has
communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct.”[38] It is not necessary to “inform a client . . . of facts or implications already known to the client . . . ; nevertheless, a lawyer who does not personally inform the client . . . assumes the risk that the client . . . is inadequately informed and the consent is invalid.”

Thus, although the process by which independent counsel was provided and selected will often have informed the policyholder about some aspects of independent counsel’s representation, it is wise for independent counsel to discuss the terms of that representation and some of the problems it can present at the outset and to have that consent and the underlying advice confirmed in writing. Of particular importance are any facts that might raise questions as to counsel’s independence of the insurer, such as representations of the insurer or its affiliates in other matters. Such facts might cause the policyholder to look elsewhere for counsel, if the policyholder makes the selection, or to object to the insurer’s selection, if the insurer makes the selection.

The policyholder should understand any significant limitations on the scope of the representation and some important aspects of the way in which the representation will be conducted. The policyholder should be informed of the extent to which the insurer will be consulted in defense planning and the general nature of the problems that can arise if the insurer disagrees with the defensive activities proposed by counsel. This information could affect the ways in which the policyholder chooses to be involved in defense planning, even where no dispute has yet arisen. The policyholder should be informed of the arrangements with the insurer regarding payment of fees or the need to negotiate such arrangements, and of any possibility that the policyholder might have to pay or advance some portion of the fees. The policyholder should be informed of the extent to which confidential information will be shared with or withheld from the insurer and of the problems that can arise from such sharing or withholding.

In an independent counsel situation, the insurer will have no right to control the defense so that counsel’s independence of judgment would seem assured. But the fee arrangement (or any collateral relationship with the insurer) may provide incentives that could affect counsel’s judgment. If so, these must be explained.

A matter likely to be of particular importance to a policyholder is the possibility that independent counsel will perform coverage-related services for which the policyholder will billed directly. Independent counsel need not undertake to perform coverage work, of course; the policyholder may retain separate counsel with coverage expertise for that purpose. But the roles of defense counsel and coverage counsel may be combined without creating any conflict, because independent counsel represents only the policyholder. However, the insurance policy does not obligate the carrier to pay for the policyholder’s coverage work (or, more generally, for any work independent counsel may perform relating to any subject other than the defense of the liability claim). The policyholder’s personal responsibility for fees incurred in connection with coverage-related work should be explained at the outset of the representation.
Handling Confidential Information and Cooperation with the Insurer

As in all representations, information relating to the representation must be kept confidential, as provided in Model Rule 1.6.[39] However, disclosure of such information may be impliedly authorized if useful to the representation, not injurious to the interests of the policyholder, and not forbidden by the policyholder.

Disclosure is useful to the representation if necessary to comply with the policyholder’s duty of cooperation, thereby preserving the policyholder’s coverage. Even if disclosure may not be necessary to comply with the policyholder’s duty of cooperation, it may be useful if it avoids a risk that the duty might be breached. Disclosure may also be useful if it will help persuade the insurer to take or authorize some action favored by the policyholder (such as settling the case). As long as such disclosure does not implicate issues (such as coverage) on which the interests of insurer and policyholder diverge, the insurer should be considered a person of common interest, such that any attorney-client privilege will not be waived.[40]

Disclosure would be injurious to the policyholder’s interests if it would assist the insurer in disputing coverage, so coverage-sensitive information must be kept from the insurer unless the policyholder gives informed consent to disclosure.[41] (If defense counsel is not a coverage lawyer, it may be necessary to obtain coverage advice to determine what information is or is not coverage sensitive.) Disclosure may also be injurious to other interests of the policyholder, such as interests in reputation. And, of course, the policyholder may forbid disclosure of certain information even if not otherwise injurious to the policyholder.

If information to be withheld is not coverage sensitive, withholding it might breach the policyholder’s duty of cooperation. The policyholder should be advised of this risk. If defense counsel is not able to evaluate that risk, the policyholder should be warned of it and advised to consult other counsel if evaluation is desired.

Honesty and Avoidance of Fraud

Representation of a policyholder by independent counsel typically takes place in a context where the policyholder and the insurer are adversaries with respect to coverage. As a result, both policyholder and counsel are entitled to withhold from the insurer information relating to the defense representation that is coverage sensitive. But even in the context of an adversarial relationship, the lawyer is not permitted to lie to the insurer. Model Rule 4.1 provides that “[i]n the course of representing a client, a lawyer shall not knowingly . . . make a false statement of material fact or law to a third person”[42] (i.e., someone other than the client). Moreover, Model Rule 8.4 provides that “[i]t is professional misconduct for a lawyer to . . . (c) engage in conduct involving dishonesty, fraud, deceit, or misrepresentation.”[43]

Professor Fischer has noted the following implications of these rules:

An attorney may not make a misrepresentation and may not use the rule of confidentiality to justify the speaking of untruths. When the attorney speaks, the

Published in Coverage Vol. 22 No. 4, July/August 2012. Copyright © 2012, American Bar Association. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or downloaded or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.
attorney must speak honestly. A statement that is a half-truth because it omits material facts needed to put the statement in its proper context may be deemed a misrepresentation subjecting the speaker to civil liability. As recently noted by the Montana Supreme Court, the privilege to withhold client confidential information does not provide a license or justification for misleading utterances. An attorney who discloses information to the insurer to enable the insurer to determine its duties and obligations under the insurance contract must take care to disclose accurately and truthfully or not disclose at all. Even a negligent statement may be actionable if it contains a material misrepresentation on which the recipient of the information (the insurer) reasonably relies to its detriment. The scope of a lawyer’s liability for negligent misrepresentation has been hotly debated and disputed. The fact that the identity of the recipient of the information is known and the specific end and aim of the communication is to induce action by the insurer are factors enhancing the likelihood that the court would find Cumis counsel owed a duty of candor to the insurer. Cumis counsel must be careful not to confuse the absence of a duty of care owed to the insurer with the existing duty to avoid making material misrepresentations to the insurer.[44]

The lawyer need not even be the source of the false statement. Douglas Richmond notes that “a lawyer may violate Rule 4.1(a) by knowingly affirming or ratifying another person’s false statement, or by failing to correct it.”[45]

These rules can be triggered by very limited culpability. The Rule 4.1 requirement that the misrepresentation be made “knowingly” requires only actual knowledge of the falsity, not any “evil intent or a bad purpose.”[46] Many courts require knowing falsehood to establish violation of Rule 8.4(c).[47] But others hold that even statements made with reckless disregard for their truth or falsity can constitute violations.[48] Indeed, at least one jurisdiction will find a violation based on grossly negligent misstatements.[49]

Nor does a violation of these rules require that anyone be misled or harmed by the misrepresentation.[50] Rule 8.4(c) contains no express requirement of materiality, though some courts will infer one.[51]

Thus, independent counsel must take care to avoid false or misleading statements or omissions in communicating with the insurer. Moreover, independent counsel must be careful in advocating the policyholder’s position to the insurer. Thus, in trying to induce the insurer to settle, it may be useful to argue that there is a great risk of excess liability if the case is tried. And it may be possible to argue that the likelihood or likely magnitude of the judgment is greater than counsel personally believes it to be. If so, counsel must avoid stating any opinion regarding the risk that does not reflect counsel’s actual beliefs.

Assisting Fraud

Model Rule 1.2(d) forbids a lawyer to “counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent.”[52] If independent counsel learns that the policyholder is perpetrating a fraud, counsel may not assist in doing so.
The first step will usually involve remonstration with the policyholder to correct any prior misrepresentations and refrain from any in the future. If the policyholder will not do so, it may sometimes be sufficient for independent counsel to withdraw from the representation. But, as Professor Fischer points out, in some instances,

[O]ne may even argue that counsel has affirmative disclosure obligations here and may not simply remain silent if counsel is aware that the policyholder client is perpetrating a fraud on the insurer. Rule 4.1(b) provides that an attorney must disclose a material fact when necessary to prevent assisting a criminal or fraudulent act by the client, unless disclosure is prohibited by Rule 1.6. Traditionally, the Rule 1.6 confidentiality exception swallowed the rule. Recent amendments to Rule 1.6 have, however, added exceptions that “permit” the attorney to disclose client confidential information to prevent “the client from committing a crime or fraud reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer’s services.” Disclosure is no longer “prohibited,” as that term is used in Rule 4.1(b) because Rule 1.6(b)(2)–(3) permits disclosure; therefore, the exception no longer significantly constrains the duties set forth in Rule 4.1(b), i.e., disclose material facts “to avoid assisting a criminal or fraudulent act by a client.”[53]

Of course, even if that argument is accepted, it would still be necessary to determine when disclosure is necessary to prevent assisting a fraud.

