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Cumis, Conflicts and the Civil Code: Section 2860 Changes Little

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Where there are divergent interests of the insured and the insurer brought about by the insurer's reservation of rights based on possible non-coverage under the insurance policy, the insurer must pay the reasonable cost for hiring independent counsel by the insured.¹

This short, concise statement started a revolution in the business of law² in California. In spite of establishing a bright line rule, this statement spawned a great deal of litigation. Since the Fourth District Court of Appeal of the State of California made this statement, insurance companies have filed a vast array of declaratory relief actions in San Diego County Superior Court alone.³

The bursting of floodgates led to a lobbying battle between the California Trial Lawyers Association and various tort reform groups.⁴ The lobbying battle resulted in a truce⁵ with compromise legislation—Senate Bill No. 241.⁶ The governor approved Senate

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1. San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y, 162 Cal. App. 3d 358, 208 Cal. Rptr. 494 (1984).

2. The phrase "business of law" is used to distinguish the business practices of attorneys from the "practice of law." The latter connotes the legal representation of clients. The former involves the economic and other business decisions made by lawyers to support their practice.

3. See Mallen, *A New Definition of Insurance Defense Counsel*, 53 INS. COUNSEL J. 108 (1986). Indeed, the business of law has changed all across the nation on the same or similar theories. *Id.* Although Mallen plays "fast and loose" with some of the authorities he has cited, his article does an excellent job explaining the problem from the insurer's perspective. See also Note, *The Cumis Decision—What Has it Done to Insurance Policies?*, 23 CAL. W.L. REV. 125 (1986).

Insurance companies filed 302 declaratory relief actions in the Superior Court for San Diego County between June 15, 1987, and June 15, 1988. That is more than one per working day.

4. The tort reform groups include the Association for California Tort Reform, The Association of California Insurance Companies, The California Chamber of Commerce, and California for Fair Liability Laws. See Cox, *Tort Reform Draws Fire at California Bar Meeting*, Nat'l L.J., Oct. 5, 1987, at 8.

5. Cox, *Accord Reached in Calif. Tort Reform*, Nat'l L.J., Sept. 28, 1987, at 3.

6. The Bill as originally passed by the Senate was completely scuttled in the Assem-

Bill 241 on September 30, 1987. The law went into effect January 1, 1988, and will likely spark a new wave of disputes between private counsel and insurance defense counsel. These disputes will revolve around the intent, meaning, and application of California Civil Code Section 2860.⁷

This Article will first survey the legal history of requiring insurers to pay independent counsel fees for an insured when retained counsel forces a conflict of interest. Second, the developing controversy surrounding the conflicts of interest issue will be discussed. Third, the legislative history and apparent intent of Section 2860 as it applies to these conflicts will be analyzed. Finally, this Article will discuss the problems inherent in the Legislature's treatment of the conflict of interest situation and how some of these problems may be resolved.

I. HISTORY OF THE INSURER'S DUTY TO PROVIDE THE INSURED WITH INDEPENDENT COUNSEL WHEN A CONFLICT OF INTEREST ARISES

*San Diego Navy Federal Credit Union v. Cumis Ins. Society, Inc.*⁸ explained the insured's right to independent counsel when an attorney retained by the insurance company faces a conflict of interest. It provided a bright line rule that established when a conflict arises, and became a benchmark in California law. However, before analyzing *Cumis*, it will be helpful to explore the authority leading up to that case.

A. *An Insurance Contract Creates a Duty on the Insurer to Defend the Insured Against Legal Actions Potentially Covered by the Policy*

1. *General Insurance Concepts*—The basis of the bargain for a liability and indemnity⁹ insurance contract is that in return for the

bly. It originally started as a tort reform package related to health care. SENATE HISTORY, Apr. 28, 1987, at 1642. Assemblyman W. Brown proposed substantial amendments and the bill (creating CAL. CIV. CODE § 2860 and amending many other sections) was passed as amended.

7. CAL. CIV. CODE § 2860 (Deering Supp. 1988).

8. 162 Cal. App. 3d 358, 208 Cal. Rptr. 494 (1984).

9. The California Insurance Code does not recognize the term "general comprehensive liability" insurance or even "indemnity insurance." It recognizes only "liability insurance" which protects against loss resulting from physical injury, property injury caused by the insured, or property damage suffered by the insured that is caused by an uninsured third party. CAL. INS. CODE § 108 (West 1972 & Supp. 1988). Nonetheless, the insurance industry, lawyers, and judges who deal with insurance issues regularly distinguish among indemnity policies, liability policies, liability and indemnity policies, and comprehensive policies. Even though each falls within the rubric of "liability policy," each provides different contractual rights and duties.

insured's promise to pay premiums, the insurer promises to provide a defense to actions against the insured and to indemnify the insured for all payments the insured is legally obligated to make for an occurrence¹⁰ within the policy's provisions.¹¹

The purpose and theory of insurance is risk management.¹² The vehicle owner, homeowner, business owner, or manufacturer purchases a policy, written by an insurance company, to cover the risks associated with the individual's legal status as a person responsible for damages due to his activities. The insurance company pools the funds generated by the premiums of similarly situated people. The law of large numbers dictates that accidents will not involve all of these subscribers at the same time. Thus, when an accident does occur, the funds of all similarly situated people are used to pay for the unfortunate few.

Consistent with this concept of risk management, insurance companies try to manage the risks they assume for the insured. Insurance companies manage their risks by selection of insureds,¹³ premium discrimination,¹⁴ coverage language,¹⁵ exclusion of certain risks from the policy,¹⁶ and defining terms used to create or exclude coverage.¹⁷

2. The Duty to Defend—Historically, an insurance company did not provide a defense if the allegations of the complaint indicated that the incident would not be a covered claim.¹⁸ Eventu-

10. An event or accident causing harm which the insured neither intended nor expected.

11. For a good general explanation of standard insurance contract provisions, see CALIFORNIA INSURANCE LAW & PRACTICE (Matthew Bender 1987, Rev. 1988).

12. "Insurance necessarily involves three elements: (1) A risk of loss to which one party is subject; (2) a shifting of that risk to another party; and (3) distribution of risk among similarly situated persons." *Metropolitan Life Ins. Co. v. State Bd. of Equalization*, 32 Cal. 3d 649, 186 Cal. Rptr. 578, 652 P.2d 426 (1982) (citing *California Physicians Serv. v. Garrison*, 28 Cal. 2d 790, 172 P.2d 4 (1946)).

13. See K. ABRAHAM, *DISTRIBUTING RISK* 14 (1986).

14. CAL. INS. CODE § 1850, 1852 (Deering 1976); see also *id.* at 19-31.

15. K. ABRAHAM, *supra* note 13, at 33-34; CALIFORNIA INSURANCE LAW & PRACTICE, *supra* note 11.

16. See THE DEFENSE RESEARCH INSTITUTE, INC., *ANNOTATED COMPREHENSIVE GENERAL LIABILITY POLICY* 67 (1979).

17. Typically, the insurance contract covers only liability for "personal injuries" or "property damage" caused by an "occurrence" "covered" by the policy. All of these terms are defined and restricted by the policy to something less than their broader common sense meanings. See THE DEFENSE RESEARCH INSTITUTE, INC., *supra* note 16, at 66, 103; Morris, *Conflicts of Interest in Defending Under Liability Insurance Policies: A Proposed Solution*, 1981 UTAH L. REV. 457.

18. See the insurer's arguments in *Greer Robbins v. Pacific Sec.*, 37 Cal. App. 540, 174 P. 110 (1918); *Lamb v. Belt Casualty*, 3 Cal. App. 2d 624, 40 P.2d 311 (1935); *Ritchie v. Anchor Casualty*, 135 Cal. App. 2d 245, 286 P.2d 1000 (1955). In fact, historically the insurer's right to control the defense was construed to allow the insurer to defend to its own advantage and against the interests of the insured in the conflict of interest

ally, courts required that the company provide a defense initially,¹⁹ while allowing the company to preserve its right to assert non-coverage through a reservation-of-rights letter.²⁰ If the insurance company later discovered that the claim was not within the coverage of the contract or was excluded by an appropriate provision, the insurer could cease its defense of the insured.²¹

Once this procedure was established, California²² and other states²³ determined that the insurer's duty to defend was independent of its duty to indemnify. This meant that insurers were no longer free to refuse to defend an insured for claims which the insurer would not likely be liable for, so long as the insurer was potentially liable.

An excellent example of the duty to defend, duty to indemnify distinction is the seminal case of *Gray v. Zurich Insurance Co.*²⁴ Dr. Gray, the insured, sued Zurich, his insurer, for its failure to defend an action filed against him. The complaint in the underlying action alleged that Dr. Gray intentionally and maliciously assaulted the plaintiff. Dr. Gray notified Zurich of the underlying suit, and admitted to the altercation, but claimed he acted in self-defense. Zurich refused to provide Dr. Gray with defense counsel on the ground that the complaint alleged an intentional tort which was excluded from policy coverage.²⁵

situation. 7C J. APPLEMAN, *INSURANCE LAW AND PRACTICE*, § 4681 at 4 (1977).

19. See 7C J. APPLEMAN, *supra* note 18, § 4682 at 16.

20. A reservation-of-rights letter gives the insured notice that although the insurer will provide a defense for now, it does not waive its right to assert defenses against liability or to seek a judicial determination that the action is not covered under the policy. *Id.* at 24.

21. In order to withdraw the insured's defense, the insurer had to seek a declaratory judgment that the action was not covered under the policy and the insurer, therefore, owed the insured no further duty to defend him. See *General Ins. Co. of Am. v. Whitmore*, 235 Cal. App. 2d 670, 45 Cal. Rptr. 556 (1965).

22. *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 54 Cal. Rptr. 104, 419 P.2d 168 (1966).

23. See, e.g., *Continental Ins. Co. v. Bayless & Roberts, Inc.*, 608 P.2d 281 (Alaska 1980); *Fulton v. Woodford*, 26 Ariz. App. 17, 545 P.2d 979 (1976); *All Star Ins. Corp. v. Steel Bar, Inc.*, 324 F. Supp. 160 (N.D. Ind. 1971); *Burd v. Sussex Mut. Ins. Co.*, 56 N.J. 383, 267 A.2d 7 (1970); *S. Md. Agric. Ass'n v. Bituminous Casualty Corp.*, 539 F. Supp. 1295 (D. Md. 1982); *Magoun v. Liberty Mut. Ins. Co.*, 346 Mass. 677, 195 N.E.2d 514 (1964); *United States Fidelity & Guar. Co. v. Louis A. Roser Co.*, 585 F.2d 932 (8th Cir. 1978) (predicting that the supreme courts of Minnesota and Utah would adopt a similar position); *Prashker v. United States Guar. Co.*, 1 N.Y.2d 584, 154 N.Y.S.2d 910 (1956); *Employers Fire Ins. Co. v. Beals*, 240 A.2d 397 (R.I. 1968); *Steel Erection Co. v. Travelers Indem. Co.* 392 S.W.2d 713 (Tex. Civ. App. 1965).

24. 65 Cal. 2d 263, 54 Cal. Rptr. 104, 419 P.2d 168 (1966).

25. The insurance policy provided that the insurance company agrees, "[T]o pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages because of bodily injury or property damage, and the company shall defend any suit against the insured alleging such bodily injury or property damage and seeking damages which are payable under the terms of this endorsement, even if any of the allegations are groundless, false or fraudulent. . . ." The policy also stated, "This endorsement does not apply . . . to bodily injury or property damage caused intentionally by or at the direction of

The California Supreme Court rejected Zurich's argument on several grounds. First, construing the contract as proposed by Zurich would frustrate the reasonable expectations of the insured.²⁶ This followed because the language of the contract broadly and clearly established a duty to defend.²⁷ In addition, the insurer buried the intentional injury exclusion amidst thirteen pages of fine print, and the exclusion was written in technical and ambiguous terms.²⁸ Therefore, even if the exclusion clause clearly negated the insurer's duty to indemnify the insured for the damages resulting from his intentional conduct, it did not clearly exclude the insurer from its duty to defend him against those allegations. Thus, Dr. Gray could have reasonably expected a defense of the claim.

Second, the claim contained the potential for coverage under the policy. Although pleaded as an intentional tort, the complaint could have been amended to include a negligence cause of action. Furthermore, recovery could be based on unintentional conduct because the defendant could be found to have exceeded the scope of the privilege of self-defense, while at the same time may not have intended physical injury. The court reasoned that the insurer could not know in advance of the proceedings whether liability would be founded on intentional or unintentional wrongdoing. This follows because of the nature of pleadings—i.e. the same general facts can support various theories of recovery. Thus, a rule allowing the insurer to avoid the costs of defense on the basis of the technical theory of the pleading ignores the reality of modern pleading. Modern pleading is “malleable, changeable and amendable.”²⁹ Furthermore, such a rule would make the plaintiff the final arbiter as to whether or not the defendant received an insur-

the insured.” *Id.* at 267, 54 Cal. Rptr. at 106, 419 P.2d at 170.

26. “[A] contract entered into between two parties of unequal bargaining strength, expressed in the terms of a standardized contract, written by the more powerful bargainer to meet its own needs and offered to the weaker party on a take it or leave it basis” is an adhesion contract. *Id.* at 269, 54 Cal. Rptr. at 107, 419 P.2d at 171. Adhesion contracts are construed differently from regular contracts. *Id.* at 270, 54 Cal. Rptr. at 108, 419 P.2d at 172. “The court interprets the form contract to mean what a reasonable buyer would expect it to mean and thus protecting the weaker parties’ expectation at the expense of the stronger’s.” *Id.* at 271, 54 Cal. Rptr. at 108, 419 P.2d at 172. Thus, insurance contracts are construed to protect the reasonable expectations of the insured.

