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The other tripartite relationship

WHEN A CARRIER AGREES TO DEFEND UNDER RESERVATION OF RIGHTS: RULE 3-310

Almost all attorneys know liability insurers rarely agree to acknowledge coverage and to defend and indemnify an insured. Typically a response to a tender of litigation is a letter reserving the insurer's right to assert coverage defenses should the facts, as known and as developed, establish such defenses. The attorney chosen to defend the insured plays a significant role in turning the potential of coverage – which resulted in a defense being provided – into actual settlement authority at the proper time.

Defense counsel, as the primary source of the insurer's information about the case, colors the insurer's view of the case, from status reports to legal analyses to litigation tactics. When a carrier agrees to defend under a reservation of rights, and appoints defense counsel, there are things insureds can do to protect themselves from the reality that the lawyer appointed by the insurer has a preexisting relationship with the insurer. The insured usually has no idea of the depth of that relationship.

While an insurer has the duty to notify the insured it may be entitled to choose its own attorney at the insurer's expense, it is more frequently the case that it will simply select the attorney from its panel of lawyers, or its staff counsel, and tell the insured. Obtaining Rule 3-310 information is the key to enforcing the insured's rights to *Cumis* (independent) counsel, who is the lawyer loyal to and only representing the insured.

Section 2860 cannot constitutionally stop a court from controlling its officers

An insurer is wrong in insisting that Civil Code § 2860 is the last word on appointing defense counsel. Rule 3-310 of the California Rules of Professional Conduct and the common-law fiduciary duty of loyalty require the appointee give the prospective client copies of Rule 3-310 information and written disclosures. Only then can the insured make an informed decision about whether it accepts the appointee as its counsel, and give its written informed consent. The integrity of the system, let alone the public's trust in it, requires no less.

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Section 2860 cannot constitutionally be applied to immunize defense counsel from ethical duties imposed by common law and Rule 3-310. Any interpretation that exempts a lawyer from making disclosures to client-insureds would not only violate the separation of powers, it would be discriminatory. The law requires all similarly situated clients be equally protected by fiduciary attorney disclosures.

> "Case law has interpreted this rule [3-310(C)], and its predecessors, to prohibit attorneys, without consent, from representing not only clients with conflicting interests in particular matters of representation, but also to prohibit attorneys from accepting employment adverse to a client even though the employment is unrelated to the representation of the current client. [Citation.] . . . [Citation.] . . . The rationale for these rulings was the maintenance of the attorney's 'duty of undivided loyalty,' without which 'public confidence in the legal profession and the judicial process' is undermined."

(*Santa Clara Co. Counsel Attys. Assn. v. Woodside* (1994) 7 Cal.4th 525, 544, fn.6.)

Rule 3-310's duties to disclose embody a lawyer's parallel and concurrently applicable common law fiduciary duty of loyalty.

> "The attorney's duty of loyalty to his or her client – the duty central to concurrent representation conflicts – is specified in the California State Bar Rules of Professional Conduct. (Rules Prof. Conduct, rule 3-310(C) & (E); see *City and County of San Francisco v. Cobra Solutions, Inc.* (2006) 38 Cal.4th 839, 846.)"

(*M'Guiness v. Johnson* (2015) 243 Cal.App.4th 602, 614.)

> "It is clear that the duties to which an attorney in this state are subject are not exhaustively delineated by the Rules of Professional Conduct, and that these rules are not intended to supersede common law obligations."

(*Santa Clara, supra,* 7 Cal.4th at 548.)

The judiciary has established *higher* standards of ethical conduct than are required by statutes. Disqualification of counsel not only prevents attorneys from breaching their ethical duties, but also protects the judicial process from any taint of unfairness that might arise from conflicts of interests. Any statute *lowering* those standards interferes with the judiciary's constitutional powers.

