HOW SHOULD A POLICYHOLDER RESPOND TO THE INSURANCE COMPANY'S RESERVATION OF RIGHTS TO SEEK REIMBURSEMENT OF DEFENSE COSTS?

By Jordan S. Stanzler

Insurance companies often agree to provide a defense to liability claims, while reserving their rights to deny coverage *and* to seek reimbursement of defense costs that they pay. This "sword of Damocles" presents the threat of a lawsuit by the insurance company to recoup every dollar the insurance company has spent in defending a claim.

The right to reimbursement was established in *Buss v. Superior Court*, 16 Cal. 4th 35 (1997), where the California Supreme Court held that in a "mixed" action, in which some claims are potentially covered and some are not potentially covered, the insurance company must defend the action in its entirety, including those claims for which there is no potential for coverage under the policy. The Court also ruled that the insurance company has an "implied-in-law" right to be reimbursed for those defense costs which are allocable solely to claims that are not even potentially covered. In seeking such reimbursement, the insurance company bears the burden of proving by a preponderance of evidence that the defense costs pertain solely to claims that are not even potentially covered.

Buss did not decide whether the reservation of rights to seek reimbursement itself creates a conflict of interest that requires the appointment of independent counsel. Independent counsel, who represents only the insured, is required when there is a conflict of interest between the insurance company and the policyholder arising from a reservation of rights. See *San Diego Federal Credit Union v. Cumis Ins. Society*, 162 Cal. App. 3d 358 (1984) and Civil Code section 2860.

Existing case law, notably *James 3 Corp. v. Truck Ins. Co.*, 91 Cal. App. 4th 1093 (2001), has held that a "*Buss* reservation," in and of itself, does not require the appointment of independent counsel in this situation. We submit that *James 3* was wrongly decided and that a "*Buss* reservation" breaks the bonds of trust between attorney and client, beyond repair.

The policyholder is surely placed in peril. The scope and extent of the peril may not even be known to the policyholder when the reservation of rights is sent, typically by letter at the outset of the underlying lawsuit. The policyholder has to be concerned – and rightly so -- that every dollar of defense costs billed by the insurance company's choice of appointed counsel will become the subject of a later lawsuit by the insurance company to recover those very same dollars. However, the ordinary person is helpless to control the situation. The ordinary policyholder has no control over how the appointed defense attorney decides to defend the case, how the attorney incurs expenses, how the attorney bills the insurance company, and how the attorney keeps time records. Yet, allocation of defense costs to covered or non-covered claims will be at the heart of a future lawsuit which the insurance company reserves its right to bring. The appointed defense counsel will likely, if not inevitably, become a witness for the insurance company and against the policyholder when the insurance company seeks reimbursement. How can the ordinary

policyholder place trust in the appointed lawyer who may later provide the ammunition for a reimbursement claim brought by the insurance company? The policyholder would of course be much better served to control the situation with the defense provided by independent counsel who represents solely the interests of the insured. Such an attorney would control, minimize or eliminate the problem of allocating defense resources to non-covered claims and thus would, in turn, undercut or dissuade the basis for a later lawsuit by the insurance company.

Despite these considerations, *James 3 Corp. v. Truck Insurance Company*, 91 Cal. App. 4th 1093 (2001) held that there is no automatic right to independent counsel in this situation and rejected these very arguments. The Court of Appeal concluded that the "*Buss* reservation", *standing alone*, does not constitute a coverage issue, because the allocation of covered and non - covered claims is not an issue that will be litigated in the underlying Coca- Cola action. Furthermore, the court held that there was nothing in the record to suggest that appointed counsel would violate his ethical duties to the insured. *Id*. at 1108-1109. Thus, the policyholder failed to rebut Truck's showing that that there was no "actual" conflict of interest which required the appointment of insurer-paid independent counsel.

This decision is deeply flawed. The policyholder was actually entitled to independent counsel for a reason the Court did not address: because Truck reserved its rights to deny coverage for an intentional tort–i.e., the claim of fraud. That is the paradigm situation, recognized in the *Cumis* decision, requiring the appointment of independent counsel when the claimant has alleged an intentional tort. Yet this point – the insurance company's reservation of rights to deny coverage for fraud -- is nowhere recognized, addressed, or analyzed in the *James 3* decision. This critical fact is merely noted in passing, but never given any consideration.

Furthermore, the mere fact that the allocation itself does not get litigated in the underlying case is the wrong focus. Coverage issues rarely, if ever, get litigated in the underlying case. The real issue is whether the allocation of defense costs to covered or non-covered claims, in the underlying case, puts the appointed defense counsel in a conflict with the insured in the subsequent insurance coverage case over reimbursement of defense costs. Without question, the reservation of rights puts the appointed counsel in the position that counsel *can* affect the outcome of the lawsuit for reimbursement. The counsel's ability to affect the outcome of the coverage case is the critical fact requiring independent counsel. Under *Cumis*, the focus is upon the ability of the appointed counsel to affect the outcome of the coverage case. Proof that the counsel has in fact acted improperly is not required.

What should a policyholder do upon receipt of a reservation of rights to seek reimbursement of defense costs? If there is a lesson to be learned from *James 3*, it must be that the policyholder *should* create a factual record to support the conflict of interest. For example, the policyholder should ask the insurer- appointed attorney how, if at all, that attorney is going to handle the diametrically opposed interests on the subject of reimbursement. How does the attorney view the distinction between covered and non-covered claims? How will the counsel allocate defense costs between covered and non-covered claims? Where does the attorney draw the line? Does the attorney recognize a conflict? If so, what is the conflict in the specific facts of the case? What if anything is the attorney going to do about it? Conceivably, the answers to those questions might

not only provide grounds for the appointment of independent counsel, but might also be provided grounds for disqualification of the attorney. At the very least, the prudent policyholder should scrutinize every legal bill submitted by defense counsel and every communication between defense counsel and the insurance company.

Unfortunately, *James 3* compels the advisability, if not the outright necessity, of an adversarial relationship between the policyholder and the insurer-appointed attorney. The trust needed between attorney and client cannot operate in the normal and usual way. There is nothing usual, and nothing to be taken for granted, when the insurance company reserves its right to seek reimbursement of defense costs. The trust between attorney and client is broken beyond repair. The appointed attorney and the policyholder-client proceed at their peril.