Involvement in Policyholder Disputes with the Insurer
If there are disagreements with the insurer on the conduct of the defense, the policyholder will require advice on the risks and benefits of acceding to the insurer’s wishes or proceeding contrary to those wishes. Defense counsel is better positioned than any other lawyer in evaluating the impact on the lawsuit being defended of proceeding one way or another. After all, defense counsel may have considered both alternatives before making a recommendation and certainly considered both alternatives before concluding that another course was preferable to the one recommended by the insurer. Defense counsel might not be competent to advise on the risks of breaching insurance policy duties by proceeding contrary to the insurer’s wishes. But the insured will require advice on this subject, and if defense counsel is competent to provide that advice, defense counsel is the most logical person to do so.

Such advice might be considered coverage advice, for which the policyholder, rather than the insurer, should pay. But it might not be separable from advice regarding the defense, or any separable component might be too small to be worth trying to break out.

Disputes Regarding Coverage and Claim Handling
Because the insurer is not a client of independent counsel, there is no ethical obstacle to counsel also representing the policyholder on coverage and other disputes with the insurer.[54] But there is an argument that, as a matter of insurance law, “an insurer is within its rights to insist that lawyers serving as independent counsel not advise insureds on coverage.”[55]
This argument is not very strong. It relies on two cases,[56] which both take the position that the insurer is entitled to approve the policyholder’s selection of defense counsel, such approval not to be unreasonably withheld.[57] Those cases are therefore unlikely to be followed in jurisdictions holding that the policyholder is entitled to select independent counsel unilaterally.

More importantly, both cases proceed on the basis that the insurer is under a duty to provide only an impartial defense—not to sacrifice its own interests. [The policyholder’s] defense counsel must not be motivated to slant the defense in any manner relating to whether a claim is or is not in the scope of coverage. Allowing [the policyholder] to appoint as “independent counsel” a firm that bears its loyalty to [the policyholder] or any animus to [the insurer] would reintroduce, albeit in a converse manner, the very difficulties that necessitate in the first instance the appointment of independent counsel.[58]

But this ignores the fact that defense counsel often must advocate a position on coverage-sensitive issues. Thus, when the policyholder is alleged to have harmed the plaintiff either negligently or intentionally, the policyholder surely does not receive a complete defense unless defense counsel argues that the injury was no more than negligent. A policyholder defended other than in this way could be subjected to both an unjustified finding of intentional injury (with the resulting increased damages) and, in consequence, a loss of coverage. Such a policyholder could wind up worse off than had there been no insurance The insurer’s protection is not some artificial “impartial” defense; it is the right not to be bound on coverage by the findings made in a case where control of the defense rested in the hands of a policyholder with coverage interests adverse to those of the insurer.[59]

More generally, the right to independent counsel exists only because of a conflict arising out of the manner in which the defense can be conducted. The point of giving the insured independent counsel is to ensure that judgment calls relating to the defense are made in the way that benefits the policyholder rather than the insurer. Independent counsel must therefore be able to advise the policyholder as to how different defense choices could have an impact on coverage.

The insurer is entitled to have bills limited to services required to defend the policyholder, so it does not pay for the policyholder’s representation in coverage disputes. But there is no reason to deny the policyholder the right to the economies of using one law firm for both defense and coverage, if the lawyers in that firm are competent to render both types of service and the policyholder wishes them to do so.[60]

**Conclusion**

Policyholders are asserting rights to independent defense counsel more frequently than in the past. Although the special duties of independent defense counsel are less complex
than those of counsel selected and directed by an insurer, lawyers serving in the role of independent counsel need to be aware of those duties and careful that they comply.

**Keywords:** ethical obligations, independent defense counsel, fraud, honesty

William T. Barker is a partner with SNR Denton, Chicago. Charles Silver teaches law at the University of Texas School of Law.

---

[1] William T. Barker is a partner in the Chicago office of SNR Denton, with a nationwide practice representing insurers in complex litigation, including matters relating to coverage, claims handling, sales practices, risk classification and selection, agent relationships, duties of insurance defense counsel, and regulatory matters. Mr. Barker also provides expert consultant and witness services. Mr. Barker is a coauthor, with Ronald D. Kent, of *New Appleman Insurance Bad Faith Litigation, Second Edition* (LexisNexis). Mr. Barker is a member of the editorial board of *The New Appleman on Insurance Law* and a cochair of the Bad Faith Subcommittee of the Insurance Coverage Litigation Committee. Mr. Barker is also an adviser to the American Law Institute project on Principles of the Law of Liability Insurance.

Charles Silver holds the Roy W. and Eugenia C. McDonald Endowed Chair at the University of Texas School of Law, where he writes and teaches about civil procedure, professional responsibility, and health care law and policy. He is a leading academic authority on the professional responsibilities of insurance defense counsel and was one of the reporters for the DRI-IADC study of that subject. In 2009, he received the Robert B. McKay Award from ABA-TTIPS for outstanding scholarship on tort and insurance law.


[17] Sarchett v. Blue Shield, 43 Cal. 3d 1, 8–10 (1987) (medical insurance, requiring payment for all “necessary” services; collecting cases from other jurisdictions).


The procedures approved in ABA Opinion 01-421 for handling particular conflicts in insurance defense representations appear to have been first recommended in Ellen S. Pryor & Charles Silver, “Defense Lawyers’ Professional Responsibilities: Part I—Excess Exposure Cases,” *78 Tex. L. Rev.* 599, 644 (2000). But those procedures are logically implied by the conflicts rules applicable to all representations involving duties to multiple persons.


Cal. Civ. Code § 2860 (c); *See also Alaska Stat. § 21.96.100* (d) (similar provision).


*See Restatement (Second) of Contracts* § 270 (1981).


Restatement (Second) of Contracts § 261.


[34] 3 Jeffrey E. Thomas & Francis J. Mootz, III, New Appleman on Insurance Law, Library Edition § 17.01 (LexisNexis); Barker & Kent, New Appleman Insurance Bad Faith Litigation § 3.02[1]-[4] (LexisNexis 2d ed.).


[37] Model Rules of Prof’l Conduct R. 1.8(f) (2011). See also Model Rules of Prof’l Conduct R. 5.4(c) (“A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer’s professional judgment in rendering such legal services.”).

[38] Model Rules of Prof’l Conduct R. 1.0(e).


[41] Illinois law is exceptional on this issue, taking the view that the insurer and policyholder are persons of common interest on all aspects of a defense representation, even where there is a coverage dispute and the policyholder is represented by independent counsel. Waste Mgmt. v. Int’l Surplus Lines Ins. Co., 144 Ill. 2d 178, 194 (1991). Where this rule applies, the policyholder must be warned. As a practical matter, this results in an exception to what would otherwise be the applicable attorney-client privilege. Independent counsel subject to this rule should still not make disclosures of material damaging to the policyholder’s interests without a court order to do so.


In re Edison, 724 N.W.2d 579, 584 (N.D. 2006).

See, e.g., Fla. Bar v. Mogil, 763 So. 2d 303, 309–11 (Fla. 2000); In re Firstenberger, 878 N.E.2d 912, 913–14 (Mass. 2007); In re Conduct of Skagen, 149 P.3d 1171, 1184 (Or. 2006).


In re Conduct of Skagen, 149 P.3d at 1184.


In VSL Corp., that position was based, in part, on policy language found to reserve that right. 738 F.2d at 65. That makes the case even less likely to be followed in the absence of such policy language.


Restatement (Second) of Judgments § 58(2) (1982).
When a Broker's Presence Breaks the "Cone of Silence" Surrounding Attorney-Client Communications

By Louis A. Chiafullo and Stephanie Platzman-Diamant – September 12, 2012

When coverage disputes arise between a policyholder and its insurer, the policyholder’s broker can become an invaluable resource. Typically, the broker will have knowledge of the placement of the insurance program, but the broker may also have extensive knowledge about the claims being discussed. Because of these factors, policyholders often believe that their communications with the broker on issues related to the claim are protected by both the attorney-client privilege and the work-product doctrine. However, policyholders should tread carefully because some courts have disagreed with that notion. Other courts have correctly determined that policyholder-broker communications should be protected from disclosure in a lawsuit or arbitration between the policyholder and the insurer.

The case law suggests that if the parties intend that the broker share in the attorney-client privilege or work-product protection, the broker’s participation must be necessary to the legal representation. That is, the privilege or protection will be maintained where the broker is present in an effort to assist the lawyer (whether in-house counsel or outside counsel) in gathering factual information, preparing for litigation, or otherwise formulating confidential legal advice to the client.