> "We recognize that in the field of attorney-client conduct, as in these other areas, this court has the inherent power to provide a higher standard of attorney- client conduct than the minimum standards prescribed by the Legislature. [Citations.] We also recognize that any statute which would permit an attorney to act in such a way as to seriously violate the integrity of the attorney-client relationship, so as to 'materially impair' the functioning of the courts [citation], would be constitutionally suspect."

(*Santa Clara, supra,* 7 Cal.4th at 544.)

Moreover, the client-insured has the right to refuse the appointee if the disclosures are unsatisfactory under Rule 3-310(B).

> "The County is quite correct that the disclosure required by rule 3-310(B) implies the right of the client to dismiss the attorney if it finds the disclosed conflict sufficiently problematic."

(*Santa Clara*, *supra*, 7 Cal.4th at 546, fn.3.)

Public trust in the integrity of the judicial system is primary. That is why no client has an absolute right to any particular attorney; public confidence in the judicial system comes first.

> "The paramount concern must be to preserve public trust in the scrupulous administration of justice and the integrity of the bar. The important right to counsel of one's choice must yield to ethical considerations that affect the fundamental principles of our judicial process."

(*People ex rel Dept. of Corporations v. SpeeDee Oil Change Systems* (1999) 20 Cal.4th 1135, 1145.

Courts can act sua sponte when the appropriate circumstances arise and the impropriety is brought to the court's attention.

> "We deem it appropriate that the court's attention to the applicability of rule 2-111(A)(4), or any other rule of professional conduct, be invited by a party to the proceedings. However, the rule is not intended to personally benefit such other party, or to aid counsel for such other party. The court is charged with taking discretionary action with or without a motion therefor when it is made to appear on considerations affecting an attorney, his client and the public trust . . . ."

(*Comden v. Superior Court* (1978) 20 Cal.3d 906, 915, fn. 3.)

The judiciary is constitutionally authorized to carry out its function of administering justice in an orderly fashion. (Calif. Const., Art. VI, § 1.) The Rules emanate from this power, being the mechanism used to regulate attorneys who are officers of the court.

> "'[M]embers of the bar are *officers of the court* . . . under the constitutional doctrine of separation of powers, the court has inherent and *primary regulatory power*.'"

(*In Re Attorney Discipline System* (1998) 19 Cal.4th 582, 593, original italics.)

Thus a court has inherent authority to disqualify a lawyer and control its proceedings; that power is *not* dependent on any statute: All courts have such equitable, supervisory and administrative powers "which exist apart from any statutory authority. [Citations.] . . . That inherent power entitles trial courts to exercise reasonable control over all proceedings connected with pending litigation . . . ." (*Rutherford v. Owens-Illinois* (1997) 16 Cal.4th 953, 967.)

Section 2860 cannot supersede Rule 3-310 or the duty of loyalty. "Courts must be vigilant to prevent Legislative encroachment of judicial power. (*People v. Superior Court* (1977) 19 Cal.3d 255, 262.) The authority to control its own officers is integral to the judicial duty to ensure public trust in the integrity of the system.

Our Constitution invests the courts with the power to regulate and control their proceedings and the attorneys,

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court officers, who appear in them. This power is in addition to, and not dependent on, any legislative enactment. It is the foundation of the Rules of Professional Conduct, the judicial rules of engagement for lawyers. Neither the executive nor legislative branches of government may impair it because of the Separation of Powers set forth in Cal. Const., Art. III, § 3 ["The powers of state government are legislative, executive and judicial. Persons charged with the exercise of one power may not exercise either of the others
except as permitted by this Constitution"].) A court's inherent power to regulate lawyers is *not* subordinate to Civil Code § 2860. Nor can the section violate equal protection by treating similarly situated clients differently.

The legislature is barred from impairing this power by the separation of powers doctrine. In *Merco Construction Engineers v. Municipal Court* (1978) 21 Cal.3d 724, a statute authorizing a corporation to appear in municipal court by lay corporate officer violated the separation of powers and was unconstitutional. Because only the judiciary regulated admission to practice law, a "conflict exists, [and] the legislative enactment must give way." (*Id.* at 729.) And in *Hustedt v. WCAB* (1981) 30 Cal.3d 329, a statute which gave worker's compensation judges the power to discipline attorneys appearing before them was similarly held unconstitutional. "The power to regulate the practice of law, including the power to admit and to discipline attorneys, has long been recognized to be among the inherent powers of the article VI courts." (*Id.* at 336.)

