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From the Chair

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Elaine M. Pohl

I hope the summer finds you all well. I have several exciting developments to report in this issue.

Annual Meeting and Program

A 360 Degree Perspective on Reforming Auto Insurance in Michigan: Can we find any Common Ground in the No-Fault Debate?

This year's Annual Meeting will take place at the Lansing Center, and our Section meeting and program will take place on Thursday, September 19 at 10:00 a.m.

Probably no topic in insurance law creates as much interest – and as much passion and confusion – as the proposed reforms to Michigan's No-Fault law. That is why we chose it as our program topic for this year. Thanks to Chair Elect Kathleen Lopilato and our Programs Committee, it promises to be a great event.

As you know, our Section never takes a position on insurance issues in favor of either insureds and claimants or insurers. The purpose of our Section is to serve as a forum for the exchange of information. So, for our program, we plan to present the views of those who favor reform and those who oppose it. Come join us and express your views. Even if you don't practice in the area of No-Fault, this should be a lively debate and we hope to see you there.

We have scheduled a special council meeting on August 20 in order to confirm our plans for the meeting.

Membership Directory Project

In the last issue, I explained our project to set up a directory of all of our members. The directory will be searchable, so that members with expertise in certain areas will be able to list that expertise, and other relevant information. Other attorneys, both in our Section, and State Bar members generally, will then be able to access the directory and search for Section members with the relevant expertise.

We have now received final approval from the State Bar, and we have hired a contractor to create the database that will gather the information for the searchable member directory. Our council voted unanimously to proceed with the project.

In the coming months, as the directory takes shape, each of you will receive notice and an invitation to fill out the data collection form and return it for uploading in the directory. This searchable directory is a member benefit that no other Section has.

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Cumis Counsel: A Better Choice for Michigan

By J. Joseph Sadler, *Warner, Norcross and Judd LLP*

Introduction

This article concerns conflicts of interest between an insured person, his liability insurer, and the defense counsel appointed by the insurer to defend him. Under ordinary circumstances, an insurer has a contractual "right and duty" to defend the insured from covered claims, meaning that the insurer gets to select defense counsel for the insured and gets the final word on most litigation decisions. In most states, this right is not absolute, and may be forfeited because of conflicts of interest. While Michigan's Supreme Court has characterized the insurer/insured/appointed lawyer relationship as "rife" with the "possibility of conflict,"[1] it has not yet adopted a rule requiring an insurer to relinquish control of the defense in conflict situations.

The most well-known and well-litigated conflicts of interest involve those situations where "the interests of the insurer would be furthered by providing a less-than-vigorous defense."[2] Courts have found the insurer's interest lacking in many situations, of which the below are the most common.

- An insurer assumes the duty to defend, but denies indemnity outright and files a parallel declaratory judgment action seeking a declaration that it has no duty to indemnify the insured.
- The insurer reserves the right to deny indemnity on the basis of an exclusion, and retains control of the defense, when the applicability of the exclusion may be determined by facts adduced in the underlying case.
- The insurer assumes the defense when the amount of covered damages is likely very small, but the uncovered damages (such as punitive damages) are quite large.

In these situations, the insurer's interests are so divergent that it must yield control of the defense to the insured, including forfeiting its right to select counsel. This rule is frequently called the *Cumis* counsel rule, named after the well-known case of *San Diego Navy Federal Credit Union v Cumis Ins Soc, Inc.*[3] In *Cumis*, the insurer assumed the duty to defend all claims against the insured, including a claim for punitive damages.[4] However, it reserved the right to deny coverage at a later date, and specifically disclaimed coverage for punitive damages.[5] Because the insurer's liability might rest on conduct excluded by the policy, the court concluded that the appointed lawyers might reasonably act for the benefit of the insurer instead of the insured, such as by seeking special verdict forms that would make the insurer's disclaimer of coverage more likely to succeed.[6] Under such circumstances, the insurer cannot control the litigation.[7] One aspect of the insurer's control is the right to select counsel, which must also be relinquished.[8]

At this time, Michigan courts do not follow the *Cumis* counsel rule. The state appellate courts have been silent, while those federal cases to have addressed the issue appear to reject *Cumis*. The purpose of this article is to argue for a re-examination of the *Cumis* rule in Michigan, and propose that it be adopted.

