Is defense counsel conflicted when insurer takes certain coverage positions?

For the Defense

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Posted May 13, 2020 9:53 AM

The practice of law requires that a lawyer practice ethically, which especially includes not laboring under a conflict of interest when representing a client. That is hardly controversial. The question of when a conflict has arisen is especially frequent for lawyers who handle assignments from insurers on behalf of insureds.

Insurers too, and their coverage counsel, face this question and must determine when there is a conflict between it and its insured that requires the insurer to provide independent counsel to the insured or else risk being found to have breached the duty to defend. The intersection of professional responsibility and insurance coverage is like peanut butter and jelly.

The leading case discussing how to identify a conflict and what an insurer is to do about it is Illinois is *Maryland Casualty Co. v. Peppers*, 64 Ill.2d 187 (1976). *Peppers* and its progeny rest on the presumption that when an insurer has taken certain coverage positions or when certain types of allegations are made in the underlying matter, e.g. intentional acts and punitive damages, insurance defense counsel has divided loyalty and will choose the interests of the insurer over the insured, thus requiring counsel independent of the insurer to be engaged to represent the insured. See *Nandorf v. CNA Ins. Cos.*, 134 Ill.App.3d 134, 137 (1st Dist. 1985).

The similar California rule holds that "for independent counsel to be required, the conflict of interest must be 'significant, not merely theoretical, actual, not merely potential.'" *James 3 Corp. v. Truck Ins. Exchange*, 91 Cal.App.4th 1093, 1101 (2001).

In *Peppers*, the alleged conflict was based on allegations of intentional acts and that if the insured was found liable to the plaintiff for the intentional acts, there would be no coverage. Accordingly, the insurer would prefer that the insured be found to have acted intentionally so that there would be no indemnity. As recently explained in *Ryerson v. Travelers Indemnity Company of America*, 2020 IL App (1st) 182491, ¶ 54, this reasoning has been expanded by Illinois courts to include situations where an

The federal courts have attempted to broaden the kinds of conflicts still further by including any situation in which there is a non-trivial probability of an excess judgment. See *Perma-Pipe, Inc. v. Liberty Surplus Insurance Corp.*, 38 F.Supp.3d 890 (N.D. Ill. 2014), citing *R.C. Wegman Construction Co. v. Admiral Insurance Co.*, 629 F.3d 724, 729 (7th Cir. 2011).

The *Ryerson* court rejected a per se rule that every time there is a non-trivial probability of an excess judgment that a conflict of interest has arisen requiring an insurer to provide independent counsel. *Ryerson*, 2020 IL App (1st) 182491, ¶ 56. In so doing, the court, likely unintentionally, showed the fault in the reasoning of *Peppers* and its progeny. That reasoning is premised on the grave assumption that insurance defense counsel will harm the insured's interests if they get the chance. The *Ryerson* court properly held that notice of a possibility of an excess verdict was all that was required. As the insurer in that case disclosed the possibility of an excess judgment, the insurer's conduct was proper, and there was no conflict for defense counsel. The court agreed that the insurer could defend the case, even for broader ulterior motives, because the issue was disclosed and the interests between the insurer and the insured were not divergent.

In the *Peppers* situation in which the insured is alleged to have acted intentionally, those allegations are obviously disclosed because they are in the complaint and the insurer, if it is going to assert a coverage position while defending, will need to have issued a reservation of rights letter. Further, it is very unlikely that in the effort of defending the insured from a claim of negligence, that defense counsel somehow steer the evidence to show that the client did, in fact, act intentionally. Unless the theory of the conflict is that defense counsel has an incentive to abrogate the duty to defend the insured entirely, this theory of conflict does not make sense. Indeed, the alleged incentive to please the insurer creates precisely the opposite incentive for defense counsel: to prevail entirely and have the insured found not liable at all.

Likewise, in a situation where punitive damages are alleged like in *Nandorf*, when defending an insured from allegations of negligence, defense counsel necessarily defends the insured from the kind of willful and wanton misconduct that could lead to such an award. Just as in *Ryerson*, where there was a unity of interest in defending the insured, so too there is a unity of interest in defending an insured from allegations of intentional conduct and willful and wanton misconduct.

To achieve unconflicted counsel in situations where insurance is implicated, it is unnecessary to disparage all insurance defense counsel with the conclusion that simply because they are hired by an insurer that may have given them business in the past and may do so in the future, that their loyalty is divided to the detriment of the insured. An actual conflict is possible in a given circumstance and a particular lawyer could act in a way that harms the insured, but the blanket characterization of all insurance defense counsel by a presumption that a whole class of lawyers is engaged in institutionalized violations of the Rules of Professional Conduct is unwarranted and harms all insureds by raising defense costs and thus premiums.