While some judicial powers may also be set forth in statutes, still the Constitution is their source.

> "Although some of these powers are set out by statute (§ 128, subd. (a)), it is established that the inherent powers of the courts are derived from the Constitution (art. VI, § 1 reserving judicial power to courts; [citations], and are not confined by or dependent on statute [citations] . . . ."

(*Walker v. Superior Court* (1991) 53 Cal.3d 257, 266-267.)

Public trust in the integrity of the system is primary

A strong argument can be made that the legislature overstepped its bounds to the extent that § 2860 attempts to limit the ethical standards set forth in *San Diego Navy Federal Credit Union v. Cumis Ins. Society* (1984) 162 Cal.App.3d 358 (*Cumis*.) The court held the Canons of Ethics governed how insurer-selected defense counsel must conduct themselves when an insurer reserves its right to deny coverage based on the nature of the insured's conduct.

> "Here, it is uncontested the basis for liability, if any, might rest on conduct excluded by the terms of the insurance policy. . . Goebel & Monaghan will have to make certain decisions at the trial of the *Eisenmann* action which may either benefit or harm the insureds. For example, it will have to seek or oppose special verdicts, the answers to which may benefit the insureds by finding nonexcluded conduct and harm either *Cumis*' position on coverage or the insureds by finding excluded conduct."

(*Id.* at 364-365.)

> "We conclude the Canons of Ethics impose 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 rights to deny coverage. If the insured does not give an informed consent to continued representation, counsel must cease to represent both."

(*Cumis*, supra, *Id.* at 375.)

All attorneys – including staff counsel – are bound by this ethical principle, embodied in Rule 3-310. (Rule 1-100(A), ¶3).)

Cumis held the appointee's duty of full disclosure to obtain informed consent applies to *potential* as well as actual conflicts.

> "*Cumis* 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. It may well be in a given case special verdicts will not be requested or given, and other indicators of the basis of liability such as punitive damages will not come into play. Nevertheless, this often cannot be known until shortly before the case is submitted to the jury. By that time, it is normally too late to prevent prejudice."

(*Cumis supra*, 162 Cal.App.3d at 371, fn. 7.)

The court in *Long v. Century Indemnity* 163 Cal.App.4th 1460, agreed:

> "A conflict of interest or *potential* conflict of interest may impose upon the insurer a duty under section 2860 to provide independent counsel, commonly referred to as '*Cumis* counsel,' for the insured."

(*Id.* at 1468, italics added.)

> "But the *potential* conflict described in subdivision (b) exists because the interests of the insurer and its insured diverge, thereby precluding the use of counsel (absent a waiver by the insured) who purports to jointly represent the interests of both insurer and insured. It is not the presence of the insurer-selected attorney that creates the conflict; rather, the existence of the conflict or potential conflict creates the need for "independent" or *Cumis* counsel – an attorney who owes his or her allegiance solely to the insured."

(*Id*. at 1472, italics added.)

So did the court in *Assurance Co. of America v. Haven* (1995) 32 Cal.App.4th 78:

> "In some cases, such as this one, there is a conflict of interest or a *potential* conflict of interest between the insurer and the insured. Usually, these conflicts involve the insured trying to obtain coverage and the insurer trying

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to avoid it. [Citation.] When this happens, defense counsel may not be permitted to represent both the insurer and the insured. [Citation.] The insurer may be required to provide the insured, at the insurer's expense, with independent counsel (i.e., *Cumis* counsel), who then controls the litigation."

(*Id.* at 84, italics added.)