27. “[T]he company shall defend any suit against the insured alleging such bodily injury or property damage and seeking damages which are payable under the terms of this endorsement, even if the allegations of the suit are groundless, false, or fraudulent.” *Id.* at 272, 54 Cal. Rptr. at 109, 419 P.2d at 173 (quoting the insurance contract).

28. The court noted that the limits of phrases contained in insurance contracts “prepared by lawyers, defended by lawyers, and authoritatively interpreted by lawyers,” are probably not appreciated by the lay insured. Even the more sophisticated insured has no choice in the matter because the provisions are often standard. *Id.* at 275 n.14, 54 Cal. Rptr. 111, 419 P.2d at 175.

29. *Id.* at 276, 54 Cal. Rptr. at 112, 419 P.2d at 176.

ance funded defense.³⁰ Noting that the plaintiff should not be the final arbiter of the policy's coverage,³¹ the court determined that the insurer must look beyond the pleading to the potential bases for liability. If there is a potential basis for liability within the coverage of the policy, the insurer must provide a defense.³² The court reasoned that it would defeat the very purpose of buying the insurance:

[I]f he [the insured] is to be required to finance his own defense and then, only if successful, hold the insurer to its promise by means of a second suit for reimbursement, we defeat the basic reason for the purchase of the insurance. In purchasing his insurance, the insured would reasonably expect that he would stand a better chance of vindication if supported by the resources and expertise of his insurer than if compelled to handle and finance the presentation of his case.³³

In a desperate attempt to avoid liability and an adverse precedent, the insurance company argued that providing a defense in the intentional tort situation would embroil the insurance company in a difficult conflict of interest situation. The insurer explained that to *protect its interest*, it would seek to prove: (1) that the defendant was not liable at all;³⁴ or, alternatively, (2) that any liability resulted from intentional conduct.³⁵ On the other hand, to *protect the insured's interest*, the insurer would be required to prove: (1) that the insured was not liable at all; or, alternatively, (2) that any liability resulted from unintentional conduct.³⁶

30. "To him [the insured] the possibility of an ambitious claimant who would begin a lawsuit with a charge of an intentional injury for the sake of a favorable bargaining position and later be willing to abandon that charge for one of simple negligence might not occur; or if the possibility did occur the insured might not pause to consider whether it would be fatal to part of his insurance coverage." *Id.* at 275 n.14, 54 Cal. Rptr. 112, 419 P.2d at 176.

31. In spite of the court's disapproval of the plaintiff's control of the defendant's ability to gain a funded defense, much of that tactic still occurs. Occasionally plaintiffs make allegations of intentional conduct outside the scope of any insured relationship specifically to try to prevent the defendant from obtaining defense funds from their insurance companies. In some of these cases, the insurance company's counsel will write long letters, without denying coverage, but explaining why such a cause of action would not be covered. Some of the attorneys in those cases accept the letters at face value without pressing the issue. Thus, in the same case with the same insurance company, some defendants receive insurance funded defenses, while others, similarly situated, do not. *Gray*, 65 Cal. 2d at 276, 54 Cal. Rptr. at 114, 419 P.2d at 178.

32. *Id.* at 278, 54 Cal. Rptr. at 113-14, 419 P.2d at 177-78.

33. *Id.*

34. This would protect Zurich's interest by eliminating any duty to pay for damages. *Id.* at 278-79, 54 Cal. Rptr. at 113-14, 419 P.2d at 177-78.

35. This would protect Zurich's interest by establishing that the damages fell squarely into the policy exclusion. Thus, Dr. Gray, rather than Zurich, would have to pay any damages. *Id.*

36. This would establish that the damages fell squarely into the coverage provisions, thus, Zurich, rather than Dr. Gray, would have to pay any damages.

The *Gray* court handily dismissed this candid admission of counsel. First, it noted that the underlying case litigates only the insured's liability, because the victim cares little about the theory of recovery. The victim seeks to prove facts that support recovery and to maximize the amount of the recovery.³⁷ Furthermore, if a special verdict was requested, "the insurer will still be bound, ethically and legally, to litigate in the interests of the insured."³⁸ Finally, if the insurer availed itself of the reservation-of-rights procedure,³⁹ the insurer would not face the proposed dilemma.

Thus, the *Gray* court established that an insurance company must provide its insured with a defense whenever a complaint discloses that the insurance company is potentially liable for the damages according to the coverage terms of the policy. *Gray* recognized that a conflict of interest may arise when the insurer is defending the insured, while at the same time contending it has no obligation to pay. However, the *Gray* court believed that the conflict would arise only in the exceptional case.⁴⁰ Furthermore, the *Gray* court believed that retained counsel for the insurer would resolve whatever conflicts arose in favor of the insured, thus eliminating the conflict.⁴¹

As will be seen, the *Gray* court's trust in the ethics of retained counsel and insurers may have been misplaced.⁴²

3. The Duty to Defend and the Insurance Counsel's Dilemma After Gray—For five years following *Gray*, the California courts remained remarkably silent about the insurance defense counsel's conflict of interest. The first appellate court to examine the scope and application of the insurer's duty to defend in a conflict of interest situation was *Executive Aviation, Inc. v. National Insurance Underwriters*.⁴³ *Executive Aviation* presents both a more subtle and a more dramatic conflict of interest than *Gray*. It is more subtle because the conflict revolves around the definition of a term contained within the policy. It is more dramatic in that it shows how a small detail can create a large conflict.

Executive Aviation operated an aircraft sales and air taxi business. It negotiated an aircraft sale with Dakin, who conditioned the sale on a test flight from Oakland, California, to La Paz,

37. *Id.* at 279, 54 Cal. Rptr. at 114, 419 P.2d at 178.

38. *Id.* n.18.

39. *See supra* note 20 and accompanying text.

40. *Gray*, Cal. 2d at 279 n.18, 54 Cal. Rptr. at 114, 419 P.2d at 178.

41. *Id.* However, this does not resolve the conflict of interest, it merely violates the attorney's duty to the insurer. *See infra* note 94 and accompanying text.

42. *See infra* notes 58-61 & 93-94 and accompanying text.

43. 16 Cal. App. 3d 799, 94 Cal. Rptr. 347 (1971).

Mexico. Executive required Dakin to pay the costs of the flight, with such payments to be credited against the purchase price. With a pilot, another crew member and eight members of the Dakin family aboard, the flight left Oakland, refueled in San Diego, and disappeared. It was believed to have crashed in the Gulf of California.

The pilot of that flight was qualified to fly demonstration flights, but not commercial transportation flights. The insurance policy covered physical injury and property damage to the passengers,⁴⁴ but only if the plane was operated by a “qualified” pilot.⁴⁵ The insurance company took the position that the transportation of the eight Dakins, for payment, constituted commercial transportation. If the insurer could prove that the flight was a commercial carriage flight, then the pilot was not “qualified” and the insurer would not have to pay any damages. Executive asserted that the flight was a demonstration flight, for which the pilot was “qualified.” Therefore, the insurer would be liable for the losses resulting from the plane’s disappearance. Executive Aviation put in a claim for the value of the lost aircraft. Heirs of the Dakin family sued Executive Aviation for wrongful death. Executive Aviation tendered the defense to its insurer. The insurance company reserved its right to assert non-coverage.⁴⁶

The insurance company recognized the conflict of interest it faced. The insurance company’s claims manager wrote a letter to one of the insurer’s associates stating: “We are faced with the paradoxical position of having to prove the insured a common carrier to avoid coverage, while such proof will jeopardize the defense of the passengers’ actions.”⁴⁷

In an attempt to resolve the conflict of interest, the insurer retained a separate lawyer to defend Executive in the wrongful death action but allowed the insured no say in the matter.⁴⁸ Fur-

44.

The insurer agreed to pay on behalf of the insured all sums that the insured shall become legally obligated to pay as damages sustained by any passenger arising out of the ownership or use of the Lodestar (aircraft), as well as to pay for all physical loss or damage to aircraft while in flight, including disappearance of aircraft. The policy contained the usual provisions indicating that the insured would defend any suit against the insured and reimburse the latter for reasonable expenses.

Id. at 803, 94 Cal. Rptr. at 349 (explaining the insurance provisions).

45. The policy further provided: The insurance applies when the aircraft is in flight only while being piloted by any Pilot while holding a valid Private or Commercial Pilot Certificate and only while being operated by any Commercial Pilot Property Rated in Type and Qualified for the aircraft and flight having a minimum of 2,000 flying hours experience as a Pilot. *Id.*

46. *Id.* at 804, 94 Cal. Rptr. at 350.

47. *Id.* at n.1.

48. *Id.* at 810, 94 Cal. Rptr. at 354.

thermore, the retained attorney was well known for his insurance defense practice.⁴⁹

Finally, the insurer refused to turn over the defense file to the second attorney. Executive declined the offer of the second attorney; retained its own independent counsel; and proved that the flight was a demonstration flight, not commercial carriage.⁵⁰

Having proved that the claim was covered by the policy, Executive sought to hold the insurer responsible for the attorney fees it incurred. The court of appeal determined that *Gray* had not established the scope of the duty to defend when insurance counsel is faced with a conflict of interest.⁵¹ The court further noted that other states treated the situation in various ways.⁵² Finally, the court observed:

A reasonable solution was proposed by the New York Court of Appeals in *Prashker v. United States Guarantee Company*⁵³ . . . , namely, that where a conflict of interest has arisen between an insurer and its insured, the attorney to defend the insured in the tort suit should be selected by the insured and the reasonable value of the professional services rendered assumed by the insurer. If the insured and the insurer are represented by two different attorneys, each of whom is pledged to promote and protect the prime interests of his client, adequate representation is guaranteed and the deleterious effect of the conflict of interest imposed on an attorney who attempts the difficult task of representing both parties is averted.⁵⁴

The *Executive Aviation* court recognized that the insurance company may be dismayed at having to pay the cost of two attorneys. However, it reasoned that the insurer was responsible as it failed to provide for such a situation in the insurance contract.⁵⁵

Executive Aviation has been frequently cited for the proposition that where a conflict of interest arises between the insurer and the insured, the insured may select his own independent counsel and the insurer must pay the reasonable value of the independent counsel's services. This has become the law in many states.⁵⁶

49. *Id.* at n.6.

50. *Id.* at 805, 94 Cal. Rptr. at 350-51.

51. *Id.* at 809, 94 Cal. Rptr. at 353-54.

52. *Id.*

53. 1 N.Y.2d 584, 154 N.Y.S.2d 910, 136 N.E.2d 871 (1956).

54. *Executive Aviation*, 16 Cal. App. 3d at 809, 94 Cal. Rptr. at 353-54.

55. Since the insurance company wrote the policy, it could have provided for the situation where the insurance defense counsel faces a conflict of interest. Since the contract did not provide for such a situation, the promise to defend is ambiguous as applied to the conflict of interest situation. Since an ambiguity in the insurance contract is to be construed against the insurer and in favor of the insured, it was appropriate to construe the contract to require the insurer to pay the reasonable costs of independent counsel selected by the insured. *See id.* at 810, 94 Cal. Rptr. at 354.

56. *See supra* note 23.

However, the courts have done a rather poor job explaining what facts and circumstances give rise to a conflict of interest. Thus, analysis of cases following *Executive Aviation* is necessary.

4. *Although an Insurer Must Pay for Independent Counsel Retained by the Insured when a Conflict of Interest Arises It May be Unclear When a Conflict Arises*—There is no doubt that an actual conflict of interest exists when a lawyer must contend on behalf of one client that which he must oppose on behalf of another client.⁵⁷ This type of conflict is easy to recognize. It most often arises when a plaintiff has alleged several causes of action. Often a plaintiff alleges willful conduct in addition to nonintentional or negligent conduct. Therefore, some of the causes of action are covered by the insurance policy, while others are excluded. In this situation, insurance defense counsel, in order to adequately represent the interests of the insured, must steer any liability toward a covered claim. At the same time, that attorney must steer any liability away from a covered claim in order to adequately represent the insurer. Regardless of counsel's high ethics and competence, it is simply impossible to represent both parties adequately.

In this situation, courts have recognized that separate counsel retained by the insurance company is under the less-than-subtle influence of the insurance company.⁵⁸ Insurance companies concentrate their legal representation into a few firms.⁵⁹ The attorney, wishing to maintain the insurer's business, does not want to aggravate the company.⁶⁰ Furthermore, the insurance counsel has close ties and a long term relationship with the insurer, while he has only a transient relationship with the insured.⁶¹ These factors could, unconsciously, dilute the loyalty of the most honest attorney. These factors would lead less scrupulous attorneys to protect the insurer's interest at the expense of the insured's interest. Either of these results violates the ethical requirements of the profession.⁶²

57. MODEL CODE OF PROFESSIONAL RESPONSIBILITY EC 5-15 n.19 (1981) (hereinafter "ABA Code").

58. See *Purdy v. Pacific Auto. Ins. Co.*, 157 Cal. App. 3d 59, 203 Cal. Rptr. 524 (1984).

59. *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y*, 162 Cal. App. 3d 358, 364, 208 Cal. Rptr. 494, 498 (1984).

60. *Morris*, *supra* note 17, at 457.