In *Cumis*, the insurer assumed the duty to defend all claims against the insured, including a claim for punitive damages. However, it reserved the right to deny coverage at a later date, and specifically disclaimed coverage for punitive damages. Because the insurer's liability might rest on conduct excluded by the policy, the court concluded that the appointed lawyers might reasonably act for the benefit of the insurer instead of the insured

The State of Michigan's Law

There are no modern Michigan appellate court decisions on point. Two federal district court cases in Michigan have acknowledged the problems of the *Cumis* situation (directing a defense while reserving rights under one or more exclusions) but have not provided clear guidance on how to address them.

In *Federal Ins Co v X-Rite, Inc*,[9] the issue was presented to the court in an unsatisfying way. There, X-Rite had already selected defense counsel prior to tendering the claim to the insurer. The insurer agreed to defend under a reservation of rights, and attempted to appoint "independent" counsel to defend X-Rite.[10] However, X-Rite completely ignored the insurer and continued to control the litigation through their chosen lawyers. After it had settled the case, X-Rite tendered its attorneys' fees to the insurer and argued that they should be paid because of the conflict of interest, which required the insurer to relinquish its right to choose counsel.

The court found this argument unpersuasive, particularly because X-Rite made no effort to ascertain whether appointed counsel was indeed biased in favor of the insurer.[11] Instead, X-

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Rite's sole complaint seemed to be that appointed counsel was inferior to its chosen lawyers. The court concluded that, under the facts of the case, the insurer remedied any conflict by appointing "independent" counsel of its choice. Having failed to develop evidence that the appointed lawyer was not "independent," the insured was unable to convince the court that the putative conflict was sufficient to divest the insurer of the right to choose counsel. Accordingly, the court held that "under the present facts" X-Rite had no right to counsel of its choice.[12]

Likewise, the insured in *Central Michigan Board of Trustees v Employers Reinsurance Corp*,[13] seemed not to care about the "independence" of appointed counsel, but rather objected because he believed that his own lawyer could do better. There, the insured doctor was accused of inappropriate sexual contact with the plaintiff.[14] The insured had been defended in pre-suit administrative proceedings by counsel of his choice, who obtained a good result.[15] Upon suit being filed, the insurance company reserved rights on the basis of an intentional acts exclusion and appointed a different lawyer to defend the insured. The insured declined the representation and proceeded with the litigation with his previous lawyer.

The court agreed that the reservation of rights created a conflict of interest, but held that it did not require the insurer to accept counsel chosen by the insured.[16] Rather, the insurer remedied that conflict by appointing "independent counsel." As in *X-Rite*, the court noted that the insured did not bother to investigate the "independence" of the appointed lawyer, and that he merely questioned that lawyer's competence.[17] The court observed that "any attorney selected by defendant, or anyone else, would not have satisfied [the insured] if it were not the person who successfully represented him at the University's administrative hearing."[18]

These cases did not present strong facts upon which a meaningful discussion of conflicts of interest and the *Cumis* rule could be had. Not only did the insureds fail to develop any evidence regarding the conflict, it appeared to the courts that the conflict of interest issues were pretextual. The insureds in *X-Rite* and *Central Michigan* wanted to be able to choose their own lawyer at the insurer's expense, and sought to exploit the conflict in order to make that possible. The insureds in these cases were, in retrospect, less-than-ideal advocates for the *Cumis* counsel rule. These decisions should not be read as shutting the door forever on *Cumis*, nor does it appear that the courts intended them to be read thusly.