Our Supreme Court recently affirmed the viability and preeminence of *Cumis* in this area. *Hartford Casualty v. J.R. Marketing* (2015) 61 Cal.4th 988, 992, fn. 1, succinctly stated the *Cumis* rule:

"The *Cumis* decision held that where the insurer provides a defense, but reserves the right to contest indemnity liability under circumstances suggesting that the insurer's interest may diverge from that of its insured, a conflict arises between insured and insurer. In such circumstances, a single counsel cannot represent both the insurer and the insured unless the insured gives informed consent. Absent the insured's consent to joint representation, the insurer must pay the insured's 'reasonable cost' for hiring independent counsel to represent the insured's litigation interests under the insured's control. (*Cumis, supra,* 162 Cal.App.3d at p. 375.)"

It also noted the Legislature's failure to preempt *Cumis*' standards for independent counsel, dispelling the notion that the section superseded *Cumis* as mentioned in a few appellate decisions.

"In *section 2860*, the Legislature sought to codify and flesh out the independent counsel requirements of the *Cumis* decision."

(*Id.* at 994, fn. 4.)

Significantly, the Court did *not* say the Legislature had accomplished its attempt. Nor would the Court continue to cite a superseded appellate case as authority in an opinion discussing the allegedly superseding statute.

Having been judicially imposed, the Legislature has no power to lower *Cumis*' standards. Rule 3-310(B) requires a lawyer to explain – in writing – the relevant circumstances and the actual and reasonably foreseeable adverse consequences to the client-insured of any legal, business, financial, professional, or personal relationship with the insurer. Is the lawyer panel counsel, meaning the firm has some form of agreement to continuously handle cases for it, a form of retainer? Is the lawyer an employee of the insurer, such as house counsel, or is the firm a "captive" which does no work for any other parties? Does the firm represent the insurer itself in other matters? The client-insured then must make its own decision about accepting the lawyer if the disclosure shows divided loyalties.

An attempt to limit *Cumis* appears in § 2860(b), declaring there is no conflict based on allegations seeking punitive damages. Since the basis for punitive damages is the insured's conduct, any suit alleging them necessarily involves arguably non-covered conduct. This creates a classic *Cumis* conflict requiring independent counsel because the insurer will have reserved its right to deny coverage. (*Cumis*, *supra*, 162 Cal.App.3d at 372, fn. 8, at 375; *J.R., supra*, 61 Cal.4th at 992, fn. 1, at 998.)

Subdivision (b) also declares there is no conflict when an insured is sued for more than its policy limits. But when the plaintiff makes a policy-limits demand, and the insurer doesn't want to settle but refuses to agree to hold the insured harmless from any resulting judgment, the defense attorney will have two clients with divergent interests. The same situation occurs if the insured has a valid reason to object to when the insurer wants to settle. Even though it controls settlements, an insurer has a duty to avoid using its discretionary power to do so "in a manner injurious of [the insured's] rights." (*Barney v. Aetna* (1986) 185 Cal.App.3d 966, 978; see discussion in *Western Technology v. Reliance Ins.* (1995) 32 Cal.App.4th 14, 24-26.) Independent counsel will again be required.

The insurer cannot force the insured to accept its lawyer

The insured cannot arbitrarily select an unqualified attorney as *Cumis* counsel; the insurer's rights involving potential indemnity must also be protected. (*Center Foundation v. Chicago Ins.* (1991) 227 Cal.App.3d 547, 560.) Some insurers take the position that after having agreed to *Cumis* counsel, subdivision (f) allows it to select another attorney to act as co-defense counsel – without the insured's consent. But the duties of disclosure apply to that appointee. The client-insured should seek the aforementioned Rule 3-310(B) disclosures, then the appointee must respond. And Rule 3-310(C) provides a lawyer must inform the client-insured – in writing – of any *potential* or actual conflict. Representation cannot proceed unless the lawyer receives the client-insured's informed written consent. Without it, the insurer cannot force its appointee on the insured. (*J.R., supra*, 61 Cal.4th at 992, fn. 1, at 998; *Cumis, supra*, 162 Cal.App.3d at p. 375.) Section 2860 must yield to judicially imposed rules.