61. See *Purdy v. Pacific Auto. Ins. Co.*, 157 Cal. App. 3d 59, 203 Cal. Rptr. 524 (1984).

62. ABA CODE, *supra* note 57. EC 5-14 provides: "Maintaining the independence of professional judgment required of a lawyer precludes his acceptance or continuation of employment that will adversely affect his judgment on behalf of or dilute his loyalty to a

These various considerations have led California courts to determine that a conflict of interest between jointly represented parties occurs whenever "their common lawyer's representation of the one is rendered less effective by reason of his representation of another."⁶³ As with all generalized statements of law, this definition of conflicting interests is too subjective, difficult to apply, and of little practical guidance to practicing attorneys.⁶⁴ An examination of the cases after *Executive Aviation* indicates that the definition is of little practical guidance to the courts as well.

One of the first reported cases after *Executive Aviation* was *St. Paul Fire & Marine Ins. Co. v. Weiner*.⁶⁵ In *Weiner*, the insurer issued a policy to an accounting firm. The policy covered employees of the accounting firm. The individuals and the firm were criminally charged for securities fraud, and also sued by the victims of the fraud. The insurer brought an action for declaratory relief seeking to absolve itself of the duty to pay for the defense of the civil action. The insurer argued that the criminal convictions made it clear that the insureds had acted willfully, and therefore, the claims were excluded from insurance coverage. Alternatively, the insurer sought to limit the defense to defending the firm.⁶⁶

After determining that the criminal convictions arose from acts different from those complained of in the civil suit, the Court of Appeals for the Ninth Circuit decided that the insurance company had a duty to defend the insureds.⁶⁷ Furthermore, the court explained that there were potential conflicts of interest between the firm and the individual defendants, as well as potential conflicts between the individual defendants.⁶⁸

The court did not explain what constituted the perceived conflict. As far as the conflict between the firm and the individual employees, it seems fair to infer that the conflict arose from the insurance provisions. The firm was covered for claims arising out of fraud, misrepresentation, and dishonesty of its employees.⁶⁹

client. This problem arises whenever a lawyer is asked to represent two or more clients who may have differing interests, whether such interests be conflicting, inconsistent, diverse, or otherwise discordant."

ABA CODE CANON 9 provides: "A lawyer should avoid even the appearance of professional impropriety."

See also ABA CODE DR 5-105.

63. *Spindle v. Chubb Pac. Indem. Group*, 89 Cal. App. 3d 706, 152 Cal. Rptr. 776 (1979).

64. R. MALLEN & V. LEVIT, *LEGAL MALPRACTICE* § 151 at 241 (1977).

65. 606 F.2d 864 (9th Cir. 1979).

66. *Id.* at 866.

67. *Id.* at 868, 870.

68. *Id.* at 870.

69. The policy provided: "This Insuring Agreement includes as a part of the professional service of an accountant such legal liability arising from any claim or claims which

However, the very next paragraph excluded coverage to employees for their acts of dishonesty, misrepresentation or fraud.⁷⁰ Thus, the individuals' interest was best served by avoiding liability based on a theory of dishonesty. By avoiding liability based on dishonesty, the employees would be covered under the terms of the policy. The firm, on the other hand, would be covered under any theory of liability.⁷¹ Thus, the firm would have no economic incentive to vigorously litigate the theory of liability. This would be a sufficient conflict under *Tomerlin v. Canadian Indemnity*.⁷²

The conflict between the individuals is fairly obvious. Due to the doctrines of equitable indemnity⁷³ and equitable apportionment,⁷⁴ each would want to show that the other was more at fault.

In a later case, *Previews, Inc. v. California Union Ins. Co.*,⁷⁵ the Ninth Circuit found a conflict of interest where it was within the insurer's best interest to have a class action certified, while such certification was not in the best interest of the insured.⁷⁶ Again, the court did not explain what created the conflict. Again, the conflict apparently arose from construction of the insurance contract. The insurer claimed that the \$5,000 deductible applied to each member of the class. The insured argued that the deductible applied only to the single claim (the lawsuit against the insured) submitted to the insurer. If the insurer was right, the insured would not want the class certified because that would make it economically infeasible for plaintiffs with relatively small claims to join in the litigation. The insurer, on the other hand, would save litigation costs by qualifying the class action, while suffering no greater exposure to liability.

The Ninth Circuit's failure to elucidate the factors it considered to determine the existence of a conflict of interest reached its zenith in a case which found no conflict. In *Zieman Manufactur-*

may be brought about or contributed to by reason of: dishonesty, misrepresentation or fraud." *Id.* at 867.

70. The policy stated: "Coverage does not apply to the liability of (a) any employee of the named insured for his dishonesty, misrepresentation or fraud, or (b) any other insured for his affirmative dishonesty or actual intent to deceive or defraud." *Id.* at 867-68.

71. The firm would not care whether liability was based on negligence or fraud because the professional liability policy covered both. *Id.* at 867.

72. 61 Cal. 2d 638, 39 Cal. Rptr. 731, 394 P.2d 571 (1964). Where the insurer "lacks an economic motive for vigorous defense of the insured, or where there is a conflict of interest, the insurer may not compel the insured to surrender control of the litigation." *Id.* at 648, 39 Cal. Rptr. at 738, 394 P.2d at 578.

73. The landmark case developing equitable indemnity is *San Francisco v. Ho Sing*, 51 Cal. 2d 127, 330 P.2d 802 (1958).

74. Equitable apportionment applies even where equitable indemnity does not. See *American Motorcycle Ass'n v. Superior Court*, 20 Cal. 3d 578, 146 Cal. Rptr. 182, 578 P.2d 899 (1972).

75. 640 F.2d 1026 (9th Cir. 1981).

76. *Id.* at 1028.

ing Co. v. St. Paul Fire & Marine Ins. Co.,⁷⁷ the insured was sued for injuries under products liability and warranty theories. The insurer undertook the defense with its in-house counsel. The plaintiff amended the complaint to include a prayer for punitive damages. The insurer reserved its rights under the policy which excluded coverage for willful acts. The insured retained independent counsel. Eventually, the plaintiff offered to settle the dispute for \$250,000. The insured urged the insurer to settle and offered to contribute \$20,000 itself. St. Paul refused the settlement offer. At trial, plaintiff was awarded \$387,107 in compensatory damages and \$30,000 in punitive damages.⁷⁸

It seems obvious that a conflict of interest was present. The insured's best interests would have been served by a settlement that admitted no willful conduct. In such a situation, the claim would be covered unless the insurer could prove in a subsequent action that the conduct was willful.⁷⁹ Furthermore, the insured would not feel comfortable disclosing confidences relating to the issue of willfulness to the insurer's counsel. Thus, the trust and confidence necessary for a good attorney-client relationship would be absent.⁸⁰ The attorney's relationship with the insurer could therefore easily reduce the effectiveness of the attorney's representation of the insured.⁸¹

Nonetheless, the Ninth Circuit found no conflict of interest. The court determined that it was necessary to the insured's claim of conflict to find that as a matter of law, a conflict exists whenever a claim of punitive damages is alleged. The court astutely observed, "that simply is not the law of California."⁸²

The *Zieman* court's analysis, as far as it goes, is accurate and

77. 724 F.2d 1343 (9th Cir. 1983).

78. *Id.* at 1345.

79. *See, e.g.*, Gray v. Zurich Ins. Co., 65 Cal. 2d 263, 54 Cal. Rptr. 104, 419 P.2d 168 (1966).

80. ABA CODE, *supra* note 57, EC 4-1 states: "A client must feel free to discuss whatever he wishes with his lawyer and a lawyer must be equally free to obtain information beyond that volunteered by his client. A lawyer should be fully informed of all of the facts of the matter he is handling in order for his client to obtain the full advantage of our legal system." (Emphasis added).

See also 2 F. MECHAM, AGENCY § 2297 (2d ed. 1914), as follows: "The purposes and necessities of the relation between a client and his attorney require, in many cases, on the part of the client, the fullest and freest disclosures to the attorney of the client's objects, motives and acts. This disclosure is made in the strictest confidence, relying upon the attorney's honor and fidelity." 8 J. WIGMORE, EVIDENCE, §§ 2290-2329 (3d ed. 1978): "The modern theory underlying the privilege is subjective and is to give the client freedom of apprehension in consulting his legal advisor (*ibid.*, § 2290, p. 548). The privilege applies to communications made in seeking legal advice for any purpose (*ibid.*, § 2294, p. 563)."

81. *See supra* note 62 and accompanying text.

82. *Zieman*, 724 F.2d at 1346.

well founded in *Gray v. Zurich Ins. Co.*⁸³ In *Gray*, the California Supreme Court observed that a claim for punitive damages could cause a conflict of interest only in rare cases.⁸⁴ Without discussing the facts, the *Zieman* court concluded that the facts did not indicate an actual conflict existed. In resolving the conflict issue, the Ninth Circuit never considered the differing interests of the insured and the insurer in settlement negotiations.

The court did consider this argument in responding to the insured's contention that the insurer breached the covenant of good faith and fair dealing. The court was sensitive to the plight of the insurer if it could be found liable for breach of the covenant by refusing to settle within policy limits simply because punitive damages were sought.⁸⁵ Having recognized the insurer's position, it is unfathomable that the court did not recognize that there were sufficiently differing interests so that both parties would be better served by independent counsel.⁸⁶

B. The Cumis Case: California Attempts to Resolve the Issue as to When the Insured's Right to Independent Counsel Arises

[W]here there are divergent interests of the insured and the insurer brought about by the insurer's reservation-of-rights based on possible non-coverage under the insurance policy, the insurer must pay the reasonable cost of hiring independent counsel by the insured.⁸⁷

With this statement, *San Diego Navy Federal Credit Union v. Cumis Ins. Society, Inc.*,⁸⁸ laid down a bright line rule and became a landmark case in insurance law.⁸⁹ The bright line rule established that when the insurer issues a reservation of rights letter to assert non-coverage concerning issues controlled by defense

83. 65 Cal. 2d 263, 54 Cal. Rptr. 104, 419 P.2d 168 (1966).

84. *Id.* at 279 n.18, 54 Cal. Rptr. at 114, 419 P.2d at 178.

85. *Zieman*, 724 F.2d at 1346.

86. A case more sensitive to the deleterious effect of differing interests, which may or may not constitute an actual conflict of interest, is *Nike v. Atlantic Mut. Ins. Co.*, 578 F. Supp. 948 (N.D. Cal. 1983). In that case, Nike was sued for libel. The insurer accepted its duty to defend but reserved its rights to assert non-liability if malice was found. Recognizing that the insurer would best be served by a finding of malice, the court noted: "[T]here is greater danger that the interests of the insured, or of the insurer, will not be protected to the maximum extent possible where the issue upon which the conflict turns is to be litigated in the same lawsuit in which the liability of the insured is also to be determined." *Id.* at 950.

87. *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y*, 162 Cal. App. 3d 358, 208 Cal. Rptr. 494 (1984).

88. *Id.*

89. See Mallen, *A New Definition of Insurance Defense Counsel*, 53 INS. COUNSEL J. 108 (1986). As will be seen, *Cumis* is better understood as a professional responsibility case. See *infra* notes 100-03 and accompanying text.

counsel, there are per se divergent interests. Where an attorney represents multiple clients with divergent interests, he must disclose all such differing interests. If the insured does not consent to the multiple representation, the insurer must pay for independent counsel.⁹⁰

The *Cumis* decision was based on a long line of conflict of interest cases as well as the ABA Code of Professional Responsibility. The *Cumis* court's analysis of conflicts and ethics will elucidate subsequent analysis of statutory changes.⁹¹ Thus, that analysis will be discussed in great detail here.

1. Conflicts May Arise at Any Point in the Proceedings and the Insured May Be Prejudiced by Their Effects

What the defense attorney in the third party case does impacts the coverage case, in that, the questions of coverage depends [sic] on the development of facts in the third party case and their proper development is left to the attorney paid for by the carrier.⁹²

The court explained that in trial the attorney is tempted to develop facts to help his "real" client, the carrier company, as opposed to the insured for whom he will never likely work again. "A lawyer who does not look out for the carrier's best interests might soon find himself out of work."⁹³ Furthermore, at trial the insurance defense counsel will have to make various tactical decisions. "These decisions are numerous and varied. Each time one of them is made, the lawyer is placed in the dilemma of helping one of his clients concerning insurance coverage and harming the other."⁹⁴

The tactical decisions made in litigation affect all areas of the proceeding. The attorneys for both the insured and the insurer may face a conflict as to the advisability of settlement.⁹⁵ Furthermore, the divergent interests between the insured and the insurer

90. *Cumis*, 162 Cal. App. 3d at 374, 208 Cal. Rptr. at 505.

91. See *infra* notes 173, 206 & 214-21 and accompanying text.

92. *Cumis*, 162 Cal. App. 3d at 363, 208 Cal. Rptr. at 497.

93. *Id.* at 364, 208 Cal. Rptr. at 498.

94. *Id.* at 365, 208 Cal. Rptr. at 499.

95. In the *Cumis* case, the plaintiff offered to settle her wrongful termination suit within policy limits. The insurance defense counsel did not even notify the insured until the settlement conference was concluded. Navy Federal, the insured, wrote a letter to the insurer explaining: "Our insurance coverages, duly paid and contracted for, are precisely for such cases and any settlement liability that may arise therefrom. Your confidence in the defensibility of this case is greatly appreciated. Should trial prove you wrong, however, the insurance may no longer cover the Credit Union's possible losses. As you know, such losses would considerably exceed any possible settlement amount. It is clear that trial in lieu of settlement in this case subjects the Credit Union to a considerably additional risk while possibly lowering or eliminating a claim payout by Cumis. Such is not the basic premises upon which we contracted for insurance with Cumis." *Cumis*, 162 Cal. App. 3d at 365, 208 Cal. Rptr. at 499.

may create problems in pre-trial discovery. Investigation and client communications may relate directly to the coverage issue. Yet, the duty of confidentiality prevents the attorney from being frank as to coverage issues with either client.