Both *Central Michigan* and *X-Rite* seem to hold, or at least strongly suggest, that conflicts can be cured by providing "independent" counsel that is selected by the insurer. *X-Rite* notes in *dicta* that "independent" counsel would represent only the insured, that it would "direct its efforts only to the best interests" of the insured, and that it would not be involved in coverage issues.[19] The courts did not discuss, however, the kinds of problems that might arise in a conflict scenario, and therefore did not analyze whether "independent" counsel could reasonably address these concerns.

> It would be burdensome for an insured to conduct discovery in order prove that the lawyer retained by the insurer will not provide fair, honest and vigorous representation. Additionally, many insureds probably know very little about the relationship between appointed counsel and the insurer, such that the potential conflict might not even occur to them.

Problems that Might Arise in Conflict Scenarios

Imagine a situation where a department store ("Store") is sued for the misbehavior of a security guard ("Guard"). The allegations are that Guard wrongfully detained a 12-year-old boy on suspicion of shoplifting, and while the boy was in custody, subjected the child to verbal abuse and threats of physical harm. The detention was brief, however, and the child suffered very minimal physical injuries. The vast majority of damages will be for emotional distress and punitive damages (in states allowing punitive damages under these conditions).

Under the CGL policy issued to Store, there are two insureds, Store and Guard. The allegations of the complaint trigger the duty to defend the Guard (false imprisonment, negligent infliction of emotional distress) and the Store (negligent supervision of Guard, vicarious liability). The insurer agrees to defend both parties, while reserving rights on the following issues:

- There is no coverage for punitive damages;
- With respect to Guard, there is an intentional acts exclusion that applies if his conduct is found to be calculated to harm the plaintiff, and
- There is coverage for emotional distress, but only when such distress is directly attributable to otherwise covered bodily injury.

Under these facts, the insurer's likely liability for a verdict is small. It will not pay for punitive damages, and its liability for emotional distress is negligible, as such damage will probably not be connected to bodily injury, and accordingly not covered. Moreover, there is a reasonable chance that the Guard's

behavior may trigger the intentional acts exclusion. These are classic conflict of interest problems.

These conflicts create the possibility of two related problems. One is that retained defense counsel could steer the litigation towards triggering the intentional acts exclusion, defeating coverage for the Guard entirely, and possibly allowing the insurer to withdraw the defense prior to trial. Second, the insurer may neglect the suit and may not allocate sufficient defense resources to it, as it has little (if any) liability for a verdict. In many states, these conflicts would cause the insurer to lose control of the defense, including the right to appoint counsel of its choice.

Presumption in Favor of Retained Counsel

The court in *Central Michigan,* for one, was not convinced that these concerns were significant enough to divest the insurer of the right to select counsel. The court reasoned that all appointed lawyers understand that their principal duty is to the insured, and courts should assume that an "independent" lawyer will never prefer the insurer's interests in a conflict situation. The court credited the affidavit of the appointed lawyer, which affirmed that lawyer's commitment to act in the best interests of the insured, and noted that the insured offered no evidence to the contrary.

First, one might question whether this is a fair presumption in a conflict situation. When a lawyer's loyalty and independence could realistically be questioned, it is not clear why the lawyer's good conduct should be presumed (and not surprising that the lawyer would promise to behave himself). *Central Michigan* suggests that, so long as counsel promises to be independent, the insured must come forward with facts disproving this promise. It would be burdensome for an insured to conduct discovery in order prove that the lawyer retained by the insurer will *not* provide fair, honest and vigorous representation. Additionally, many insureds probably know very little about the relationship between appointed counsel and the insurer, such that the potential conflict might not even occur to them. Merely because the insured is in the dark about a particular conflict of interest does not mean that no danger exists.

Moreover, a presumption of fairness seems unjustified in light of the relationship between appointed counsel and the insurance industry. A liability insurer will very frequently assign the defense of insureds to a small number of pre-approved lawyers or firms, sometimes called "panel counsel." Panel counsels enjoy a symbiotic relationship with the carriers. By virtue of their "panel" status they are eligible to be assigned cases by the insurer, and therefore need only compete with other "panel" firms for assignments. In exchange, they often must perform work at discounted rates and must abide by the insurer's billing guidelines and regulations. The insurers' guidelines for retained counsel (which are often treated as confidential by insurers) can be extensive, and may set limits on things like research time and partner involvement with certain tasks. It is fair to say that these guidelines exist to protect the insurers' interests, not the policyholders'.