Courts have been far from consistent in their treatment of this issue. Instead, depending on the specific factual circumstances, courts have come down squarely on both sides of the question. Indeed, courts within the same jurisdiction have reached different results.[1] A review of some of the more recent decisions is instructive and can provide guidance to policyholders who intend to use brokers as a resource in claims handling or claims litigation.

Courts Rejecting Attorney-Client Privilege for Broker-Policyholder Communications

Some courts have narrowly interpreted the attorney-client privilege and have not afforded such protection to policyholder-broker communications. For example, in *SR International Business Insurance Co. v. World Trade Center Properties, LLC*, the court held that communications between the policyholder and its broker’s employees during preparation for the broker’s employees’ depositions were not protected from discovery by the attorney-client privilege, the common-interest doctrine, or the work-product doctrine.[2]

In that case, insurers moved to compel deposition testimony regarding post-9/11 conversations between attorneys for holders of leases on the World Trade Center complex and employees of Willis, the insurance brokerage firm that obtained insurance coverage for the World Trade Center.[3] The leaseholders argued that conversations between their counsel and the Willis employees were protected by the attorney-client privilege that exists between the policyholder’s counsel and its agents and employees because Willis was acting as an agent of the leaseholders in placing the insurance for the
World Trade Center.[4] Alternatively, the policyholders argued that they shared with
Willis a common-interest privilege or that the work-product doctrine protected the
communications.[5]

The court reasoned that the facts of the case did not warrant extending the attorney-client
privilege to communications between the Willis employees and the leaseholders’ counsel
because “the conversations at issue here . . . were between Willis, a multinational
corporation with its own retained counsel, and the lawyers for one of its many clients.”[6]
The court further reasoned that the leaseholders’ attorneys did not have any ethical
obligation “to hold inviolate” information that they received from the broker’s
employees.[7] Analyzing the attorney-client relationship from the Willis employees’
point of view, the court found that the broker’s employees “had no reason to believe that
they were talking to lawyers who were representing their interest and would hold
inviolate [their] confidences and secrets.”[8] The court also regarded the fact that
“counsel advised their clients to enter into a joint defense agreement” as further
demonstrating that no privilege existed between the Willis employees and the
leaseholder’s attorneys.[9]

In addition, the court held that the broker’s communications were not protected by the
common-interest doctrine, which it described as “permit[ting] a client to share
confidential information with the attorney for another who shares a common legal
interest.”[10]

There has been no showing that Willis and the [leaseholders] have an identical legal
interest . . . . Willis is not a party to this litigation, and its legal position will be
unaffected by the outcome of this case. If it did . . . anticipate litigation after
September 11, it would seem that it would have been more likely to be sued by [the
leaseholders] than by the insurance companies.[11]

Finally, the court held that the work-product doctrine did not preclude deposition
questions about conversations between the Willis employees and the leaseholders’
attorneys. The court stated that under the Federal Rules of Civil Procedure, “the work
product doctrine applies only to tangible things—not testimony.”[12] Given this
limitation, the work-product doctrine protects only “questioning that is either specifically
designed to discover the attorney’s work product or for some other reason presents a
substantial likelihood that a response to the question will result in a significant disclosure
of counsel’s legal strategy and thought processes.”[13] Applying these principles, the
court concluded that the work-product doctrine did not preclude (1) questioning the
broker’s employees about their conversations with the leaseholders’ counsel prior to their
deposition preparation; (2) questioning the broker’s employees about what they said to
the leaseholders’ counsel during their deposition preparation; and (3) questions
concerning what leaseholders’ counsel said to the broker’s employees during their
preparation, to the extent that the lawyers’ statements were necessary to provide an
understanding of what the broker’s employee said to the lawyer.[14]
In a 2005 case in the Northern District of California—Sony Computer Entertainment America v. Great American Insurance Co.—the court addressed a situation where the policyholder’s broker was present during meetings between the policyholder and its outside counsel.[15] There, the policyholder sued certain of its insurers after the insurers denied coverage to Sony for two consumer lawsuits.[16] During discovery, two of the policyholder’s in-house attorneys, one of whom was designated as a Rule 30(b)(6) witness, gave deposition testimony.[17]

Because of objections to questions concerning the policyholder’s communications with its attorney in the presence of its insurance broker, one of the insurers filed motions to compel responses to these questions.[18] The insurer argued that the broker’s presence vitiated application of the attorney-client privilege.[19] The policyholder responded by arguing that the communications were confidential and privileged because the broker was “present indisputably to further [the policyholder’s] interest in [in-house counsel’s] consultations.”[20]

The court noted that the burden was on the policyholder to demonstrate that the broker was acting as an agent of the outside counsel or the policyholder during the discussions in order to preserve the confidentiality of the communications.[21] Because the court found that the policyholder failed to provide any admissible evidence from either the broker or the policyholder to support its position (e.g., including declarations by either the policyholder’s in-house attorney or broker), the court granted the insurer’s motion to compel.[22]

The following year, a federal court in New Jersey weighed in on the issue. In Cellco Partnership v. Certain Underwriters at Lloyd’s, London, Cellco sued its insurers after they denied its claim relating to the misappropriation by a former employee of personal identification numbers and calling cards.[23] During discovery, the insurers moved to compel production of communications that were prepared by or transmitted to or that summarized communications with the policyholder’s insurance broker, Aon.[24]

The policyholder sought to withhold these communications pursuant to the attorney-client privilege, claiming that in addition to being its insurance broker, Aon also provided legal counsel; thus, any communications between them were subject to the privilege.[25] The policyholder relied in part on the fact that the Aon employee responsible for handling its claim submission was also a licensed attorney and was providing legal counsel to the policyholder.[26] The court rejected Cellco’s argument, finding that there was no retainer agreement between Aon and Cellco and that Cellco failed to demonstrate sufficiently how Aon functioned as legal counsel.[27] The court also found that the broker/attorney employed by Aon explicitly stated that the information he was providing was not intended to be legal advice.[28]

Alternatively, Cellco argued that Aon acted as an “agent/interpreter” for it and its attorney.[29] The court was unconvinced, reasoning that “Aon did not act as an agent of the attorney or Plaintiff for the purposes of providing or interpreting legal advice.”[30] The court explained that “[w]hile the information and advice provided may have proved
helpful, it was not needed to interpret complex issues in order to provide competent legal advice or to facilitate the attorney-client relationship.”[31] Thus, the court concluded that Aon’s communication with Cellco was not protected by the attorney-client privilege.[32]

In another case decided in 2006, *J.E. Dunn Construction Co. v. Underwriters at Lloyd’s London*, the court ordered production of correspondence among the policyholder, its broker, and its shared counsel.[33] There, the policyholder argued that this correspondence was protected by the common-interest/joint-defense exception to the waiver of the attorney-client privilege.[34] In support of its argument, the policyholder pointed to the broker’s payment of its counsel fees, the broker’s interest in seeing the return of the premium for the policyholder’s allegedly nonexistent coverage, and the common interest and joint defense agreement between the policyholder and the broker.[35] The policyholder further stated that although its broker was at least partially responsible for ensuring that it received the insurance coverage it requested, the policyholder, “realizing that [the broker] was as much of a victim of [the insurer’s] tortious conduct[,] . . .has not made a claim against [the broker] in this litigation.”[36]

The court was not convinced, holding that although the policyholder and the broker had a common “commercial” interest, this alignment of interests did not satisfy the requirement of the common-interest exception to the attorney-client privilege, which required that the parties have a common “legal” interest.[37] The court reasoned that the broker’s “interest is in avoiding liability to [the policyholder-]plaintiff,” which was obviously different than that of the policyholder.[38] The court was likewise not persuaded by the existence of a common interest and joint defense agreement between the policyholder and the broker, stating that a party’s beliefs, “subjective or otherwise, about the law of privilege cannot transform an otherwise unprivileged conversation into a privileged one.”[39]

**Courts Extending Attorney-Client Privilege and Other Protections**

Other courts have examined the relationship between the broker and the policyholder and have held that broker-policyholder communications are protected from disclosure. For example, in *Atmel Corp. v. St. Paul Fire & Marine Ins. Co.*, the insurer moved to compel the production of attorney-client privileged materials that the policyholder, Atmel, had sent to its insurance broker.[40] The insurer argued that brokers are independent contractors and do not act as agents for either the insurer or policyholder.[41] The court rejected that argument, noting that the broker had negotiated the policies at issue and thereafter served as a “necessary advisor” to Atmel on insurance coverage and claim issues.[42] Accordingly, the court ruled that “[g]iven the relationship between [the broker] and Atmel, the attorney-client privilege was not waived because [the broker] was present to further Atmel’s interests and disclosure to [the broker] was reasonably necessary to provide information to the insurers.”[43]