Clearly the *Cumis* court viewed the tripartite relationship of the insured-attorney-insurer as fraught with potentially conflicting interests. Furthermore, since the conflict could arise at any time, providing a prophylactic rule which prevents conflicts from developing protects the parties better than waiting until an actual conflict arises. Once an actual conflict arises, the attorney would be required to withdraw from representing at least one party.⁹⁶ Presumptively, the attorney is in possession of confidential information, and would thus be disqualified by the other client.⁹⁷ This would cause needless delay, expense, and repetition of effort.

2. Maintaining the Ethics, Reputation, and Confidence in the Profession Demands Separate Counsel

A lawyer should never represent in litigation multiple clients with differing interests; and there are few situations in which he would be justified in representing in litigation multiple clients with potentially differing interests. If a lawyer accepted such employment and the interests did become actually differing, he would have to withdraw from employment with likelihood [sic] of resulting hardship on the clients; and for this reason it is preferable that he refuse the employment initially.⁹⁸

This ethical consideration is premised on the rule that: "A lawyer should exercise independent professional judgment on behalf of his client."⁹⁹ While the ethical aspirations of the ABA Code do not provide rules for which an attorney can be disciplined, they do establish norms for the profession. Furthermore, the ABA Code does provide rules, the violation of which is considered so egregious as to justify disciplining the attorney. One of these, DR 5-

96. ABA CODE, *supra* note 57, DR 2-110(B)(2): Mandatory Withdrawal.

A lawyer representing a client before a tribunal, with its permission if required by its rules, shall withdraw from employment, and a lawyer representing a client in other matters shall withdraw from employment if:

(1) . . .
(2) He knows or it is obvious that his continued employment will result in violation of a disciplinary rule.

(For DR 5-105(B) see *infra* note 101).

97. ABA CODE, *supra* note 57, DR 4-101(B): "A lawyer shall not knowingly:

(1) Reveal a confidence or secret of his client.
(2) Use a confidence or secret of his client to the disadvantage of the client.
(3) Use a confidence or secret of his client for the advantage of himself or, of a third person, unless the client consents after full disclosure.

98. ABA CODE, *supra* note 57, EC 5-15 (quoted in *Cumis*, 162 Cal. App. 3d at 366-67, 208 Cal. Rptr. at 500).

99. *Id.* Canon 5.

105, precludes accepting employment by parties with differing interests,¹⁰⁰ or continuing representation once the adversity of interests is apparent.¹⁰¹ The only exception to the prohibition against representing multiple clients with differing interests is:

[A] lawyer may represent multiple clients if it is *obvious* that he can adequately represent the interest of each AND if each consents to the representation after full disclosure of the possible effect of such representation on the exercise of his independent professional judgment on behalf of each.¹⁰²

Thus, to a large extent, *Cumis* is merely a judicial declaration enforcing the disciplinary rule. The *Cumis* decision would allow multiple representation after the attorney fully disclosed the effects of his representing differing interests and the client consented to such representation. If the insured does not consent to such representation, the attorney is forbidden to serve both clients. This leaves the insured without defense counsel. Because the insurer is required by the insurance contract to provide a defense, it must provide counsel who is not conflicted. Due in part to judicial recognition of the insurer's leverage against classic insurance defense counsel,¹⁰³ which may subtly (or not so subtly) effect his judgment, the court determined that the insured could select his own counsel.

Part of the decision to allow the insured to select his own counsel lies in the nature of the attorney-client relationship. The attorney-client relationship is necessarily one of special trust and confidence.¹⁰⁴ Once divergent interests arise, the insured may no longer

100. *Id.* DR 5-105(A): "A lawyer shall decline proffered employment if the exercise of his independent professional judgment in behalf of a client will be or is likely to be adversely affected by the acceptance of the proffered employment, or if it would be likely to involve him in representing differing interests, except to the extent permitted under DR 5-105(C)."

101. *Id.* DR 5-105(B): "A lawyer shall not continue multiple employment if the exercise of his independent judgment in behalf of a client will be or is likely to be adversely affected by his representation of another client, or if it would be likely to involve him in representing differing interests, except to the extent permitted under DR 5-105(C)."

102. *Id.* DR 5-105(C) (emphasis added).

103. *Cumis*, 162 Cal. App. 3d at 363-64, 208 Cal. Rptr. at 497-98; *see also* Morris, *supra* note 17. "Once selected the attorneys report to the insurers on a regular basis, consult with the insurers through each stage of the litigation and appear with the insurer's representative at settlement conferences.

The typical situation thus provides a substantial incentive for attorneys to favor the interests of the insurers over the insureds. Defense attorneys are usually specialists who do a substantial volume of business with insurers. They naturally form close personal relationships with the insurers that, coupled together with expectations of future business, provide compelling grounds to favor the interests of the insurers over the insureds." Morris, *supra* note 17, at 463.

104. *Pennix v. Winton*, 61 Cal. App. 2d 761, 143 P.2d 940 (1943); ABA CODE, *supra* note 57, DR 4-101: Preservation of Confidences and Secrets of a Client.

See also CAL. BUS. & PROF. CODE § 6068 (Deering Supp. 1988): "(e) To maintain

trust insurance defense counsel. Without the high level of trust necessary for the attorney-client relationship, the insured may refrain from disclosing confidential information relevant to liability issues.¹⁰⁵ It has long been recognized that confidential candor is necessary for effective assistance of counsel.¹⁰⁶ The need to encourage clients to disclose all possibly pertinent information to their attorneys is the basis of the attorney-client privilege¹⁰⁷ as well as the attorney's duty of confidentiality.¹⁰⁸ The prohibition against representing differing interests is based partially on trust and partially on confidentiality:

The duty not to represent conflicting interests . . . is an outgrowth of the attorney-client relationship itself, which is confidential, or fiduciary, in a broader sense. Not only do clients at times disclose confidential information to their attorneys; they also repose confidence in them. The privilege is bottomed only on the first of these attributes, the conflicting-interest rule, on both.¹⁰⁹

As the *Cumis* court noted, once a conflict arises, "the insured is placed in an impossible position; on the one hand the insurance carrier says it will happily defend him and on the other it says it may dispute paying any judgment, but trust us."¹¹⁰ The insured's inability to repose confidence in the insurance defense counsel breaks down the attorney-client relationship. When that relationship is broken, the client is no longer "represented" by retained counsel. He should then be able to select counsel of his own choosing.¹¹¹ Indeed, once the attorney-client relationship breaks down,

inviolate the confidence, and at every peril to himself to preserve the secrets, of his client."

105. An insured has a duty to cooperate with the insurer in evaluating the loss and in defending an action under the policy. In order for the insurer to defend its action on the basis of noncooperation, the insurer must show that it was substantially prejudiced by the insured's failure to cooperate. CALIFORNIA INSURANCE LAW & PRACTICE, *supra*, note 11, § 8.13(6), at 8-63.

106. ABA CODE, *supra* note 57, EC 4-1: "[T]he observance of the ethical obligation of a lawyer to hold inviolate the confidences and secrets of his client not only facilitates the full development of the facts essential to proper representation of a client but also encourages laymen to seek early legal assistance."

See *American Mut. Liab. Ins. Co. v. Superior Court*, 38 Cal. App. 3d 579, 113 Cal. Rptr. 561 (1974).

107. The attorney-client privilege is provided in CAL. EVID. CODE § 954 (Deering 1986). The purpose of the privilege is to encourage clients to fully disclose confidential information which may be relevant to the case without fear that others may be informed. *Grover v. Superior Court*, 161 Cal. App. 2d 644, 327 P.2d 212 (1958); *Glade v. Superior Court*, 76 Cal. App. 3d 738, 143 Cal. Rptr. 119 (1978).

108. CAL. BUS. & PROF. CODE § 6068(e); ABA CODE, *supra* note 57, Canon 4; *Industrial Indem. Co. v. Great Am. Ins. Co.*, 73 Cal. App. 3d 529, 140 Cal. Rptr. 806 (1977).

109. *E.F. Hutton & Co. v. Brown*, 305 F. Supp. 371 (S.D. Tex. 1969) (quoted in *Cumis*, 162 Cal. App. 3d at 366 n.5, 208 Cal. Rptr. at 499).

110. *Cumis*, 162 Cal. App. 3d at 364, 208 Cal. Rptr. at 498.

111. "It has long been the law of this state that when a conflict develops, the insurer

counsel ought to withdraw.¹¹²

Another ground for the prohibition against representing clients with differing interests, but one not relied on by the *Cumis* court, is the attorney's duty to avoid even the appearance of impropriety.¹¹³

The premise of the concept is to preserve the integrity of the legal system for the public. Despite the private nature of an attorney-client relationship, there is a public interest in protecting the integrity of future attorney-client relationships. The objective is to assure that clients will be able to repose trust and confidence in their attorneys.¹¹⁴

It seems obvious to the authors that once a client realizes that his attorney is trying to serve two masters—one rich and powerful, one himself—the client will perceive that something is amiss. Knowing that this dual representation is a common practice, it is little wonder that the public has a low regard for the ethics of lawyers.¹¹⁵ Because it is the perception of impropriety, not impropriety in fact¹¹⁶ which is to be remedied, dual representation is suspect from the inception.

C. *Effect of Cumis on the Business of Law*

Many private attorneys welcomed the *Cumis* decision with open arms, and pocketbooks.¹¹⁷ To them the decision uncovered a new

cannot compel the insured to surrender control of the litigation, and must, if necessary, secure independent counsel for the insured." *Purdy v. Pacific Auto. Ins. Co.*, 157 Cal. App. 3d 59, 203 Cal. Rptr. 524 (1984) (cited in *Cumis*, 162 Cal. App. 3d at 364 n.3, 208 Cal. Rptr. at 498).

112. ABA CODE, *supra* note 57, EC 5-15.

113. *Id.* EC 9-6 provides:

Every lawyer owes a solemn duty to uphold the integrity and honor of his profession; to encourage respect for the law and for the courts and judges thereof; to observe the Code of Professional Responsibility; to act as a member of a learned profession, one dedicated to a public service; to cooperate with his brother lawyers in supporting the organized bar through the devoting of his time, efforts, and financial support as his professional standard and ability permit; to conduct himself so as to reflect credit on the legal profession and to inspire the confidence, respect, and trust of his clients and of the public; and to strive to avoid not only professional impropriety but also the appearance of impropriety.

See also *supra* note 54 and accompanying text.

114. R. MALLEEN & V. LEVIT, *supra* note 64, § 16 at 249.

115. *What America Really Thinks about Lawyers*, 8 Nat'l L.J. S1-13 (Aug. 18, 1986).

116. "As important as it is that people should get justice, it was even more important that they should be made to feel and see that they were getting it." R. MALLEEN & V. LEVIT, *supra* note 64, § 156 at 249 (quoting Lord Herschell from 2 J. ATLAY, VICTORIAN CHANCELLORS 460 (1908)).

117. "The ink was barely dry on *Cumis* before its holding was exploited. Conflicts were claimed by allegations of punitive damages, possible demands in excess of limits, and contract causes of action not insured under any view of the facts; *Cumis* counsel acted as if free gold had been discovered, sending gouging invoices to recalcitrant carriers." Kenner-

source of revenues. Private attorneys could now take a complaint served against their client, and tender it to the client's insurance carrier.¹¹⁸ When the carrier issued its inevitable reservation-of-rights letter,¹¹⁹ the private attorney could defend his client at the expense of the carrier. This practice is consistent with the opinion and reasoning of *Cumis*. If this were the only result of *Cumis*, the reaction of carriers would probably be less intense.¹²⁰

However, it has become apparent that some attorneys have abused the position of "Cumis counsel."¹²¹ As has been noted in other third party payment situations,¹²² counsel has had little incentive to minimize defense costs. Because the client does not pay the bill, the only reviewing authority is the insurance company. Although the insurance company is required to pay only the "reasonable value" of the independent counsel's services,¹²³ the line between an excessively costly defense and zealous advocacy is easily blurred.¹²⁴ Thus, it is not unforeseeable that in complex cases the insurance company will pay for four lawsuits: (1) the underlying lawsuit, (2) a declaratory relief suit, (3) defense of a "bad faith"¹²⁵ suit against the insurer, and (4) prosecution of a bad faith suit by the insurer against some of the *Cumis* counsel.¹²⁶

son, *A Redefinition of Conflicts of Interest*, TRIAL BAR NEWS, May 1988, at 10 (San Diego Trial Lawyers Association).

118. In some of these cases, the insurer simply allows *Cumis* counsel to defend the insured against all issues in litigation. In other cases, the insurer's retained counsel defends the case and *Cumis* counsel merely works with the retained counsel to protect the client against conflict problems. The private attorney anticipating a conflict of interest must look to the claims management book of each carrier to determine when the insurer selects either alternative. The *Cumis* decision clearly supported the first course of action as it declared that retained counsel must withdraw. *Cumis*, 162 Cal. App. 3d 358, 208 Cal. Rptr. 494.

119. The reservation-of-rights letter is nearly inevitable, as attorneys have learned in the years since *Gray* to plead all possible theories of liability. Thus, it is the standard practice of many firms to allege intentional torts along with causes of action for negligence, breach of contract, and common counts.

120. Insurance companies have spent \$43 million on lobbying and forwarding referendums in California alone. San Diego Union, Oct. 2, 1988 § C2 col. 1.