For appointed counsel, representation of any individual insured is probably a "one-shot deal." The insured is a stranger to the firm and likely not shopping for new lawyers. The repeat business comes from the insurance company, which often has a long history of assigning cases to the firm.[20] In one hand, there is a client that has provided the firm with years of repeat business and thousands, if not millions of dollars, of billable fees over the years. In the other is an insured that the firm may never see again, and that may be resentful because counsel was chosen over its objection. The potential conflict of interest here is apparent.

There are a multitude of litigation decisions in which appointed counsel may take the insurer's preferences into consideration, to the insured's detriment. While the appointed lawyer is unlikely to openly throw the game to please the insurer, it is very reasonable to wonder whether the lawyer might cut corners in order to appease the entity paying the bills and try to increase the odds of another assignment from the insurance company. This behavior is economically (but not ethically) rational, would be incredibly difficult to detect, and almost impossible to prove. Moreover, once it occurs, the damage to the insured is done, and can only be remedied (if at all) by a malpractice suit.

Thinking back to our hypothetical, imagine that counsel must decide whether to hire an expert psychologist to undermine the emotional damages component of the case. The cost would be $100,000. There are pros and cons to hiring the expert, and either decision could be reasonably justified (meaning that the decision would not subject the lawyer to malpractice). However, counsel believes that the expert's testimony may link the emotional distress to the (minimal) physical damage, making it substantially more likely that the insurer would be liable for any emotional distress damages. More, counsel's experience suggests that the insurer would not approve of hiring an expert in these circumstances, and fears that too much hiring of expensive experts will result in a loss of work for his firm. Is it unreasonable to wonder if counsel's concerns will color his decision making with respect to this expert?

This is not meant to besmirch any attorney, panel counsel or otherwise, appointed by an insurance company. Certainly, it is true that most lawyers will try their absolute best to render unbiased representation to the insured, consistent with their ethical obligations. But the fact remains that temptations do exist, and human nature and experience suggest that someone will give in to them. In light of this, the

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question then becomes: what is the best way to remedy the problem?

Bright-Line Rules Are Best

Ultimately, it is impossible to evaluate the degree to which the judgment of any appointed counsel will be affected by loyalty to the insurance company; it is a fact-and-lawyer-specific inquiry. The court in *Central Michigan* cut this Gordian knot by simply crediting the appointed lawyer's assurances of good behavior and requiring the insured to adduce evidence to the contrary. As argued above, placing the burden of proof on the insured seems unfair. It is the policyholder that needs protecting from conflicts of interest, and it is the insurance company and appointed counsel that are in possession of all the relevant information concerning conflicts of interest. It is questionable whether the policyholder should be tasked with the burden of prying this information from the insurer and counsel, at the very time when these entities are supposed to be protecting the insured in the underlying lawsuit.

Cumis and its progeny resolve the problem by promulgating a bright line prophylactic rule: when a conflict of interest exists, the insurer must yield control of the defense, including by accepting the insured's counsel of choice. It is submitted that this is a preferable way of addressing the conflict. It resolves all doubts by assuring non-conflicted representation to the insured. It reduces litigation and debates concerning the relative "independence" of any specific lawyer or firm, which is inherently difficult to prove in any event. It also promotes the integrity of the judicial system by minimizing even the appearance of impropriety.

The most frequent response, and the concern that motivates many courts, is that the insured gave up its right to control the defense when it purchased a "duty to defend" policy, and that it has either contracted away its right to object, or implicitly assumed the risk of a conflicted representation. This response is unsatisfactory for several reasons.