In holding that the relationship between Atmel and its broker triggered the attorney-client privilege for the documents in question, the court likened the factual situation to that in *Royal Surplus Lines Insurance Co. v. Sofamor Danek Group, Inc.*[44] In that case, the district court upheld the magistrate judge’s discovery orders holding that the attorney-client privilege protected communications between the policyholder and the insurance
broker, Sedgwick’s senior vice president. In arriving at this conclusion, the court analyzed the agency relationship between the policyholder and the broker using the factors set forth in Couch on Insurance 3d, Section 45:4—namely, (1) who first set the agent in motion, (2) who controlled the agent’s actions, (3) who paid the agent, and (4) whose interest the agent was attempting to protect. Applying these factors, the court found that “[a]side from the lack of evidence regarding who paid Sedgwick once the coverage was written, it is clear that the remaining factors weigh heavily in favor of viewing Sedgwick as [the policyholder’s] broker for the purposes of this transaction.”[45]

In support of its holding, the Sofamor court pointed to the fact that the policyholder—who had substantial ongoing liability exposure from personal injury suits arising out of the manufacture of orthopedic bone screws—had no employees knowledgeable about complex commercial insurance and, therefore, relied on Sedgwick.[46] Furthermore, Sedgwick’s senior vice president participated in meetings and strategy sessions with the policyholder and its counsel after the policy was issued and the insurer began to question its obligation to cover the costs of additional bone screw claims.[47] Thus, the court concluded that the broker’s vice president “should be deemed an ‘insider’ with respect to communications he shared in both before and after the issuance of the policy,” and those communications were within the attorney-client privilege.[48]

The court in Atmel also rejected the insurer’s reliance on SR International, because “[t]hat case did not describe the relationship between the insurance broker and the policyholder, and did not discuss the necessity of the communications or of the broker’s involvement under California law.”[49] The court further distinguished SR International on the basis that the case involved deposition preparation of the broker’s employees by policyholder’s counsel, which was not an issue in Atmel.[50]

In a more recent opinion, In re Tetra Technologies, Inc., the Southern District of Texas held that as long as the communications between the policyholder and the policyholder’s broker were made “for the purpose of facilitating the rendition of professional legal services to the client,” they would fall within the attorney-client privilege.[51]

In that case, Tetra shareholders alleged that Tetra misrepresented its likely insurance reimbursements for hurricane-related repairs.[52] The plaintiffs then moved to compel discovery of certain communications between Tetra employees and Tetra’s insurance brokers.[53] In support of their application, the plaintiffs argued that the communication with the brokers, who were third parties, vitiates the attorney-client privilege.[54] In response, Tetra argued that its insurance brokers were its agents and therefore fell within the ambit of the attorney-client privilege.[55] The plaintiffs argued that many of Tetra’s communications with its brokers took place in the context of a dispute between Tetra and its insurer—thus, the brokers were simply facilitators and not agents.[56]

The court held that, even where a policyholder and its insurers are engaged in a coverage dispute, an insurance broker can nonetheless act as the policyholder’s agent when the purpose of the communication is “to facilitate the rendition of legal services.”[57] The court noted that what is vital to the attorney-client privilege is that “the communication
be made in confidence for the purpose of obtaining legal advice from a lawyer.” The court ruled that it would review in camera the communications that the plaintiffs alleged did not meet such criteria to determine whether or not that particular communication fell within the attorney-client privilege.

**Practice Points for Protecting Policyholder-Broker Communications**

Given the inconsistency with which courts have addressed the issue, policyholders and their brokers should consider entering into an all-purpose confidentiality agreement as part of the basic retention arrangement between them. This confidentiality agreement should provide that the broker understands and recognizes that (1) the policyholder may become involved in disputes with its insurers; (2) part of its duty to the policyholder is to maintain documents and information relevant to the policyholder’s coverage; (3) the policyholder and its counsel may communicate with the broker regarding the facts of an insurance dispute; and (4) it should keep such communications confidential.

Although a policyholder engaged in a discovery dispute will still need to make the requisite showing regarding the privilege of the communications at issue, having a confidentiality agreement in place would allow counsel to show that the claim of non-waiver is not a fiction invented by counsel to shield discovery.

In addition, when the policyholder’s counsel confers with the broker about a legal concern related to a pending litigation or claim, it is important to document these particular circumstances contemporaneously. This will help distinguish privileged interactions from routine communications. One way of accomplishing this is to mark “Privileged and Confidential” all communications with an insurance broker that are truly of a privileged nature.

At the same time, when entering into joint-defense and/or common-interest agreements, policyholders should keep in mind that courts do not necessarily view such agreements as dispositive of the existence of joint-defense or common-interest exceptions to waiver of the attorney-client privilege. The court in *J.E. Dunn Construction* rejected the argument that a common-interest and joint-defense agreement between a policyholder and its broker was evidence that those parties shared a common interest that would shield their communications from discovery. Furthermore, a court may even interpret the existence of such agreements, or the suggestion by counsel that their clients enter into such agreements, as an indicator that broker-policyholder communications are not subject to the attorney-client privilege. For example, the court in *SR International* viewed counsel’s suggestion that the policyholders and the broker enter into a joint-defense agreement as indicative of the lack of privilege between the policyholders’ attorneys and the broker.

When considering making an argument that policyholder-broker communications are protected by a common interest between the policyholder and broker, counsel for the policyholder should keep in mind that courts have been reluctant to shield such communications from discovery where the nature of the policyholder’s and broker’s common interest was found to be commercial, rather than legal. Policyholders should...
exercise special caution in advancing this argument in situations where the broker may be liable for negligent placement of the insurance at issue, which would weaken any argument that the policyholder and the broker share a common legal interest.

If a policyholder finds itself litigating whether oral communications made in the presence of a broker vitiate the attorney-client privilege, the policyholder should, at the very least, submit to the court declarations or affidavits by its employees/principals and key employees of its broker detailing why the broker’s presence was necessary to accomplish the purpose for which the attorney was consulted.

**Conclusion**

Courts are the ultimate arbiters as to whether a particular communication, in fact, facilitated legal advice and is protected by the attorney-client privilege. Policyholders, however, can take the steps outlined above so that they can make the best argument—and have the best factual record—against disclosure when it comes time to produce documents or give testimony during litigation.

**Keywords:** coverage disputes, attorney-client privilege, work product doctrine, broker-policyholder communications

Louis A. Chiafullo and Stephanie Platzman-Diamant are with McCarter & English, LLP, Newark, NJ.


[22] See *Sony Computer Entertainment America*, 229 F.R.D. at 634.


[41] See Atmel Corp., 409 F. Supp. 2d at 1181.


[43] Atmel Corp., 409 F. Supp. 2d at 1182; see also Miller v. Haulmark Transp. Sys., 104 F.R.D. 442, 445 (E.D. Pa. 1984), where the court upheld the policyholder’s claim of attorney-client privilege by finding that the broker’s presence was necessary to assist counsel in preparing an answer to a complaint. As the court explained:

[T]he presence of [the broker] at the meeting does not constitute a waiver of the privilege as to the contents of that meeting, or the other material sought. [The broker] was instrumental in arranging that coverage, and his purpose at the meeting was to aid in the preparation of an answer. The presence of one so closely related to [the policyholder] and this [coverage] lawsuit for the limited purpose of aiding the attorneys involved in defending the lawsuit does not void the privilege.


[50] See Atmel Corp., 409 F. Supp. 2d at 1182 n.3.

[51] In re Tetra Techs., Inc., 2010 U.S. Dist. LEXIS 33012, at *13–14 (S.D. Tex. Apr. 5, 2010). See also Navigators Mgmt. Co. v. St. Paul Fire & Marine Ins. Co., 2009 U.S. Dist. LEXIS 14021 (E.D. Mo. Feb. 24, 2009). There, the court held that the insurance agency was acting as the policyholder’s “representative” to the extent that its communications were made for the purpose of “facilitating the rendition of professional legal services”; thus, such communications were protected by the attorney-client privilege. However, the agency was not the policyholder’s “representative” to the extent that its communications did not involve an attorney or were not made to facilitate legal services.


Courts Are Now Rejecting Insurers’ Reimbursement for Defending Non-covered Claims

By Benjamin D. Morgan – September 12, 2012

A coverage issue yet to be decided by several jurisdictions is whether a commercial general liability (CGL) policy providing an insurer with the duty and right to defend its insured against third-party claims also authorizes that insurer to be reimbursed for defense costs related to claims that are later determined to be beyond the policy’s grant of coverage.