121. "Cumis counsel" has become a standard phrase to describe independent counsel selected by the insured because of the conflict of interest between insurance defense counsel and the insured.

122. Economists generally recognize that the rise of health insurance and third party payments partially caused the substantial increase of medical costs.

123. *Executive Aviation v. National Ins. Underwriters*, 16 Cal. App. 3d 799, 810, 94 Cal. Rptr. 347, 354 (1971); *Cumis*, 162 Cal. App. 3d at 375, 208 Cal. Rptr. at 506.

124. ABA CODE, *supra* note 57, EC 7-1: "The duty of a lawyer, both to his client and to the legal system, is to represent his client zealously within the bounds of the law. . . ."

EC 7-2: "The bounds of the law in a given case are often difficult to ascertain. . . ."

125. "Bad faith" as used here is generic. It refers to a breach of the covenant of good faith and fair dealing, as well as violation of the Insurance Code's Unfair Practices Act, CAL. INS. CODE §§ 790-790.10 (Deering 1976 & Supp. 1988).

126. Although there are no reported appellate decisions upholding "counter or reverse" bad faith suits, dictum in *Orient Handel v. U.S. Fidelity and Guar.*, 192 Cal. App.

1. *Creating Nonexistent Conflicts*—In addition to abusing *Cumis* to create additional cash flow, some attorneys have taken the language of *Cumis* out of context in an attempt to create conflicts that do not exist. One such case is *McGee v. Superior Court*.¹²⁷ McGee was injured while a passenger in her own car, driven with her permission, by Byron Pedersen. McGee retained her mother as counsel and complained against Riverside County alleging negligence in maintaining and posting the road. Riverside cross-claimed against McGee for indemnity. McGee filed a separate action against Pedersen.

McGee's attorney took Pedersen to an attorney to defend him in the Riverside action. Pedersen's attorney tendered the McGee claim to McGee's carrier under the permissive driver clause of that policy. The insurer issued a reservation-of-rights letter asserting that the claim was not covered, as the policy excluded injuries to McGee's resident relations, of which McGee was one. The insurer funded Pedersen's attorney in the Riverside dispute, but retained counsel for Pedersen in the McGee case.

McGee moved to disqualify the retained counsel arguing that a conflict of interest existed. McGee lost her motion and petitioned for an extraordinary writ. The appellate court held that McGee had no beneficial interest in the requested relief¹²⁸ and had failed to prove a conflict existed.¹²⁹

McGee argued that carrier appointed counsel has a conflict of interest whenever the carrier reserves its rights to assert non-coverage at a later date. McGee snatched words from *Cumis* out of context to support this contention. The *McGee* court, like the *Cumis* court before, pointed out that a conflict only exists when the coverage dispute turns on issues which can be controlled by defense counsel.¹³⁰ Because Pedersen's counsel could not affect whether McGee's injuries fell within the resident relative exclusion, the court held that Pedersen's attorney had no conflict of interest.¹³¹

2. *Insurers Deny Existing Conflicts*—*McGee* is a decision soundly based on the conflict of interest doctrine as expressed in the *Cumis* decision and the ABA Model Code. Nonetheless, some

3d 684, 237 Cal. Rptr. 667 (1987), indicates that such an action could be brought because good faith is "a two way street." G. KORNBLUM, M. KAUFMAN & H. LEVINE, CALIFORNIA PRACTICE GUIDE, BAD FAITH § 10.57, at 10-16 (1988).

127. 176 Cal. App. 3d 221, 221 Cal. Rptr. 421 (1985).

128. *Id.* at 228, 221 Cal. Rptr. at 425.

129. *Id.*

130. *Id.* at 226, 221 Cal. Rptr. at 423.

131. *Id.* at 227-28, 221 Cal. Rptr. at 424.

insurers, as unscrupulous as the abusive *Cumis* counsel, have snatched language from *McGee* out of context to assert that *McGee* modifies *Cumis*. The language in question is:

The crucial fact in *Cumis*, as the court took pains to point out and explain several times, was that the insurer's reservation of rights on the ground of non-coverage was based on the nature of the insured's conduct, which as developed at trial would affect the determination as to coverage.¹³²

and

[I]t [*Cumis*] is only applicable when the basis for the insurer's reservation of rights [is] such as that of which the *Cumis* court spoke. . . .¹³³

Some insurers have taken the position that the only time a conflict of interest arises is when the *conduct* of the defendant is in question.¹³⁴ This position is not supported by *McGee* or *Cumis*.¹³⁵

The *McGee* court stated that a conflict of interest arose from a reservation-of-rights only in a situation "such as that of which the *Cumis* court spoke."¹³⁶ The *Cumis* court spoke of many situations in which a conflict of interest arises. The essential element of those situations was not the insured's conduct; the essential element was attorney control.

A conflict of interest in the insurer-attorney-insured relationship can arise in many ways. It can arise from facts like those in *Cumis* where the insurance policy covers the insured for some of the allegations within the complaint but not for others. A conflict

132. *Id.* at 226, 221 Cal. Rptr. at 423-24.

133. *Id.* at 227, 221 Cal. Rptr. at 424.

134. There is some authority for the proposition that the bright line rule of *Cumis* applies only when the reservation-of-rights is based on the conduct of the insured as potentially falling into covered or uncovered claims. For authority for this proposition, see *Native Sun Inv. Group v. Ticor Ins. Co.*, 189 Cal. App. 3d 1265, 235 Cal. Rptr. 34 (1987); *United States Fidelity & Guar. Co. v. Superior Court*, 88 Daily Journal D.A.R. 12988 (Oct. 14, 1988).

135. Neither does *Native Sun Inv. Group v. Ticor Title Ins. Co.*, 189 Cal. App. 3d 1265, 235 Cal. Rptr. 34 (1987), support such a contention.

Native Sun bought property and insured its title through *Ticor*. While *Native Sun's* development plan awaited approval of the City of Carlsbad, the State of California claimed an interest in the property. *Ticor* agreed to defend *Native Sun* against the state's claim. It agreed to indemnify *Native Sun* if the state took the fee interest. However, *Ticor* reserved its right to assert non-coverage if the state proved an unrecorded right-of-way by implied public dedication through historic public use.

As in *McGee*, *Native Sun's* own attorney asserted that whenever an insurer issues a reservation-of-rights letter, the insurance defense counsel has a conflict of interest. As in *McGee*, the court took pains to point out that the conflict arises only when defense counsel can affect the coverage dispute. *Id.* at 1277, 235 Cal. Rptr. at 40. Because counsel could not control whether the state asserted a right-of-way by implied dedication, defense counsel had no conflict of interest. Equally important—*Native Sun* accepted the defense counsel offered by *Ticor* to defend all of *Native Sun's* rights even after the reservation-of-rights letter was issued. Thus, *Native Sun* waived any potential conflict.

136. *McGee*, 176 Cal. App. 3d at 227, 221 Cal. Rptr. at 425.

can arise from the insurer's interpretation of the contract when applied to defense counsel's tactical decisions, such as whether to oppose qualification of a class action where the insurer asserts the policy's deductible applies to each plaintiff.¹³⁷ A conflict can arise where there are disputes as to definitions of the policy, such as whether a pilot was a "qualified pilot" as defined by the policy.¹³⁸ These situations were discussed in *Cumis*. The cases in which these situations arose were the authority upon which *Cumis* rested. They were also the foundation of *McGee*.

The harmonizing factor in all of the insurance defense conflict of interest cases is attorney control. Where the attorney can affect coverage by his handling of disputed facts, the attorney has a conflict of interest. Where the attorney can affect coverage by the tactical decisions he makes, the attorney has a conflict of interest. But when the attorney cannot affect the coverage issue, there is no conflict.

3. Confusion Over the Bright Line—In spite of the litmus test established by *Cumis*, explained by *McGee*, and reiterated in *Native Sun Investment Group v. Ticor Title Ins. Co.*,¹³⁹ there remains some confusion as to when a conflict of interest exists.¹⁴⁰ This confusion seems to come from the entanglement of insurance law with the conflict of interest question. Once it is realized that the conflict of interest cases primarily regulate attorneys, and not insurance companies,¹⁴¹ some of the confusion should vanish.

It is eminently clear that the courts are predominantly concerned with the behavior of attorneys in the conflict cases from the way they approach the analysis.¹⁴² The court determines what the attorney should do to represent the best interests of the insured. Then it determines what the attorney should do to re-

137. *Previews, Inc. v. California Union Ins. Co.*, 640 F.2d 1026 (9th Cir. 1981).

138. *Executive Aviation v. National Ins. Underwriters*, 16 Cal. App. 3d 799, 94 Cal. Rptr. 347 (1971).

139. 189 Cal. App. 3d 1265, 235 Cal. Rptr. 34 (1987). *See supra* note 135 for explanation of the case.

140. Roberts, *Intentional Acts Coverage—The Innocent Co-insured Exception*, TRIAL BAR NEWS, Sept. 1988, at 9 (San Diego Trial Lawyers Association). Mazzarella, *Cumis Counsel—Part Two: What Do We Do Now?*, DICTA, Apr. 1988, at 21 (San Diego Bar Association).

141. *United States Fidelity & Guar. Co. v. Superior Court*, 88 Daily Journal D.A.R. 12998 (Oct. 14, 1988).

142. The following courts used the same approach as discussed in the text to identify the conflict of interest: *Executive Aviation v. National Ins. Underwriters*, 16 Cal. App. 3d 799, 94 Cal. Rptr. 347 (1971); *Previews, Inc. v. California Union Ins. Co.*, 640 F.2d 1026 (9th Cir. 1981); *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y*, 162 Cal. App. 3d 358, 208 Cal. Rptr. 494 (1984); *Bogard v. Employers Casualty Co.*, 164 Cal. App. 3d 602, 210 Cal. Rptr. 578 (1985).

present the best interest of the insurer. If the two courses of action are substantially different, there is probably a conflict of interest. Insurance law is applied to the above analysis only to determine what course of action is in the best interests of each party. Thus, it is apparent that the courts are mostly concerned with the integrity of the bar.

As Mallen and Levit prophetically decreed: "The heightened integrity of the bar has not been without adverse economic impact to the public."¹⁴³ Although the authors find no study which indicates that the increase in insurance costs are directly attributable to the use and abuse of *Cumis*, the fact that the insurance industry has expended a great deal of time and money reacting to *Cumis* and like decisions¹⁴⁴ indicates that the increase is substantial.

Finally, to resolve the problem of conflict of interest, attorney groups and insurance groups appealed to the legislature. Nationally, the Insurance Services Office, Inc. (ISO) has studied many alternatives in an effort to curtail defense costs.¹⁴⁵ In California, the insurance companies launched a massive legislative campaign.¹⁴⁶

II. THE CALIFORNIA LEGISLATURE ENACTED SECTION 2860 TO ADOPT, QUALIFY, AND CLARIFY THE CONFLICT OF INTEREST SITUATION

One of the insurance industry's efforts to contain the use and abuse of *Cumis* resulted in the enactment of California Civil Code Section 2860.¹⁴⁷ Section 2860 has become a frequent topic of cor-

143. R. MALLEN & V. LEVIT, *supra* note 64, § 150 at 240.

144. See, e.g., *supra* note 23.

145. I.S.O., COMMERCIAL GENERAL LIABILITY INSURANCE—LEGAL DEFENSE COST CONTAINMENT (1985).

Discussion of the Defense Cost Containment program is beyond the scope of this paper. However, for an excellent analysis of the program, see Dorsch, *Insurance Defense Costs and the Legal Defense Cost Containment Program: Is the Free Ride Over?*, 53 INS. COUNS. J. 580 (1986).

146. Cox, *supra* note 5. Wiegand, *Battle of the Ballot*, A.B.A. J. CALIFORNIA EDITION, Sept. 1, 1988 at CE-8.

147. CAL. CIV. CODE § 2860 (Deering Supp. 1988):

Conflict of interest; duty or provide independent counsel; waiver, qualifications of independent counsel; fees; disclosure of information

(a) If the provisions of a policy of insurance impose a duty to defend upon an insurer and a conflict of interest arises which creates a duty on the part of the insurer to provide independent counsel to the insured, the insurer shall provide such counsel to represent the insured unless, at the time the insured is informed that a possible conflict may arise or does exist, the insured expressly waives, in writing, the right to such counsel. An insurance contract may contain a provision which sets forth the method of selecting such counsel consistent with this section.

(b) For purposes of this section, a conflict of interest does not exist as to allegations or

respondence between *Cumis* counsel and insurance companies.¹⁴⁸ Its language is ambiguous; its scope, unclear.¹⁴⁹ Furthermore, the scope of the Legislature's power to pass upon the ethical requirements of the bar is doubtful.¹⁵⁰

A. Section 2860 Codifies *Cumis*

The Legislature defines a conflict of interest in the insurer-attorney-insured relationship in part (b) which states: "when an insurer reserves its rights on a given issue and the outcome of that issue can be controlled by counsel first retained by the insurer for the defense of the claim, a conflict may exist."¹⁵¹ Disregarding the equivocal "may" for purposes of this discussion, this definition

facts in the litigation for which the insurer denies coverage; however, when an insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim, a conflict of interest may exist. No conflict of interest shall be deemed to exist as to allegations of punitive damages or be deemed to exist solely because an insured is sued for an amount in excess of the insurance policy limits.