First, the "right and duty to defend" language is very standard and usually silent about the possibility of a conflict of interest. There is seldom, if ever, policy language that establishes how such conflicts are to be resolved. This is a foreseeable coverage issue that could be addressed in the policy language with specificity. In most other coverage disputes, an ambiguity is resolved against the insurer. Absent very clear language waiving the right to object to conflicted counsel, it is hard to see why an insured should be deemed to have "contracted away" that right.

Second, it assumes a level of sophistication that most purchasers of insurance simply do not have. Typical policyholders know next to nothing about conflicts of interest, panel counsel fees, or the impact of coverage exclusions. They are individuals, families and small businesses that buy an insurance policy with the basic understanding that, for covered claims, the insurance company will defend them. The idea that the insurance company could furnish counsel that would not represent them faithfully is simply outside the knowledge and experience of the typical insurance consumer.

Third, conflicts of interest implicate more than merely the contractual relationship between the parties. Rather, they involve issues of lawyer conduct and the integrity of the judicial system. The Michigan Rules of Professional Conduct do not allow lawyers to accept conflicted representations absent, at minimum, full disclosure to the client and the client's consent.[21] It is hard to see how the client's "consent" to the conflicted representation can be meaningful if it is not allowed the option to select other counsel.

Under the rule suggested by *Central Michigan*, a client can either accept the "independent" counsel provided by the insurer, or it can forfeit the protections of its insurance policy and pay for the defense itself (assuming it can). It is a stretch to say that the client's consent is meaningful under these circumstances. Allowing insurance companies to force objectionable counsel on insureds, when the alternative is a forfeiture of coverage, creates considerable tension with the Rules of Professional Conduct. It also elevates the insurance contract above the Rules, allowing lawyers to disregard the "consent" requirement by assuming that, because the client purchased a standard liability insurance policy, it implicitly "consented" to any conflict.

In most other coverage disputes, an ambiguity is resolved against the insurer. Absent very clear language waiving the right to object to conflicted counsel, it is hard to see why an insured should be deemed to have "contracted away" that right.

It could also be argued that, if defense counsel could prove that it is truly "independent," meaning having no previous allegiance or entangling relationship with the insurance company, there is nothing more the insured could realistically ask for. The answer is this: if the insurer indeed has no significant prior experience with the firm in question, it is essentially picking a lawyer based on marketing, hearsay or guesswork. In such circumstances, why shouldn't the law prefer the insured's

selection instead? For example, in *Central Michigan*, the insured's preferred lawyer had already achieved a good result in pre-suit hearings and was familiar with the evidence that the plaintiff would offer. Nothing in that opinion suggests that the appointed lawyer was superior in any way to the one that the insured chose and had used with success. If the insurer is picking from a lineup of unfamiliar lawyers, and the insured already has a competent firm that it is comfortable working with, it is hard to articulate any real harm to the insurer when it does not get its way. Why should the law compel the use of a lawyer with whom neither party is familiar? ■

About the Author

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Endnotes

1 *Atlanta Int'l Ins. Co. v. Bell*, 438 Mich. 512, 519 (1991).

2 *Nandorf, Inc v CNA Ins Co*, 479 NE2d 988, 992 (Ill App 3d Div 1985)

3 *San Diego Navy Fed. Credit Union v Cumis Ins Soc, Inc.*, 162 Cal App 3d 358 (1985).

4 *Id.* at 361-2.

5 *Id.* at 362.

6 *Id.* at 365.

7 *Id.* at 369.

8 *Id.*

9 *Federal Ins Co v X-Rite, Inc.*, 748 F Supp 1223 (WD Mich. 1990).

10 *Id.* at 1225.

11 *Id.* at 1228.

12 *Id.* at 1229.

13 *Central Michigan Board of Trustees v Employers Reinsurance Corp*, 117 F Supp 2d 627 (ED Mich 2000)

14 *Id.*, 117 F. Supp. 2d at 629.

15 *Id.* at 630.

16 *Id.* at 634-5.

17 *Id.* at 635.

18 *Id.*

19 748 F. Supp. at 1228, n. 1.

20 *See generally Cumis*, at 364.

21 MRPC 1.7(b)(1-2).