Courts nationwide have split over this issue. In 1997, the California Supreme Court decided *Buss v. Superior Court*[1] and held that an insurer can properly rely on a reservation of rights letter to secure its right to reimbursement of defense costs for non-covered claims. Since that time, however, a number of courts have uniformly concluded that an insurer has no right to reimbursement of defense costs absent an express provision in the written insurance contract authorizing reimbursement.[2]

For example, the Pennsylvania Supreme Court, in *American & Foreign Insurance Co. v. Jerry’s Sports Center, Inc.*, [3] recently joined this expanding minority view. The Pennsylvania high court rejected the carrier’s contention that it was entitled to reimbursement of defense costs associated with a claim the lower court had determined was not covered. The court predicated its rationale on Pennsylvania’s broad duty to defend and the plain language of the insured’s CGL policy, which was devoid of any language suggesting the carrier had any such right to reimbursement.[4]

This article explores this divide in the courts by initially explaining the basic and universal principles related to an insurer’s duty to defend, followed by a brief discussion of the *Buss* holding and the court decisions that have followed its lead. Next, the article examines the courts that have taken a contrary view to the *Buss* decision. Last, this article will advocate why courts should similarly reject the *Buss* holding and follow the jurisdictions finding the plain language of the CGL policy simply does not allow for the reimbursement of defense costs.

**Duty to Defend**

As a general matter, an insurer’s duty to defend is broader than its duty to indemnify.[5] This contractual obligation to defend under the CGL policy is separate and apart from an insurer’s duty to provide coverage.

As a result, an insurer must provide its insured with a defense against all actions covered by the CGL policy. When a complaint is filed against the insured alleging a covered claim, the insurer’s duty to defend is triggered. Thus, when the allegations in the complaint fall within a risk that is covered by the CGL policy, the insurer is obligated to defend. Indeed, as long as the allegations in the complaint comprehend a claim or injury that may possibly be covered by the insurance policy, a duty to defend will arise.[6]
Courts will generally determine whether a third-party claim asserted against an insured is potentially covered under the CGL policy by comparing the allegations in the complaint with the insurance policy’s language. The duty to defend arises even if the allegations in the complaint are “poorly developed and almost sure to fail.”[7]

The duty to defend is not limited to only meritorious actions. Indeed, the merit of the claim asserted against the insured is immaterial. Rather, courts will look only at the allegations asserted. In other words, that the allegations may be “groundless, false, or fraudulent” does not defeat the duty to defend. [8]

As the New Jersey Supreme Court recently pronounced, the “determination of an insurer’s duty to defend requires review of the complaint with liberality to ascertain whether the insurer will be obligated to indemnify the insured ‘if the allegations are sustained.’”[9]

The Buss Line of Cases

_Buss_ arose out of an underlying lawsuit in which only 1 of 27 claims was potentially within the insurance policy’s coverage. The underlying action was brought against Jerry Buss, the owner of several sports teams, including the Los Angeles Lakers, who was alleged to have, among other things, breached a contractual obligation with a third party. The underlying complaint alleged 27 causes of action, including a count for defamation that turned out to be the only potentially covered claim. The insurer provided a defense for all 27 counts pursuant to a reservation of rights letter, which included a right to seek reimbursement of all defense costs. The coverage action eventually came before the California Supreme Court, which held that because the insurer’s duty to defend extended to claims that were at least potentially covered, the insurer was not entitled to seek reimbursement of defense costs for the one potentially covered defamation claim. The court held, however, that the insurer could seek reimbursement of all the defense costs related to the 26 claims that were not potentially covered.[10]

In support of its conclusion that the insurer was entitled to reimbursement of the non-covered claims, the California high court observed that the insurer had not been paid premiums by the insured with regard to those non-covered claims, nor did the insurer bargain to bear the costs of defending claims that were not potentially covered under the insurance policy. According to the court, the insurer had a right to seek reimbursement that is “implied in law as quasi-contractual, whether or not it has one that is implied in fact in the policy as contractual.”[11]

The court also reasoned that the insurer had the right to seek reimbursement because the insured would be “unjustly enriched” if the insurer had to incur defense costs it had not bargained for, which the court found to be unjust.[12] In short, while the insurer had no right to seek reimbursement of the potentially covered claim, the insurer did have a right to seek reimbursement for claims that were not potentially covered.
Following *Buss*, insurers have routinely issued reservation of rights letters seeking reimbursement of defense costs. Numerous courts following *Buss* have found in favor of the insurer, usually based on contractual or equitable principles, or both. For example, several courts view the insurance policy as being inapplicable because reimbursement was sought for defense costs incurred for claims that were not covered and the reservation of rights letter was an offer to create a “new contract” regarding those non-covered claims. These courts view the insured as having accepted that reservation of rights letter by virtue of having accepted the insurer’s payment of defense costs pursuant to that reservation.[13]

Besides this contractual viewpoint, other courts following *Buss* apply the equitable theory of unjust enrichment and the remedy of restitution in quantum meruit. This theory disallows the insured from being unjustly enriched when the insurer paid defense costs for non-covered claims.[14]

Although many courts have followed the *Buss* lead on this issue of reimbursement of non-covered claims, that majority view has eroded over time. As the next section demonstrates, there is now a growing minority view embraced by a number of courts that reject the reasoning of *Buss*.

**Growing Trend Rejects Buss**

A number of courts have now rejected *Buss* for a variety of reasons. Some courts have concluded that reimbursement of defense costs is simply inconsistent with the broader duty to defend.[15] Other courts have rejected the notion that reimbursement of defense costs can be allowed based on a reservation of rights letter, pointing out that the insurer voluntarily undertakes the defense in order to protect its own self-interest. The Third Circuit Court of Appeals endorsed this reasoning in *Terra Nova Insurance Co. Ltd. v. 900 Bar, Inc.*, several years before *Buss* was decided. The court explained that an insurer’s role in providing a defense with a reservation of rights is just as much for its benefit as the insured’s. By providing a defense, an insurer avoids the risks that an inept defense will expose it to should indemnity be required. By also asserting a reservation of rights, the insurer preserves its ability to contest that same indemnity should its defense ultimately be unsuccessful. If the insured were later required to pay the insurer’s defense costs, the insurer would not be required to carry any financial burden for protecting its interests in the underlying action.[16]

Further, several courts have rejected *Buss* by finding that a unilateral reservation of rights letter from the insurer does not create new contractual rights that were absent in the insurance policy itself.[17] Other courts have rejected *Buss* by finding that, as a matter of fairness, an insurer should not be able to benefit unfairly by hedging its bets on its defense obligations by reserving its right to reimbursement while potentially controlling the defense and avoiding a bad-faith claim.[18]

The Pennsylvania Supreme Court recently joined this growing trend of cases that have rejected the *Buss* rationale. In *American & Foreign Insurance Co. v. Jerry’s Sports Center, Inc.*, the National Association for the Advancement of Colored People filed a civil
action against several firearms wholesalers and distributors seeking to hold the firearms industry liable for injury, death, and other damages through the negligent creation of a public nuisance for failing to distribute firearms in a reasonable and safe manner. The insured notified its carrier of the action and requested a defense and indemnification, noting that the allegations fell under the “bodily injury” coverage provided by the CGL policy. The insurer assigned defense counsel to provide a defense and respond to this lawsuit pursuant to a full reservation of rights, which included the right to seek reimbursement for all defense costs for claims ultimately determined not to be covered. The insurer sent the insured several reservation of rights letters emphasizing this right to seek reimbursement.[19]

In rejecting Buss, the Pennsylvania high court concluded that the growing minority view was more consistent with Pennsylvania’s broad duty to defend when also viewed in light of the CGL policy’s express language.[20] The court noted that where the insurance contract is silent about the insurer’s right to reimbursement of defense costs, allowing reimbursement for costs that the insurer incurred in exercising its right and duty to defend potentially covered claims prior to a court’s determination on coverage would be inconsistent with Pennsylvania’s broad duty to defend. It would also amount to a “retroactive erosion of the broad duty to defend in Pennsylvania by making the right and duty to defend contingent upon a court’s determination that a complaint alleged covered claims, and would therefore narrow Pennsylvania’s long-standing view that the duty to defend is broader than the duty to indemnify.”[21]

The court accordingly held that the insurer could not employ a reservation of rights letter to reserve a right it did not originally have under the CGL policy, which the court found would be “tantamount to allowing the insurer to extract a unilateral amendment to the insurance contract.”[22]