(c) When the insured has selected independent counsel to represent him or her, the insurer may exercise its right to require that the counsel selected by the insured possess certain minimum qualifications which may include that the selected counsel have (1) at least five years of tort litigation practice which includes substantial defense experience in the subject at issue in the litigation, and (2) errors and omissions coverage. The insurer's obligation to pay fees to such 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. The provisions of this subdivision shall not invalidate other different or additional policy provisions pertaining to attorney's fees or providing for methods of settlement of disputes concerning those fees. Any dispute concerning attorney's fees not resolved by these methods shall be resolved by final and binding arbitration by a single neutral arbitrator selected by the parties to the dispute.

(d) When independent counsel has been selected by the insured, it shall be the duty of such 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. Any claim of privilege asserted is subject to in camera review in the appropriate law and motion department of the superior court. Any information disclosed by the insured or by independent counsel is not a waiver of the privilege as to any other party.

(e) The insured may waive its right to select independent counsel by signing the following statement: "I have been advised and informed of my right to select independent counsel to represent me in this lawsuit. I have considered this matter fully and freely waive my right to select independent counsel at this time. I authorize my insurer to select a defense attorney to represent me in this lawsuit."

(f) Where the insurer selects independent counsel pursuant to the provisions of this section, both the counsel provided by the insurer and independent counsel selected by the insured shall be allowed to participate in all aspects of the litigation. Counsel shall cooperate fully in the exchange of information that is consistent with each counsel's ethical and legal obligation to the insured. Nothing in this section shall relieve the insured of his or her duty to cooperate with the insurer under the terms of the insurance contract.

148. Mazzarella, *supra* note 140, at 21.

149. *See infra* notes 164-208 and accompanying text.

150. *See infra* notes 214-17.

151. CAL. CIV. CODE § 2860(b) (Deering Supp. 1988).

succinctly summarizes the *Cumis* problem.¹⁵² Section 2860 also provides the insured with a remedy when counsel is conflicted. Part (a) of the section provides that if the insurer has a duty to defend:

[A]nd a conflict of interest arises, which creates a duty on the part of the insurer to provide independent counsel to the insured, the insurer shall provide such counsel to represent the insured UNLESS at the time the insured is informed that a possible conflict may arise or does exist, the insured expressly waives IN WRITING the right to such counsel.¹⁵³

If one compares this language of the statute to the language of *Cumis*, the parallel is unmistakable.¹⁵⁴ In *Cumis*, the court first provides an example of a conflict of interest: “[W]here as here multiple theories of liability are alleged and some theories involve uncovered conduct under the policy, a conflict exists.”¹⁵⁵ Then the court established the insured’s remedy for conflicted counsel.

We conclude the Canons of Ethics imposed upon lawyers hired by the insurer an obligation to explain to the insured and the insurer the full implications of joint representation in situations where the insurer has reserved its right to deny coverage. If the insured does not give an informed consent to continued representation, counsel must cease to represent both. Moreover, in the absence of such consent, where there are *divergent interests* of the insured and insurer brought about by the insurer’s reservation of rights based on possible non-coverage under the insurance policy the insurer must pay the reasonable cost for hiring independent counsel selected by the insured.¹⁵⁶

Comparing the language of the statute to the reasoning of *Cumis*, the two agree that if a coverage issue can be controlled by counsel, counsel must fully disclose the implications of the multiple representation. The decision as to whether the attorney may continue to represent the insured is the insured’s.

1. Section 2860 May Favor Insured’s Interest—Furthermore, the statute is stricter in some ways than *Cumis*. The statute requires that the client give his informed consent in an express written waiver.¹⁵⁷ *Cumis* requires only consent after full disclosure.¹⁵⁸ Another way the statute favors the insured is in the definition of

152. See *infra* notes 154-56 and accompanying text.

153. CAL. CIV. CODE § 2860(a) (Deering Supp. 1988) (emphasis added).

154. United States Fidelity & Guar. Co. v. Superior Court, 88 Daily Journal D.A.R. 12998 (Oct. 14, 1988).

155. *Cumis*, 162 Cal. App. 3d at 369, 208 Cal. Rptr. at 501.

156. *Id.* at 375, 208 Cal. Rptr. at 506 (emphasis added).

157. CAL. CIV. CODE § 2860(a). The requirement of a writing may become a trap for the unwary defense counsel.

158. *Cumis*, 162 Cal. App. 3d at 375, 208 Cal. Rptr. at 506.

the conflict, which is broader and clearer.

The conflict situation is adequately summed up in part (b):

[W]hen an insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for defense of the claim, a conflict of interest may exist.¹⁵⁹

This is a simple and succinct statement of the *Cumis* problem. Furthermore, it is both adequately broad and properly narrow to provide guidance and control of the conflict dispute.

The statement is adequately broad because it selects the term “issue” to define the conflict. A coverage issue may arise from the application of the facts to any of the various tools of risk management.¹⁶⁰ For example, a definition contained in the policy can create a coverage issue.¹⁶¹ Often, definitions in the policy are used to extend or restrict coverage under the policy. Frequently, the applicability and application of those definitions turn on the facts of the case. For example, where a policy defines “scope of employment” and covers those workers acting within the scope of employment, but not those acting outside the scope of employment, a coverage issue may exist. The attorney serves the insured best by zealously establishing that the worker acted within the scope of his employment. Counsel for the insurer would best serve the interests of his client by establishing that the acts done exceeded the scope of employment. Thus, the very same conflict which arises under the classic problem of exclusionary clauses may arise in definitional issues.¹⁶² Therefore, “coverage issue” is an appropriately broad term.

The language is appropriately narrow as it limits the application of the statute to those coverage issues the outcome of which can be controlled by defense counsel. This has been the important factor in all of the independent counsel cases.¹⁶³ This simple limitation is the determining factor as to whether a conflict exists. If the attorney cannot affect the outcome of an issue, he has no divided loyalty, and no motive to sacrifice the interest of one client in favor of the other, because he cannot affect those interests. This limitation should put an end to the arguments of those attorneys

159. CAL. CIV. CODE § 2860(b) (Deering Supp. 1988).

160. See *supra* notes 15-17 and accompanying text.

161. Many insurance companies are currently disputing this contention.

162. By analogy, see *St. Paul Fire & Marine Ins. Co. v. Weiner*, 606 F.2d 864 (9th Cir. 1979).

163. *Executive Aviation v. National Ins. Underwriters*, 16 Cal. App. 3d 799, 94 Cal. Rptr. 347 (1971); *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc’y*, 176 Cal. App. 3d 358, 208 Cal. Rptr. 494 (1984); *McGee v. Superior Court*, 176 Cal. App. 3d 221, 221 Cal. Rptr. 421 (1985); *Native Sun Inv. Group v. Ticor Title Ins. Co.*, 189 Cal. App. 3d 1265, 235 Cal. Rptr. 34 (1987).

who believe they can conjure a conflict from any set of facts.

B. Ambiguity Yields Uncertainty

1. *When a Conflict Arises*—Nonetheless, other language of the statute provides ambiguity and uncertainty guaranteed to result in litigation. To begin with, the provision defining the conflict of interest ends with a qualifying phrase keynoted by an equivocal “may”:

[W]hen an insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim, a conflict may exist.¹⁶⁴

To say a conflict *may* exist when the attorney can control the coverage issue is, at best, a gross understatement. As noted above,¹⁶⁵ when the attorney can control the coverage issue, there exists an insoluble conflict of interest. To represent the interest of the insured, the attorney must vigorously establish that any liability is covered by the policy and payable by the insurer. But to represent the insurer, the attorney must establish that any liability falls outside policy coverage and must be born by the insured. This is clearly a conflict of interest.¹⁶⁶

The equivocal “may” alters the state of the law only slightly. *Cumis* had established a bright line rule; Section 2860 returns the question of conflicts to an ad hoc determination. Whether that return should be heralded or damned remains to be seen.¹⁶⁷ It will certainly spur litigation.

Nonetheless, the outcome of that litigation is fairly predictable. California courts have consistently found conflicts of interest where the attorney can control the coverage issue.¹⁶⁸

2. *When the Right to Counsel Vests*—Another wording problem, and potential source of discord may be found in the statute’s opening:

If the provisions of a policy of insurance impose a duty to defend

164. CAL. CIV. CODE § 2860(b). (Emphasis added).

165. See *supra* notes 29-36 and accompanying text.

166. O’Morrow v. Borad, 27 Cal. 2d 794, 167 P.2d 483 (1946); Lysick v. Walcom, 258 Cal. App. 2d 136, 65 Cal. Rptr. 406 (1968); Tomerlin v. Canadian Indem. Co., 61 Cal. 2d 636, 39 Cal. Rptr. 731, 394 P.2d 571 (1964); Executive Aviation v. National Ins. Underwriters, 16 Cal. App. 3d 799, 94 Cal. Rptr. 347 (1971); San Diego Navy Fed. Credit Union v. Cumis Ins. Soc’y, 162 Cal. App. 358, 208 Cal. Rptr. 494 (1984). Compare McGee v. Superior Court, 176 Cal. App. 3d 221, 221 Cal. Rptr. 421 (1985); Native Sun Inv. Group v. Tigor Title Ins. Co., 189 Cal. App. 3d 1265, 235 Cal. Rptr. 34 (1987).

167. One recent decision indicates that the bright line rule of *Cumis* continues where the conflict revolves around the insured’s conduct. United States Fidelity & Guar. Co. v. Superior Court, 88 Daily Journal D.A.R. 12998 (Oct. 14, 1988).

168. See cases cited *supra* note 166.

upon an insurer and *a conflict arises, which creates a duty on the part of the insurer to provide independent counsel to the insured*, the insurer shall provide such counsel to represent the insured¹⁶⁹

There are two problems with the quoted language. First, it may require an actual conflict to arise before the insurer must provide independent counsel. Second, it is questionable whether the parenthetical phrase is explaining or modifying the duty.

The argument that the language requires an actual conflict to arise before the right to independent counsel vests turns on one of the canons of construction.¹⁷⁰ Where the Legislature distinguishes between related concepts in the same statute, the words selected mean exactly what they say.¹⁷¹ Section 2860, part (a), distinguishes between “conflicts of interest” and “possible conflicts.” Since the Legislature chose the phrase “when a conflict of interest arises” as opposed to “when a possible conflict of interest arises,” the Legislature may have meant that an actual conflict is required before the right to independent counsel vests.

The other side of that argument rests on another canon of construction. Language of a statute is to be construed within the context of the statute.¹⁷² Section 2860 provides a right to independent counsel “unless at the time the insured is informed that a possible conflict may arise or does exist, the insured expressly waives”¹⁷³ his right to independent counsel. It seems clear that the Legislature anticipated that the insured would learn of possible conflicts. The statute allows the insured to waive the possible conflict when he learns of it. The statute also requires that independent counsel be provided unless at the time the insured is informed “that a possible conflict may arise,” he waives it. The statute clearly requires the insured to make an election upon learning of the conflict or possible conflict. It is only logical that the insured’s right vests when he makes that election. Therefore, the insured’s right to independent counsel may vest when he learns of a possible conflict and does not consent to insurance defense counsel’s continued representation.

Either construction is plausible, however, the second is more closely aligned with California decisions¹⁷⁴ and professional eth-

169. CAL. CIV. CODE § 2860(a) (Deering Supp. 1988) (emphasis added).

170. See K. LLEWELLYN, THE COMMON LAW TRADITION (1960)

171. *Id.* at 526.

172. CAL. CIV. CODE § 13 (Deering 1971); see also K. LLEWELLYN, *supra* note 170, at 524.

173. CAL. CIV. CODE § 2860(a).

174. See *Lysick v. Walcom*, 258 Cal. App. 2d 136, 65 Cal. Rptr. 406 (1968), *Navy Fed. Credit Union v. Cumis Ins. Soc’y*, 165 Cal. App. 3d 358, 208 Cal. Rptr. 494 (1984). Statutes are to be read in light of the common law and a statute affirming a common law

ics.¹⁷⁵ The *Cumis* court addressed this very issue:

Cumis (the insurer) makes a distinction between potential and actual conflicts of interest which is invalid and unworkable. Recognition of a conflict cannot wait until the moment a tactical decision must be made during trial. It would be unfair to the insured and generally unworkable to bring in counsel midstream during the course of trial expecting the new counsel to control the litigation. Contrary to *Cumis*' argument the existence of a conflict of interest should be identified early in the proceedings so it can be treated effectively before prejudice has occurred to either party.¹⁷⁶

Professional ethics also counsel adopting the second proposed construction. The California Rules of Professional Conduct require an attorney to decline professional employment representing adverse interests unless full disclosure is made and written consent obtained.¹⁷⁷ The ABA Code, quoted in *Cumis*,¹⁷⁸ counsels against representing in litigation even potentially adverse interests.¹⁷⁹ In summary, a lawyer is required to recognize and disclose *potential* conflicts of interest.

At the time of disclosure, the client must determine whether to consent to the attorney's continued representation or not. If, at that time, he waives the potential conflict, he waives his right to independent counsel.¹⁸⁰ Thus, it is necessary and fair that at the time of disclosure the right to independent counsel vests.

Another wording problem casts doubt on whether the right to independent counsel will arise at all. The other textual problem of Section 2860, part (a) involves the parenthetical expression which either modifies or explains the clause before it: "[A] conflict of interest arises, which creates a duty on the part of the insurer to provide independent counsel. . . ."¹⁸¹ This wording either means that a conflict of interest creates a duty to provide independent counsel, or it means that only some conflicts of interest create a right to independent counsel. Simple grammar and the legislative history counsel adopting the first interpretation. Twenty years of California jurisprudence recommends adopting the second.¹⁸²

rule is to be construed in accordance with the common law. CAL. CIV. CODE § 5 (Deering 1971); see also K. LEWELLYN, *supra* note 170.