If the client-insured does not consent, the insurer cannot have its attorney represent the insured. Simply stated, Rule 3-310 and case law "state the rule that counsel cannot serve two masters." (*O'Morrow v. Borad* (1946) 27 Cal.2d 794,798.) Courts and lawyers should make clear that Justice Werdegar's meaningful pronouncement in *Lexin v. Superior Court* (2010) 47 Cal.4th 1050, 1073, is still the law:

"The common law rule and [Rule 3-310(C) and Bus. & Prof. Code §6068(e)(1)] recognize '[t]he truism that a person cannot serve two masters simultaneously . . .' . . . [These ethics rules are] "'evolved from the self-evident truth, as trite and impregnable as the law of gravitation, that no person can, at one and the same time, faithfully serve two masters representing diverse or inconsistent interests with respect to the service to be performed.'"

Integrity in our profession is just as important as in government

Contrary to what many insurers believe, the majority of experienced independent counsel do keep the adjuster well-informed. Why would a lawyer want to alienate the party with the resources to provide the client's potential settlement funds? An insured who is

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being defended generally will not breach the duty to cooperate. Many marriages of convenience do work out.

Any argument that subdivision (f) excuses the appointee from Rule 3-310 because it gives the insurer an unrestricted right to designate an attorney for its insured is not reasonably related to ensuring the competency of *Cumis* counsel. No other attorneys would be exempt from the Rule 3-310 or the duty of loyalty**.** Disparate treatment of a statutory class must bear "a rational relationship to realistically conceivable purpose or goal of the legislation." (*Cooper v. Bray* (1978) 21 Cal.3d 841, 848.) Doing so would cause § 2860(f) to violate equal protection (Cal. Const., Art I, § 7, U.S. Const., 14th Amend.) because "the challenged provision inflicts a burden on [*Cumis*-represented clients] borne by *no other class* of [clients]." (*Cooper, supra,* 21 Cal.3d at 850-851, original italics.)

How this information can assist plaintiffs

Several cases allowed losing plaintiffs to successfully obtain new trials when insurer-selected defense counsel improperly represented the insured defendant. In *Pennix v. Winton* (1943) 61 Cal.App.2d 761, 773-775, insurance defense counsel's ethical misconduct impaired the parties' right to a fair trial, plaintiff appealed and judgment for defendant was reversed. In *Hammet v. McIntyre* (1952) 114 Cal.App.2d 148, 153-156, insurance defense counsel's similar misconduct denied the parties due process and plaintiff was awarded a new trial."

In *Price v. Giles* (1983) 196 Cal.App.3d 1469, 1473, involved similar defense counsel misconduct and reached the same denial-of-due-process result. ["once defense counsel had indicated to the jury his client was not credible, and impliedly had lied about driving the vehicle, it was impossible for Price to receive a fair trial."]

Conclusion

All lawyers – including an insurer's panel counsel – must disclose material information to clients, especially when the client asks. What the client then does with it is another story. Client-insureds must act reasonably but so too must insurers. Courts have a duty to make sure its officers obey the rules. Requiring disclosure puts the ball in the client-insured's court. If the information is provided early on, the tort case has a good chance of normally progressing. And if the client-insured or the insurer believes the other is being unreasonable, or if they have reached an impasse, either one can ask the court to manage the matter, decide who is right, or even appoint a defense firm just like appointing a discovery referee or arbitrator.

If you are a plaintiff 's attorney and wonder why this is a subject you need to know something about, remember that many defense attorneys who don't work for insurers are also unaware. Thus is it your task to educate them to ensure the best result for your client.

Author's Note: I was involved in the *Cumis* appeal when I practiced in San Diego, providing the research regarding the opinion's primary precedent, *Tomerlin*. Portions of this article were taken from my amicus brief filed in *Sheppard, Mullin v. J-M Mfg.*, pending before the Supreme Court in No. S 232946. The case concerns the applicability and effect of Rule 3-310 on advance conflict waivers.

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