The Pennsylvania high court also rejected the notion that there was any equitable basis on which to allow the insurer the right of reimbursement. The court reasoned that an insured is not unjustly enriched by the insurer’s payment of defense costs. This is because the insurer has not only the duty to defend but also the right to defend pursuant to the insurance agreement. This arrangement, the court observed, assists both parties in that the duty to defend benefits the insured to protect it from the costs of defense, while the right to defend allows the insurer to control the defense to protect itself against potential indemnity exposure.[23]

Last, the court recognized that if the insurer could seek reimbursement of defense costs that are beyond the express language of the CGL policy, that would allow the insurer to “design its own right to reimbursement subject only to the insurer’s designs.”[24] The court was concerned that allowing the insurer to “design” its own right of reimbursement would open the door to unjustified maneuverings by insurance companies at their policyholders’ expense.[25] Therefore, the court held that the insurer cannot obtain reimbursement of defense costs for a claim for which a court later determines there was no duty to defend, even where the insurer attempts to claim a right to reimbursement through a reservation of rights letter.[26]
Courts Should Follow Growing Trend

As noted at the outset, several courts have not yet addressed the issue of an insurer’s ability to seek reimbursement of defense costs incurred in connection with non-covered claims. Nationwide, the courts appear to be evenly divided over this issue. It appears, however, that the growing trend of authority that rejects *Buss*, as exemplified by the recent Pennsylvania Supreme Court decision, is the better-reasoned approach.

As an initial matter, the plain language of the standard CGL policy simply does not authorize an insurer to seek reimbursement. The CGL policy provides the insurer with the duty and right to defend its insured against third-party claims. Once the insurer elects to defend its insured, the carrier has no contractual right to unilaterally modify that agreement—an agreement the carrier drafted in the first instance—by trying to create a new agreement through a reservation of rights with different terms that were never agreed to by the insured. If the insurer wants to have this right to reimbursement, it can easily be included in the policy language. Presently, that language is absent and should not be imposed unilaterally on an insured after a complaint has been filed. Moreover, by defending the insured, the carrier also benefits its own self-interests by controlling the defense with the hope of avoiding or minimizing its indemnity obligation.[27]

*Buss*’s duty to reimburse rule is also inconsistent with the widely recognized broader duty to defend. All potentially covered claims trigger the insurer’s duty to defend. There is always the possibility, however, that a court will later determine a claim is not covered. In that instance, there may no longer be a duty for the insurer to indemnify that claim. However, the duty to defend is broader than the duty to indemnify. To allow the insurer to be reimbursed for defense costs would improperly place those two contractual rights on the same level—yet, they have historically always been considered separate and apart.[28]

Further, the concept of “fairness” has no place in this analysis. *Buss* espoused that it would be unfair for insurers to be required to defend non-covered claims because the insured never paid a premium for that coverage. *Buss* misses the point. The plain language of the CGL policy provides that very coverage. The insured paid a premium so it would be defended against third-party claims that are potentially covered under the insurance agreement. That was the understanding struck, and it is the insurer that is in the better position to appreciate the risks it is underwriting. Indeed, insurers are in the business of taking risks and determining when claims are covered or not covered. Insurers should not be allowed to have it both ways, which is exactly what *Buss* allows when it sanctions the unilateral abridgement of the insurance contract through a reservation of rights letter.

Because most states recognize that the insurer has a broad duty to defend its insured, because the plain language of the standard form CGL policy recognizes that duty and does not authorize the insurer to seek reimbursement for claims later determined to be non-covered, and because the insurer receives the benefit of controlling the defense in defending its insured and minimizing its indemnity exposure, the *Buss* rationale that a
carrier can unilaterally alter the CGL policy’s duty to defend by the issuance of a reservation of rights letter is inconsistent with the broad duty to defend as well as the plain language of the insurance agreement itself. For these reasons, we believe those courts that have yet to decide this issue should follow the Pennsylvania high court’s lead and, accordingly, exit the *Buss*.

Benjamin D. Morgan is with Archer & Greiner PC, Haddonfield, NJ. The views and opinions expressed in this article are those of the author and not necessarily those of Archer & Greiner or its clients.


[2] See Angela R. Elbert & Stanley C. Nardoni, “*Buss* Stop: A Policy Language Based Analysis,” 13 Conn. Ins. L.J. 61, 94 (2006–2007) (noting that many courts have overlooked the CGL policy’s “supplementary payment” clauses that “promise that the insurer will bear the full costs for cases it defends,” which policy language “runs expressly against a right of reimbursement”).


[6] See, e.g., *Erie Ins. Exch. v. Transamerican Ins. Co.*, 533 A.2d 1363, 1368 (Pa. 1987) (describing duty to defend as arising “whenever the complaint filed by the injured party may potentially come within the coverage of the policy”); *BP Air Conditioning Corp. v. One Beacon Ins. Grp.*, 871 N.E.2d 1128, 1131–32 (N.Y. 2008) (noting defense must be afforded whenever claims even potentially fall within coverage); *Abouzaid v. Mansard Gardens Assocs., LLC*, 23 A.3d 338, 346 (N.J. 2011) (noting that whenever the allegations in the complaint encompass an injury or claim that is “potentially coverable,” the insurer is required to provide a defense); *Ameron Int’l Corp. v. Ins. Co. of the State of Pa.*, 242 P.3d 1020, 1025 (Cal. 2010) (noting defense will be provided as long as insured can show a claim “may fall” within policy coverage).

[8] Abouzaid, 23 A.3d at 346 (finding defense required even if claims are groundless); BP Air Conditioning Corp., 871 N.E.2d at 1132 (same); Waller v. Truck Ins. Exch., Inc., 900 P.2d 619, 627 (Cal. 1995) (same).


[23] Jerry’s Sports Center, Inc., 2 A.3d at 545.


[26] *Jerry’s Sports Center, Inc.*, 2 A.3d at 546.


[28] See supra note 5.
Bankruptcy Treatment of Self-Insured Retentions and Deductibles


What happens when a company with outstanding insured liabilities files for bankruptcy? What if the company’s liability insurance policies contain self-insured retentions (SIRs) or deductible amounts? With the company financially unable to pay any SIR or deductible, who is left “holding the bag”?

With limited exceptions, courts generally do not allow insurance companies to escape their obligations to bankrupt policyholders simply because the policyholder lacks the financial resources to pay an SIR or deductible. As always, the starting point will be the precise language of the liability policies involved. But state insurance law requirements, public policy, and bankruptcy rules can all affect the outcome.

It is important to distinguish whether the policy contains an SIR or a deductible, because they operate differently. Where there is an SIR, the policyholder typically must pay the SIR before the insurance company’s obligation is triggered.[2] In contrast, under typical policy language, the insurance company will generally pay the deductible amount first and then seek reimbursement from the policyholder.[3] This distinction plays an important role in a court’s analysis of how the policy operates and who must pay in the event of a policyholder’s insolvency.

The key issues are as follows: Will coverage be available if the policyholder cannot pay the SIR, or does the policyholder’s failure to pay the SIR vitiate coverage? If there is underlying liability that would be covered by the policy, and there is a deductible provision, how is the insurance company compensated for that deductible payment in the event of a policyholder’s bankruptcy? Most courts find that the attachment point of the policy remains the same, but the insurer may not escape payment based on the policyholder’s inability to pay the SIR or deductible.

An Insolvent Policyholder’s Inability to Pay an SIR Does Not Vitiate Coverage

The dominant view among courts that have addressed the issue is that a liability insurer must pay the full amount of its policy for covered liabilities, regardless of the policyholder’s bankruptcy. Many states have statutes that require liability insurance policies to have language stating that the policyholder’s bankruptcy or insolvency will not affect coverage. In those states, courts will generally not void coverage based on the policyholder’s financial inability to pay the SIR. Even in such instances, however, the insurer maintains the benefit of the SIR terms and thus is not required to “drop down” and pay the SIR that the insolvent policyholder is unable to pay.[4] In other words, the court will enforce the contractual obligations but will not impose an additional liability on the insurer. This means that the claimant against the insolvent policyholder is left “holding the bag” and must seek the amount of the SIR in the bankruptcy process.[5]
One of the leading cases on this point is *Home Insurance Co. of Illinois v. Hooper.*[6] In this Illinois state intermediate appellate court case, the policyholder had a comprehensive liability and product liability insurance policy with limits of $1 million per occurrence and an SIR of $250,000 per occurrence and $750,000 in the aggregate.[7] The insurer contended that it had no obligation to indemnify its insolvent policyholder for an underlying personal injury lawsuit unless and until the policyholder made “actual payment” of the “entire amount” of the SIR.[8] The insurer argued that the plain language of the policy demanded this result.