175. See *supra* notes 96-102.

176. *Cumis*, 162 Cal. App. 3d at 371 n.7, 208 Cal. Rptr. at 503.

177. CALIFORNIA RULES OF PROFESSIONAL CONDUCT Rule 5-102(a).

178. *Cumis*, 162 Cal. App. 3d at 366-67, 208 Cal. Rptr. at 499-500.

179. See *supra* note 98.

180. "[T]he insurer shall provide such counsel to represent the insured, unless at the time the insured is informed that a possible conflict may arise or does exist, the insured expressly waives in writing the right to such counsel." CAL. CIV. CODE § 2860(a).

181. CAL. CIV. CODE § 2860(a).

182. See *supra* note 166.

The legislative history indicates the Legislature believed that the case law only provided a right to independent counsel with certain conflicts of interest. "Under the existing case law, if in a liability action against the insured the insurer reserves its right to assert non-coverage, the insured has a right to independent counsel in certain cases where there is a conflict of interest."¹⁸³ The Legislature is clearly incorrect in making this point. No reported California case decided after *Executive Aviation*¹⁸⁴ has found that a conflict of interest existed, but still determined the insured was *not* entitled to independent counsel. The cases coming closest to such a determination are *Bogard v. Employers Casualty Co.*,¹⁸⁵ *McGee v. Superior Court*,¹⁸⁶ and *Native Sun Investment Group v. Ticor Title Ins. Co.*¹⁸⁷ However, each of these cases found the attorney had no conflict of interest.¹⁸⁸ In short, the Legislature misread the existing case law.

Equally clear from the legislative history is the Legislature's intent to codify existing case law.

Under existing case law, if in a liability action against an insured, the insurer reserves its right to assert non-coverage, the insured has a right to independent counsel in certain cases where there is a conflict of interest. The bill provides that a conflict of interest does not exist as to allegations or facts in litigation for which an insurer declines coverage, but when an insurer reserves its rights on a given issue and the outcome of that issue can be controlled by the counsel retained by the insurer, a conflict exists.¹⁸⁹

It is clear from the language of the statute¹⁹⁰ and the legislative history that the Legislature intended to codify (and perhaps clarify) existing case law. The existing case law provides a right to independent counsel when a conflict of interest appears.¹⁹¹ It does not provide such a right unless a conflict is apparent.¹⁹² But, there are no conflicts of interest that do not entitle the insured to independent counsel. Thus, the legislative intent to adopt the current

183. *Legislative Counsel Digest*, Jan. 26, 1987.

184. 16 Cal. App. 3d 799, 94 Cal. Rptr. 347 (1971).

185. 164 Cal. App. 3d 602, 210 Cal. Rptr. 578 (1985).

186. 176 Cal. App. 3d 221, 221 Cal. Rptr. 421 (1985). For discussion of this case, see *supra* note 130 and accompanying text.

187. 189 Cal. App. 3d 1265, 235 Cal. Rptr. 34 (1987).

188. See *supra* notes 127-35 and accompanying text.

189. *Legislative Counsel Digest*, Jan. 26, 1987.

190. See *supra* note 147 and accompanying text.

191. *Executive Aviation v. National Ins. Underwriters*, 16 Cal. App. 3d 799, 94 Cal. Rptr. 347 (1971), *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y*, 162 Cal. App. 3d 358, 208 Cal. Rptr. 474 (1984).

192. *Bogard v. Employers Casualty Co.*, 164 Cal. App. 3d 602, 210 Cal. Rptr. 578 (1975); *Native Sun Inv. Group v. Ticor Ins. Co.*, 189 Cal. App. 3d 1265, 235 Cal. Rptr. 34 (1987).

case law and the case law itself demands that the statute be construed to require independent counsel whenever a conflict appears.

C. Negating Conflicts

1. "Facts and Allegations"—Although Section 2860(b) contains an excellent definition of an insurance conflict,¹⁹³ the remainder of part (b) is wrought with ambiguity.¹⁹⁴ The first great ambiguity is contained in the first line of part (b): "For the purposes of this section, a conflict of interest does not exist as to allegations or facts in the litigation for which the insurer denies coverage."¹⁹⁵ The scant commentary of the law available on this language interprets it to mean that there is no conflict when the insurer denies coverage altogether.¹⁹⁶ If that interpretation is adopted, the quoted language merely states the current law. However, when read closer, the language is susceptible to a different and far reaching interpretation. The words selected by the Legislature do not indicate that the insurer must deny liability altogether for the quoted language to apply. Rather, the insurer is free to deny liability for certain "facts or allegations." For example, in a title action, the insurer could deny liability for any loss caused by the state asserting an unrecorded interest in the insured's property by operation of law.¹⁹⁷ Whether the state has asserted such an unrecorded interest in the insured's property is a question of fact. The insurer can deny liability for loss if that fact is found. No conflict of interest arises because counsel cannot affect the existence or non-existence of such a fact.

The second interpretation, which allows the insurer to deny liability for certain facts, is consistent with the conflict of interest definition of the statute¹⁹⁸ and the reasoning of California courts.¹⁹⁹

How the denial of coverage as to certain "allegations" would operate is troublesome. For example, a plaintiff may bring an action for libel against a private citizen, the insured. The plaintiff alleges that the insured acted with malice. If the insurer denies

193. See *supra* text accompanying notes 151-156.

194. Kennerson, *A Redefinition of Conflict of Interest Part II: The Law and Its Effect*, TRIAL BAR NEWS, July/Aug. 1988, at 14 (San Diego Trial Lawyers Association).

195. CAL. CIV. CODE § 2860(b) (Deering Supp. 1988).

196. *Id.*; Mazarella, *supra* note 140.

197. *Native Sun Inv. Group v. Tigor Title Ins. Co.*, 189 Cal. App. 3d 1265, 235 Cal. Rptr. 34 (1987).

198. When an insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim, a conflict of interest may exist. CAL. CIV. CODE § 2860(b).

199. *Native Sun*, 189 Cal. App. 3d at 1277, 235 Cal. Rptr. at 40.

coverage if malice is found, the situation fits squarely into the coverage “issue” language of the conflict definition.²⁰⁰ It would seem that when the insurer denies liability as to certain “allegations,” insurance defense counsel would be back in the situation of defending a case with both covered and uncovered claims alleged. In this case, the insurance defense counsel would have a conflict of interest.²⁰¹ This problem can be averted by referring to the rules of pleading. Because a plaintiff’s allegations consist of “facts” stating a cause of action,²⁰² “allegations or facts” should be read as being synonymous. Thus, denial of coverage as to certain facts or alleged facts would harmonize well with existing law.

Although this broader interpretation of the first line of Section 2860(b) seems supported by case law,²⁰³ it is not without problems. For such an interpretation to be practically applied, a standard must be set which distinguishes between “allegations or facts” and “issues.” At one time a great number of cases were argued distinguishing between factual allegations, evidentiary allegations, and conclusory allegations under the Field Code; without consistent results.²⁰⁴ Similarly, imaginative lawyers can now dispute whether an insurer is denying coverage of a fact, or reserving its rights on an issue.²⁰⁵ Whether a dispute is over “facts” or “issues” is probably a matter of degree only; nice distinctions may be drawn, but decisions will likely be inconsistent.

Thus, the first line of 2860(b) is ambiguous and a likely source of litigation for attorneys with fertile imaginations; nonetheless, a larger dispute may arise from the last sentence of Section 2860(b).

2. *Punitive Damages*—The last sentence in Section 2860(b) states: “No conflict of interest shall be deemed to exist as to allegations of punitive damages or be deemed to exist solely because

200. See *Nike, Inc. v. Atlantic Mut. Ins. Co.*, 578 F. Supp. 948 (N.D. Cal. 1983).

201. *Navy Fed. Credit Union v. Cumis Ins. Soc’y*, 165 Cal. 3d 358, 208 Cal. Rptr. 494 (1984).

202. CAL. CIV. PROC. CODE § 425.10 (Deering Supp. 1988).

The federal rule does not require “facts” at all, but only a short, plain statement of the claim. FED. R. CIV. P. Rule 8(a).

203. *McGee v. Superior Court*, 176 Cal. App. 3d 221, 221 Cal. Rptr. 421 (1985); *Native Sun Inv. Group v. Ticor Title Ins. Co.*, 189 Cal. App. 3d 1265, 235 Cal. Rptr. 34 (1987).

204. 4 B. WITKIN, CALIFORNIA PROCEDURE §§ 332, 338, 341, 346 at 381-400 (3d ed. 1985).

205. “In the wake of *Cumis* some carriers have so limited the extent to which they formally reserve the right to assert coverage defenses that they retain ‘supervisory counsel’ purely for the purpose of dealing with coverage communications in an attempt to avoid retention of *Cumis* counsel.” CALIFORNIA INSURANCE LAW AND PRACTICE, *supra* note 11, § 13.03(2)(b) at 13-24.8.

an insured is sued for an amount in excess of the insurance policy limits.”²⁰⁶

The statement that “no conflict of interest shall be deemed to exist as to allegations of punitive damages” is much too broad. As discussed above,²⁰⁷ punitive damages allegations may give rise to various conflicts at the discovery, settlement, and trial phases of the proceeding. Unless the Legislature intends this section to amend the rules of professional conduct, this definitional negation of a conflict of interest is meaningless.²⁰⁸

Another anomaly in this portion of part (b) is that at the same time the Legislature enacted Section 2860,²⁰⁹ it amended California Civil Code Section 3294.²¹⁰ Section 3294 determines when exemplary damages may be allowed. It allows such damages only if there is clear and convincing evidence that the defendant is guilty of oppression, fraud, or malice. The section defines malice as con-

206. CAL. CIV. CODE § 2860(b) (Deering Supp. 1988).

207. See *supra* notes 92-96 and accompanying text.

208. See *infra* note 214 and accompanying text.

209. CAL. S.R. 241, 1987-88 Reg. Sess., 1987 Stats Ch. 1498 §§ 4-5.

210. CAL. CIV. CODE § 3294 (Deering Supp. 1988). Exemplary damages; when allowable; definitions

(a) In an action for the breach of an obligation not arising from contract, where it is proven by clear and convincing evidence that the defendant has been guilty of oppression, fraud, or malice, the plaintiff, in addition to the actual damages, may recover damages for the sake of example and by way of punishing the defendant.

(b) An employer shall not be liable for damages pursuant to subdivision (a), based upon acts of an employee of the employer, unless the employer had advance knowledge of the unfitnes of the employee and employed him or her with a conscious disregard of the rights or safety of others or authorized or ratified the wrongful conduct for which the damages are awarded or was personally guilty of oppression, fraud, or malice. With respect to a corporate employer, the advance knowledge and conscious disregard, authorization, ratification or act of oppression, fraud, or malice must be on the part of an officer, director, or managing agent of the corporation.

(c) As used in this section, the following definitions apply:

(1) “Malice” means conduct which is intended by the defendant to cause injury to the plaintiff or despicable conduct which is carried on by the defendant with a willful and conscious disregard of the rights or safety of others.

(2) “Oppression” means despicable conduct that subjects a person to cruel and unjust hardship in conscious disregard of that person’s rights.

(3) “Fraud” means an intentional misrepresentation, deceit, or concealment of a material fact known to the defendant with the intention on the part of the defendant of thereby depriving a person of property or legal rights or otherwise causing injury.

(d) Damages may be recovered pursuant to this section in an action pursuant to Section 377 of the Code of Civil Procedure or Section 573 of the Probate Code based upon a death which resulted from a homicide for which the defendant has been convicted of a felony, whether or not the defendant died instantly or survived the fatal injury for some period of time. The procedures for joinder and consolidation contained in Section 377 of the Code of Civil Procedure shall apply to prevent multiple recoveries of punitive or exemplary damages based upon the same wrongful act.

(e) The amendments to this section made by Senate Bill No. 241 of the 1987-88 Regular Session apply to all actions in which the initial trial has not commenced prior to January 1, 1988.

duct intended to cause injury or despicable conduct carried on with willful and conscious disregard of the rights or safety of others. This section thereby limits punitive damages to those situations where a defendant's conduct would fall into the willful or intentional acts exclusions of most policies.²¹¹ Thus, whenever a plaintiff alleges punitive damages based on malice, he is alleging that the conduct complained of is not covered by insurance. The Legislature's negating a conflict of interest as to allegations of punitive damages while redefining the conduct eliciting such damages so as to mimic exclusion clauses is, at best, puzzling, if not suspect.²¹²

This portion of part (b) can be easily remedied to avoid its conflict with the Code of Professional Conduct and the conflict of interest decisions of the judiciary by amending it to read:

No conflict of interest shall be deemed to exist *solely* because there are allegations of punitive damages.

With this small amendment, the Legislature would reflect the conclusions of California courts which indicate that punitive damage allegations do not, as a matter of law, create a conflict of interest,²¹³ but that the factual or procedural posture of the case may give rise to a conflict of interest on allegations of punitive damages.

To the extent that the statute seeks to negate judicially defined conflicts of interest, it is void. Judicial control of the conduct of attorneys takes precedence over legislative.²¹⁴ This is because the

211. Even if not specifically stated, an implied exclusion in every policy is contained in California Insurance Code Section 533: "An insurer is not liable for a loss caused by a willful act of the insured. . . ." For typical insurance contract language, see *supra* note 25.

212. See Cox, *supra* note 5.

213. Gray v. Zurich Ins. Co., 65 Cal. 2d 263, 279 n.18, 54 Cal. Rptr. 104, 114, 419 P.2d 168, 178 (1966); Ziemann Mfg. Co. v. St. Paul Fire & Marine Ins. Co., 724 F.2d 1343 (9th Cir. 1983).