The policyholder argued that the policy should “drop down” and cover the amount of the SIR that it was unable to pay because of its bankruptcy.[9] The policyholder also argued that the SIR language on which the insurer relied violated Illinois public policy as expressed in Illinois’ Insurance Law section 388. That statute provides as follows:

> No policy of insurance against liability or indemnity for loss or damage to any person other than the insured, for which any insured is liable, shall be issued or delivered … unless it contains in substance a provision that the insolvency or bankruptcy of the insured shall not release the company from the payment of damages for injuries sustained … .[10]

The trial court rejected both of the policyholder’s arguments and granted summary judgment for the insurer. The appellate court reversed, finding that the “operative effect of the language of the self-insured provision is directly contrary to the public policy as declared by the legislative enactment of section 388.”[11]

The appellate court in *Hooper* also relied on the policy language in an endorsement. The endorsement stated that the insurance company’s liability was “limited to pay only those: ‘claims which resulted in the amounts cumulatively equaling or exceeding $250,000, such that the amounts paid or payable by the company, plus the amounts paid or potentially payable by the Named Insured, shall equal $1,000,000.’”[12] Because of the language describing amounts “paid or payable by the Named Insured,” the court rejected the insurer’s argument that only “actual payment” would suffice to meet the terms of the policy.[13]

The appellate court affirmed the trial court on the “drop down” issue, however, holding that the insurer had “the obligation to cover any judgment in excess of $250,000 but is not obligated for the first $250,000.”[14] Other courts presented with this issue have reached similar results.[15]

But some courts have reached different conclusions. In another Illinois case, this time in a federal district court applying Illinois law, the court reached a different conclusion and determined that the insurer, not the underlying claimant, must absorb the cost of the SIR.[16] In *Keck,* the court found that the SIR was satisfied by including the amount of the SIR as an unsecured claim for the insurance company, notwithstanding that the policies contained no “drop down” provision and the insurance company was not
obligated to provide coverage until the SIR was paid.[17] The insurance company effectively had to “pay” the SIR with an “IOU” from the estate of the policyholder. The court noted that preserving the attachment point of the policy meant that the insurer’s obligation was “not increased by a penny.”[18]

SIRs and Defending Claims
A New York federal district court applying Illinois law held that the same result reached in Hooper should apply whether or not an SIR includes defense costs.[19] The court also addressed the practical issue of how to deal with the defense costs within the SIR in the bankruptcy context. “Any amounts incurred by [the insurer] for the costs of defending the personal injury suits that fall within the self-insured retention should be filed with the bankruptcy estate as unsecured claims and be dealt with accordingly.”[20]

Another New York federal district court reached the same result and rejected the insurance company’s argument that it should be reimbursed for those defense costs as an “administrative expense” with priority before general unsecured claims.[21] In Ames, the insurance company argued that the insurer would have no alternative but to assume the defense of claims if the policyholder was allowed to abandon its defense, because claims starting out well below the SIR could quickly proliferate into a judgment well in excess of the deductible if allowed to proceed.[22] The court refused to consider the defense costs to be an “administrative expense.” Rather, the court held, no order required the insurance company to defend the claims below the SIR and it was simply choosing to do so as a prudent business decision.[23]

If the insurer chooses to defend claims that are below its SIR, the defense costs paid by the insurance company may not “count” toward satisfying the SIR if the policy provides that the policyholder’s payment of defense costs do not exhaust the SIR.[24] In Kleban v. National Union Fire Insurance Co. of Pennsylvania, the Superior Court of Pennsylvania ruled that the claimant was entitled only to the amount of his claim less the $250,000 SIR.[25] The court rejected the claimant’s argument that the insurance company’s payment of $316,000 in defense costs—for which it would receive an unsecured claim in the bankruptcy along with the $250,000 SIR—satisfied the SIR requirement.[26]

Paying SIRs as a Condition of Coverage
Some courts, however, have found that payment of an applicable SIR constitutes a condition precedent to coverage. By so concluding, these courts find that the policyholder is entitled to no coverage if it cannot pay the required amount. For example, in Pak-Mor Manufacturing Co. v. Royal Surplus Lines Insurance Co.,[27] the policyholder under a CGL policy instituted a declaratory judgment action in a Texas bankruptcy to resolve this issue. The insurer moved for summary judgment, contending that it had “no obligation to defend or indemnify . . . because [the policyholder] has not satisfied its self insured retention.”[28] The bankruptcy court denied the insurer’s motion and granted partial summary judgment in favor of the policyholder.[29]

The insurer appealed to the district court. That court reversed and based its decision on policy language.[30] The district court stated that it was constrained to apply the policy...
as written and rejected the policyholder’s reliance on *Hooper* and cases like it.[31] The court distinguished *Hooper* because it relied on the Illinois state statute requiring liability insurance policies to contain language stating that “the insolvency or bankruptcy of the insured shall not release the insurer from the payment of damages.”[32] The court noted that Texas had no such statute, thus rendering the *Hooper* court’s reasoning inapplicable.[33]

Other courts have noted that the reasoning behind statutes such as the one in Illinois is to ensure that funds are available for injured claimants as a matter of public policy.[34] For example, the court in *Columbia Casualty Co. v. Federal Press Co.*, a federal bankruptcy court applying Indiana law, analyzed a similar Indiana statute. The court in *Federal Press* stated that the Indiana statute “embodies the public policy of permitting an injured victim to recover under a valid insurance policy from the insurer itself in the event the insured is unable to pay due to its insolvency or bankruptcy.”[35] Thus, public policy would likely apply with the same result reached in *Hooper* in states with statutes like the one quoted above and the one cited in *Hooper*. [36]

The court in *Pak-Mor* also noted that the policyholder could “pay the retained limit in any form it desires so long as the Bankruptcy Court confirms that the payment is performed in a credible and reliable manner.”[37] This ruling may be able to be reconciled with the *Keck* court’s reasoning that commanded the liability insurer to “stand in line” with the other unsecured creditors for whatever funds were available from the insolvent policyholder’s estate.[38] It may be that, even under an analysis like the one in *Pak-Mor*, the policyholder could “pay” the SIR by including it as an unsecured claim in a bankruptcy or receivership, thereby activating the insurance company’s obligation to pay its policy limits.

**Right to Reimbursement of Deductible Generally Treated as Unsecured Claim**

What about a deductible? Does it make sense to treat a deductible differently, because insurers generally pay a deductible first and later seek reimbursement from the policyholder? At least one of the few courts that have addressed this issue in the liability insurance context required the insurance company to pay the deductible in the first instance and then treated the insurance company’s right to reimbursement as a general unsecured claim.[39]

Another court faced with this issue went a step further and granted the insurance company administrative expense priority for some deductible payments under a liability policy.[40] For administrative expense priority, the insurer must make the proper showing under the relevant bankruptcy statutes.[41] If that is successful, the insurer’s claim can be paid before unsecured claims.

The courts that have addressed the issue have focused on two prerequisites that exist before the payment by the insurer of a deductible or other insurance-related expense may be considered an administrative expense. *First*, the deductible must be related to a liability claim that arose after the policyholder filed for bankruptcy. *Second*, the insurance
company must make a showing that its payment of the deductible was “beneficial” to the policyholder-debtor.[42] One court has described it as follows:

An expense is administrative only if it arises out of a transaction with the bankruptcy estate and only to the extent that the consideration underlying the claim was both supplied to and beneficial to the debtor in possession in the operation of the business. A claim is not entitled to administrative expense status simply because the right to payment arises postpetition.[43]

A liability insurer that advances the deductible for an insured that petitions for bankruptcy may therefore have a claim for administrative expenses for “post-petition” claims but possess only a “general unsecured claim” for claims that “arose pre-petition.”[44]

**Conclusion**
An insolvent policyholder’s inability to pay an SIR does not allow a liability insurer to escape its policy obligations in most jurisdictions. Some courts, however, will void coverage based on the policyholder’s financial inability to pay. For all but the few jurisdictions where coverage is voided, the amount of an SIR usually is deducted from the payment to the injured party with a claim against the policyholder. The liability insurer, however, must pay the rest of the covered claim.

An insurer of an insolvent policyholder will generally not be required to defend claims below an SIR but will often choose to do so as a business decision so that the underlying claim does not proceed without a defense. Courts have generally allowed such insurers to be reimbursed for those defense costs in the form of an unsecured claim against the policyholder’s estate.