214. Admission to practice law is almost without exception conceded to be the exercise of a judicial function. It is one of the inherent powers of the court. *Brydonjack v. State Bar*, 208 Cal. 439, 281 P. 1018 (1929). However, the court has recognized the Legislature's right to impose reasonable restrictions upon the practice of law. *Cohen v. Wright*, 22 Cal. 293 (1863). Furthermore, the manner, terms, and conditions of admission to practice and of attorney's continuing in practice, as well as their powers, duties, and privileges, are proper subjects of legislative control. *Ex parte Yale*, 24 Cal. 241 (1864). In sum, the Legislature may pass on matters within the jurisdiction of the judiciary provided it does not materially impair the exercise of those functions. *Brydonjack*, 208 Cal. at 444, 281 P.2d at 1020. Nonetheless, the disciplining of attorneys has been left to the judiciary, *Brotsky v. State Bar*, 57 Cal. 2d 287, 19 Cal. Rptr. 153, 368 P.2d 697 (1962), and the judiciary retains substantial and inherent power to regulate the conduct of members of the profession. *Ramirez v. State Bar*, 28 Cal. 3d 402, 169 Cal. Rptr. 206, 281 P.2d 1020 (1980). In fact, the rules of conduct drafted by the state bar and approved by the California Supreme Court is an act of the judiciary, not the Legislature. *Barton v. State Bar*, 209 Cal. 677, 289 P. 818 (1930). This is an exercise of the court's inherent power to control the courts—an outgrowth of the definition of judicial power, "such inherent and implied powers as it is

inherent power of the judiciary to control its proceedings and officers of the court extends to rules of attorney conduct.²¹⁵ Although the State Legislature and State Bar have roles in the determination of appropriate professional conduct of attorneys, the ultimate arbiter is the judiciary.²¹⁶ Thus, it seems the Legislature's attempt to negate that which the judiciary has declared a conflict of interest usurps the power of the judiciary and violates the separation of powers delineated in the Constitution of the State of California.²¹⁷

D. *Independent Counsel's Duty to Insurer?*

After the Legislature provides a statutory right to independent counsel due to a conflict of interest, it reduces counsel's independence by creating duties owed by counsel to the insurer. Parts (d) and (f) of Section 2860 require independent counsel to disclose information to the insurer,²¹⁸ to inform and consult with the insurer²¹⁹ and to allow retained counsel to participate in all aspects of the litigation.²²⁰

1. *Duty to Disclose Information*—The new statute requires independent counsel to disclose to the insurer, "all information concerning the action except privileged materials relevant to coverage disputes."²²¹ This provision is an affront to the attorney-client relationship. It requires the independent counsel to violate statutory duties²²² as the attorney for the insured, and it may reduce the effectiveness of independent counsel.

This provision creates an absurd situation. When independent counsel is retained by the insured, counsel "must impress upon the client that the lawyer cannot adequately serve the client without knowing everything that might be relevant to the client's problems and that the client should not withhold information that the client

necessary for them (the courts) to possess in order to properly and effectively function as a separate department in the scheme of our state government." *Brydonjack*, 208 Cal. at 42, 218 P. at 1020. To the extent that the Legislature is attempting to prevent the courts from determining what constitutes a conflict of interest, or preventing an attorney from representing multiple clients before the court, the Legislature is materially interfering with the court's power to control the proceedings before it. To that extent, Section 2860(b) is unconstitutional.

215. See State Bar Act, CAL. BUS. & PROF. CODE §§ 6000-6228 (Deering 1976 & Supp. 1988).

216. See *supra* note 214.

217. CAL. CONST. art. VI, § 1. See *supra* note 214.

218. See *supra* note 147.

219. See *supra* note 147.

220. See *supra* note 147.

221. CAL. CIV. CODE § 2860(d).

222. CAL. BUS. & PROF. CODE § 6068(e).

might think is embarrassing or harmful to the client's interest."²²³ Then the attorney must inform the insured of the obligation to tell the insurer those embarrassing confidences, if relevant to the action.

As noted above, the attorney-client relationship is one of special trust and confidence.²²⁴ The need for an attorney to know sensitive and confidential information is recognized by the attorney-client privilege²²⁵ and the attorney's duty of confidentiality. California has stated the attorney's duty of confidentiality in very strong terms: "It is the duty of an attorney to do all of the following: . . . (e) to maintain inviolate the confidences, and at every peril to himself to preserve the secrets of his or her client."²²⁶ It is "misconduct" for an attorney to divulge a client's confidence.²²⁷ The ABA Code considers even the indirect disclosure of a client's confidence a sufficient violation of professional conduct as to warrant discipline.²²⁸ Nonetheless, Section 2860 requires the attorney to disclose to the insurer "all information relevant to the action." This encompasses not only confidences and secrets, but privileged communications as well, and is emphasized by the narrow exception to the requirement. Independent counsel need not disclose "privileged information relevant to coverage disputes."

The language of part (d) could not be stronger; it obliges counsel and the insured to divulge all relevant information to the insurer unless that information is both privileged and related to the coverage dispute. Furthermore, Section 2860(d) allows the insurer to obtain an *en camera* review of any material claimed to be privileged under this section.

This provision ignores reality and requires independent counsel to violate his duty of client confidentiality. The section does not explain why the insurer is entitled to such broad disclosure. Once the insured has elected to receive independent counsel, the insurer loses the right to control the litigation.²²⁹ Once a conflict arises and the insured refuses to waive the conflict, retained counsel is required by the ABA Code and decisions of California courts to withdraw from representing the insured.²³⁰ Thus, the broad disclosure is not necessary to allow retained counsel to perform com-

223. ABA CODE, *supra* note 57, DR 4-101(B).

224. *See supra* note 109.

225. CAL. EVID. CODE § 954 (Deering 1986).

226. CAL. BUS. & PROF. CODE § 6068(e).

227. *Pennix v. Winton*, 61 Cal. App. 2d 761, 143 P.2d 940 (1943).

228. ABA CODE, *supra* note 57, DR 4-101.

229. *Tomerlin v. Canadian Indem. Co.*, 61 Cal. 2d 638, 39 Cal. Rptr. 731, 394 P.2d 571 (1964).

230. *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y*, 162 Cal. App. 3d 358, 375, 208 Cal. Rptr. 494 (1984).

petently.²³¹ Additionally, information relevant to liability and settlement value could be provided to the insurer by independent counsel after counsel removes or edits the client's secrets and confidences without affecting the value of the information. Therefore, the insurer does not need this broad scope of disclosure to protect the interests of the insured.

This broad duty to disclose must therefore protect some interest of the insurer. Because this provision arguably provides open access to the attorney's files, it may help the insurer to detect collusive lawsuits and "bill padding." It could help detect collusive suits by allowing the insurer to see attorney correspondence with whomever the attorney is colluding with. It may help detect padded bills by allowing the insurer to audit the file to assess whether the file contains those things for which the insurer paid. These are valuable and appropriate rights of the insurer.

But, detection of dishonest counsel does not justify requiring the secrets of the insured to be divulged to someone with whom the client has not established a "confidential relationship in the highest sense."²³²

One of the reasons for the right to independent counsel is to encourage the confidential disclosure of information that would be curtailed by dual representation.²³³ This provision thereby discounts the value of having independent counsel.

Furthermore, this section creates a conflict of interest for independent counsel. It is counsel's ethical and statutory duty to protect the confidences of his client at all harm to himself. Now, it is counsel's duty to divulge those confidences to the insurer. If counsel does not divulge the information, the insurer is entitled to demand it. The judge applying this section may order it divulged, and the attorney faces contempt charges for refusing. The attorney then faces the possibility of both jail and disbarment. Should the attorney protect the client's rights or his own? This too is a conflict of interest!

2. *Duty to Inform & Consult*—Independent counsel must "timely inform and consult the insurer on all matters relating to

231. The scope of disclosure to retained counsel is limited to that which is "consistent with each counsel's ethical and legal obligation to the insured." CAL. CIV. CODE § 2860(f). Thus, the independent counsel must disclose to retained counsel much less than he must disclose to the insurer.

232. See, e.g., *Beeks v. State Bar*, 35 Cal. 2d 268, 217 P.2d 409 (1950); *Tomblin v. Hill*, 206 Cal. 689, 275 P. 941 (1929); *People v. Allied Architects Ass'n*, 201 Cal. 428, 257 P. 511 (1927).

233. See *supra* notes 110-12 and accompanying text.

the action.”²³⁴ This duty, by itself, is not objectionable. It merely codifies a duty to cooperate with the insurer in settlement and defense of the claim.²³⁵ The possibly offensive nature of this provision depends on the scope of the duty; if construed too broadly, it may interfere with the attorney’s representation of the insured. For example, in a recent case²³⁶ the insurer issued a reservation-of-rights letter, and sought to intervene in the liability action in order to litigate policy defenses. Independent counsel opposed the intervention and obtained a writ of mandate requiring the superior court to vacate its order allowing the intervention.²³⁷ To what extent must independent counsel inform and consult with the insurer on the attorney’s decision, reasoning, and argument when the insurer is adversarial? The scope of this duty must be kept appropriately narrow. The answer to this question must await development through litigation.

One provision of Section 2860 that actually does clarify a conflict of interest issue is the provision in part (d) which provides that information disclosed by the insured or his independent counsel does not waive any privilege as to any other party.²³⁸ Although this does not eliminate conflicts centered on confidentiality,²³⁹ it does make the conflicts easier to recognize and resolve. It also helps to reconcile the insured’s duty to cooperate with the insurer with the attorney-client privilege. The rest of Section 2860 does not impact on attorney conflicts of interest.

CONCLUSION

Even after the enactment of Civil Code Section 2860, and perhaps because of it, there will be disputes as to when an attorney retained by an insurance company to represent both the insured and the insurance company has a conflict of interest. The law concerning when a conflict of interest arises was fairly clear before enactment of Section 2860. However, the application of prior case law by imaginative and aggressive lawyers was questionable. The Civil Code section has crystallized the general definition:

234. CAL. CIV. CODE § 2860(d).

235. See *supra* note 105.

236. Kuperstein v. Superior Court, 88 Daily Journal D.A.R. 11810 (Sept. 16, 1988).

237. *Id.*

238. Arguably, this provision merely applies CAL. EVID. CODE § 962 (Deering 1986) which provides that joint clients may not assert the attorney-client privilege against each other in subsequent litigation. By negative implication it remains intact against third parties. However, there had been some confusion as to whether supplying information to the insurer was different from confiding in retained counsel. See, e.g., American Mut. Liab. Ins. Co. v. Superior Court, 38 Cal. App. 3d 579, 113 Cal. Rptr. 561 (1974).

239. See *supra* note 221 and accompanying text.

[W]hen an insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by counsel . . . retained by the insurer for the defense of the claim, a conflict may exist.²⁴⁰

When the described situation appears, retained counsel must fully disclose the possible conflict and its consequences to the insured. Unless the insured intelligently and expressly waives the conflict, the attorney may not represent the insured. The duty to defend and Section 2860 require the insurance company to pay for independent counsel.

However, Section 2860 has raised new issues that will probably result in a great deal of litigation. These issues relate to the meaning, affect, and validity of certain provisions of Section 2860. Language in Section 2860 casts doubts as to when conflicts arise, as well as when the right to independent counsel vests. These questions are easily answered, and will most likely be answered by harmonizing the statutory language with the judicial decisions concerning the insurer-attorney-insured conflict.

Perhaps the greatest problems in construing and applying this statute are within Section 2860(b). The Legislature seems to draw fine distinctions between “denying liability for facts” and “reserving rights as to coverage issues.” Rather than clarifying the conflict of interest dispute, this fine distinction will force attorneys into more motions and declaratory relief proceedings to draw the dubious boundary between “facts” and “issues.” Furthermore, fine distinctions provide a playground for agile legal minds. The statutory language is as likely to be abused by some attorneys as was done with the language of the cases the statute tried to clarify.

Additionally, Section 2860(b) attempts to apply wooden definitions to negate conflicts of interest regarding punitive damages. Wooden definitions have no place in ethical determinations. A conflict may or may not exist when punitive damages are alleged depending on the facts, circumstances, and procedural background of the case. Conflicts, like all ethical determinations, are rarely black and white. Rather, they require a sensitive balancing of risks, harms, and probabilities—a matter suited to the judiciary and inherent in its power to control the proceedings and officers before the court.

Additionally, Section 2860 establishes duties that independent counsel owe to the insurer. The statute provides little guidance for determining the scope of these duties. The statutory duty to disclose information to the insurer appears much too broad. It seems

240. CAL. CIV. CODE § 2860(b) (Deering Supp. 1988).

to violate the attorney-client relationship and damage the effectiveness of independent counsel. Although some duty of disclosure may be appropriate, the statute's demand that attorneys violate their duty of confidentiality to the client creates the absurd result of a conflict of interest for the "independent" counsel.

Finally, Section 2860 requires independent counsel to consult with the insurer. This is appropriate to some extent. However, the scope of the duty is unclear. It is particularly bothersome when the insurer conducts itself as an adverse party.

Overall, Section 2860 is replete with problems of compromised legislation. It is unclear, ambiguous, and certain to create more litigation than it averts. These provisions attempt to apply a wooden definitional standard as to what does not amount to a conflict of interest. These parts are shortsighted and contradict many years of judicial decision and ethical commentary. Harmonizing construction and minor amendment of these parts will accomplish clarification of this area of law, while still allowing the flexibility of judgment and sensitivity to the case posture necessary to all ethical determinations.