In the case of a deductible, the policy usually operates such that the insurer pays first and is entitled to reimbursement from the policyholder. Most courts deem the insurer’s right to reimbursement to be an unsecured claim in the policyholder’s bankruptcy. Some courts give the payment by an insurer of a deductible a higher priority as an “administrative expense” if the event giving rise to the liability arose after the policyholder filed for bankruptcy and the insurance company demonstrates that its payment was “beneficial” to the policyholder.

**Keywords:** bankruptcy, self-insured retentions, bankrupt policyholders, conditions of coverage

**Erin L. Webb** is an associate with Dickstein Shapiro LLP, Washington, D.C.

[1] Erin L. Webb is an associate in the Insurance Coverage Practice in the Washington, D.C., office of Dickstein Shapiro LLP. She represents policyholders in insurance coverage litigation. She has experience with a wide range of insurance coverage issues,
with a particular focus on representing energy and utility companies in obtaining coverage for their liabilities. The material contained in this article was the subject of a roundtable discussion at the March 2012 American Bar Association Insurance Coverage Litigation Committee meeting.


[4] Different policy language may yield different “drop down” results in different jurisdictions. See, e.g., Premcor USA, Inc. v. Am. Home Assurance Co., No. 03 C 7377, 2004 U.S. Dist. LEXIS 9275, at *17–20 (N.D. Ill. May 20, 2004) (holding that where the policy in question stated that it was “in excess of . . . the amount recoverable under the underlying insurance,” the language required the policy to “drop down” and cover the gap left by an insolvent insurer, but an endorsement stating that the insurance company’s “liability . . . shall not be increased . . . by the refusal or inability of any underlying insurer to pay, whether by Reasons of Insolvency, Bankruptcy or otherwise”’ superseded that language and precluded drop down (quoting policy)), aff’d, 400 F. 3d 523 (7th Cir. 2005), amended by No. 04-2549, 2005 U.S. App. LEXIS 6961 (7th Cir. Apr. 21, 2005).

[5] Complex issues result when large numbers of claimants are involved or when many years and layers of the policyholder’s insurance are implicated. See, e.g., In re Pittsburgh Corning Corp., 417 B.R. 289, 296, 302–3, 311 (Bankr. W.D. Pa. 2006).


[14] Hooper, 691 N.E.2d at 70.


[18] In re Keck, Mahin & Cate, 241 B.R. at 596.


[33] Pak-Mor Manufacturing Co., 2005 U.S. Dist. LEXIS 34683, at *25; see also Gulf Underwriters Ins. Co. v. Burris, 804 F. Supp. 2d 953, 957–59 (D. Minn. 2011) (despite state statute, holding that insurance policy was “executory contract” and that failure to pay SIR was a condition precedent that the policyholder could not fulfill).


[38] In re Keck, Mahin & Cate, 241 B.R. 583, 596 (Bankr. N.D. Ill. 1999) (finding that, though policies contained no “drop down” provision and insurer was not obligated to provide coverage until SIR was paid, inclusion of SIR as unsecured claim in Chapter 11 proceeding satisfied this condition; noting that insurer’s obligation “will not be increased by a penny”).

[39] Zurich Am. Ins. Co. v. Lexington Coal Co., LLC (In re HNRC Dissolution Co.), 371 B.R. 210, 231, 233 (E.D. Ky. 2007), aff’d, 536 F.3d 683 (6th Cir. 2008) (involving insurer’s claim for administrative expense priority for deductibles it paid for workers’ compensation, commercial automobile, and general liability coverage); but see Evans v. La. Patients’ Comp. Fund, 869 So. 2d 234, 239 (La. Ct. App. 2004) (in medical insurance context, “[i]f an insured goes bankrupt, the insurer is still liable up to policy limits; the insurer does not drop down to cover the deductible unless the contract of insurance so provides or a statute so mandates”). In addition, at least one court has held that a deductible applies only to indemnity and not defense costs. See, e.g., Forecast Homes,
Inc. v. Steadfast Ins. Co., 181 Cal. App. 4th 1466, 1473–74 (2010) (internal citations and quotations omitted) (“Unlike a deductible which generally relates only to damages, an SIR also applies to defense costs and settlement of any claim.”). Thus, the insurer would be responsible for defense costs for claims for which indemnity amounts are below the deductible, with no right to reimbursement, under a policy with a deductible.


[43] In re Oread, Inc., 269 B.R. at 878 (citation omitted) (addressing question of administrative expense priority for health insurance premiums).

[44] Broaddus Hospital Ass’n, 159 B.R. at 769, 770–71 (involving coverage for defense of underlying “civil actions”).
Message from the Chairs

Fabulous Content Coming

This year, the ABA and the ICLC will be focusing on tangible deliverables to members, something the ICLC has never been short on. Expect more Sound Advice recordings from seasoned insurance practitioners and Take Five summaries on the website. We will, of course, continue to post information on timely legal developments on the ICLC’s website (e.g., surveys, articles, and case notes), and publish insightful articles in our award-winning, nationally distributed magazine, Coverage. For those that would like the ICLC’s help in marketing themselves, you can share an article and content you develop. If you are interested, please contact Coverage’s editor Erik A. Christiansen and/or our website editors, John Buchanan, Rina Carmel, Jim Davis, and Jayson Sowers.

Speaking of fabulous content, mark your calendars for the ICLC’s first Women in Insurance Network (WIN) networking and CLE workshop in Washington, DC, on October 18, 2012. WIN was conceived to capitalize on the strong presence of women attorneys and claims- and risk- management professionals in the insurance industry in general, and in the ICLC in particular. WIN’s goal is to assist women with practice and business development. We look forward to seeing and networking with all our ICLC members—female and male—in October. Thanks to our WIN meeting Chairs Cara Tseng Duffield, Angela R. Elbert, Marla Kanemitus, and Ruth Kochenderfer, attendees can look forward to panel discussions with prominent industry leaders and invaluable networking opportunities. Many thanks to our meeting chairs and to Covington & Burling, who will host the events at its 1201 Pennsylvania Avenue NW, Washington, DC, office.

Planning for the ICLC’s 25th Anniversary Meeting also is well underway. Our meeting chairs Suzan Charlton and Rahul Karnani, and vice chairs Jim Cooper and Anna Torres, are finalizing plans for more than 75 cutting-edge programs and many more substantive roundtable discussions. The ICLC’s meeting will be February 28 to March 2, 2013, in Tucson, AZ, and promises to be outstanding.

Finally, in this, my first communication as the incoming policyholder cochair of the ICLC, I express my deep appreciation for the outstanding leadership of my predecessor, Mary Craig Calkins. Mary’s unwavering dedication to the ICLC, coupled with her enthusiasm, tireless efforts, attention to detail, and sense of humor, have helped make the ICLC one of the most respected, inclusive, and well-run Committees of the ABA. Mary has been inspiring. I have big shoes to fill, and I will be looking for your help.

When Mary passed the baton, she promised to stay involved with ICLC and she reminded me of the ICLC’s nickname and status as the “Rock Star Committee.” This truly extraordinary committee derives from the determined efforts and unwavering support of its members. We are fortunate to have a group with such unmatched drive, creativity, commitment and enthusiasm. The ICLC has flourished for 25 years, and I look forward to working with my cochair Ron Kammer, our vice chairs Laura Hanson and Angela Elbert,
and with all of you, so that the ICLC’s star continues to shine brightly for many more years.

See you in Tucson.

Sherilyn Pastor
Cochair, Section of Litigation
Insurance Coverage Litigation Committee

Editor’s Notes
Kudos to Mary Craig Calkins
I would like to extend a personal thank you to Mary Craig Calkins, who just finished her term as the cochair of the Insurance Coverage Litigation Committee (ICLC). I’ve had the pleasure of working with Mary over the years, and she has been a great mentor, friend, and colleague. Anyone who knows Mary knows that she has an unbelievable work ethic and a bright, sunny, and happy disposition. She is a unique gem, and has continued to shine even in the midst of great personal and professional adversity. Thanks, Mary. I will miss working with you as the ICLC cochair.

I would also like to extend a hello to the incoming cochair, Sherry Pastor, who is succeeding Mary. I met Sherry in 2002, when I first became involved with the ICLC. She is a gifted and smart lawyer, with energy, enthusiasm, and a strong work ethic. I very much look forward to working with Sherry and Ron Kammer over the next year, and look forward to their continued leadership in steering the ICLC. The leadership in the ICLC continues to be extremely talented, and we’re all lucky when people like Mary, Ron, and Sherry give their time and energy to the ICLC. Thanks to you all.

Erik A. Christiansen
Editor in Chief–Coverage