

# ENHANCED OBLIGATION OF GOOD FAITH: A MINE FIELD OF UNANSWERED QUESTIONS AFTER *L & S ROOFING SUPPLY CO.*

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## I. INTRODUCTION

In 1987, the Alabama Supreme Court took insurance companies, insurance defense counsel,<sup>1</sup> and insureds down a road less traveled regarding the reservation-of-rights defense and good faith in a liability insurance policy. On that road, a mine field awaits even cautious insurance companies and prudent defense counsel. This Article provides guidance through that mine field.

In *L & S Roofing Supply Co. v. St. Paul Fire & Marine Insurance Co.*,<sup>2</sup> the Alabama Supreme Court adopted a minority approach to the problems presented when an insurance company defends its insured while maintaining its right to deny coverage for the claims asserted against the insured.<sup>3</sup> In a reservation-of-rights defense,<sup>4</sup> the interests of the insured and the insurance

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1. As used in this Article, "insurance defense counsel" or "defense counsel" refers to the attorney hired by the insurance company to defend its insured against a liability claim. "Insurance coverage counsel" refers to the attorney hired by the insurance company to advise it regarding coverage matters and possibly to represent it in a coverage dispute with the insured.

2. 521 So. 2d 1298 (Ala. 1987).

3. *L & S Roofing Co.*, 521 So. 2d at 1304.

4. A "reservation-of-rights" notice simply states that the insurance company will defend the insured but reserves its right to challenge coverage. A reservation of rights is unilateral, usually in the form of a letter to the insured in which the insurance company sets forth the reasons it claims that coverage may not exist and notifies the insured of the right to hire separate counsel at the insured's expense. A

company often conflict.<sup>5</sup> For example, the insurance company may benefit to the insured's detriment if the jury finds the insured liable on a count for which coverage does not exist. A majority of courts finds that such conflict—or potential for conflict—gives the insured the right to independent counsel<sup>6</sup> at the insurance company's expense.<sup>7</sup>

In rejecting the automatic right to an independent counsel approach followed by the majority of jurisdictions, the Alabama Supreme Court followed the lead of the state of Washington and imposed on insurance companies *and* defense counsel the "en-

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"non-waiver agreement" constitutes a contract between the insured and the insurance company in which the insured acknowledges that the insurance company does not waive its right to challenge coverage. If an insured refuses to sign a non-waiver agreement, the insurance company may issue a unilateral reservation-of-rights letter. See *American Home Assurance Co. v. Glenn Estess & Assoc.*, 763 F.2d 1237, 1240 (11th Cir. 1985) (applying Alabama law); see also ROBERT H. JERRY II, UNDERSTANDING INSURANCE LAW 793-94 (2d ed. 1996). Some jurisdictions allow the insured to reject the non-waiver agreement or the tender of defense under a reservation of rights, forcing the insurance company either to undertake a full, unconditional defense or to repudiate the policy and withdraw from the defense. See, e.g., *Continental Ins. Co. v. Bayless & Roberts, Inc.*, 608 P.2d 281, 291 (Alaska 1980).

5. See *Finley v. Home Ins. Co.*, No. 20830, 1998 WL 905218, at \*4-5 (Haw. Ct. App. Aug. 28, 1998); see also *Mosier v. Southern Cal. Physicians Ins. Exch.*, 74 Cal. Rptr. 2d 550, 563 (Cal. Ct. App. 1998); *Illinois Mun. League Risk Management Ass'n v. Seibert*, 585 N.E.2d 1130, 1135 (Ill. App. Ct. 1992); *Moeller v. American Guar. & Liab. Ins. Co.*, 707 So. 2d 1062, 1069 (Miss. 1996).

6. Although used unartfully by courts and commentators, in this Article, "independent counsel" refers to counsel selected by the insured and paid for by the insurance company to represent the insured when the company defends under a reservation of rights. See JERRY, *supra* note 4, at 801-06.

7. See, e.g., *Kansas Bankers Sur. Co. v. Lynass*, 920 F.2d 546, 548 (8th Cir. 1990) ("Once [the insurer] issued the reservation of rights, it could not then insist on conducting the defense of [the insured] without his consent."); *Howard v. Russell Stover Candies, Inc.*, 649 F.2d 620, 625 (8th Cir. 1981) (applying Missouri law); *Illinois Tool Works Inc. v. Home Indem. Co.*, 998 F. Supp. 868, 873 (N.D. Ill. 1998); *CHI of Alaska, Inc. v. Employers Reinsurance Corp.*, 844 P.2d 1113, 1117 (Alaska 1993); *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y*, 208 Cal. Rptr. 494, 501-02 (Cal. Ct. App. 1984), *superseded by statute as stated in* *Dynamic Concepts, Inc. v. Truck Ins. Exch.*, 71 Cal. Rptr. 2d 882 (Cal. Ct. App. 1998); *Seibert*, 585 N.E.2d at 1137; *Magoun v. Liberty Mut. Ins. Co.*, 195 N.E.2d 514, 519 (Mass. 1964); *State Farm Mut. Auto. Ins. Co. v. Van Dyke*, 668 N.Y.S.2d 821, 823 (N.Y. App. Div. 1998); see also cases cited *infra* note 29; cf. *Muneikis v. St. Paul Ins. Co. of Ill.*, 655 F.2d 818, 825-26 (7th Cir. 1981) (determining there was no conflict so as to justify independent counsel because it is possible for the same act to give rise to covered and uncovered claims); *Federal Ins. Co. v. X-Rite, Inc.*, 748 F. Supp. 1223, 1230 (W.D. Mich. 1990) (holding there is no automatic right to insured-selected independent counsel if insurer selects independent counsel in good faith).

hanced obligation of good faith.<sup>8</sup> Although the court set out a broad overview of the requirements of that enhanced duty, more than a decade later many questions remain about the practical application of that duty in daily practice.<sup>9</sup>

Those unanswered questions include: does *L & S Roofing* create a new bad-faith cause of action?<sup>10</sup> can an insured ever be entitled to independent counsel?<sup>11</sup> how should the insurer and defense counsel evaluate settlement options in view of serious questions about coverage?<sup>12</sup> what consequences does an insurer face for breach of this enhanced duty?<sup>13</sup> how should defense counsel handle confidential information learned from the insured that may affect coverage?<sup>14</sup> does the making of reports to the insurer destroy the attorney-client privilege between counsel and the insured?<sup>15</sup> how does enhanced good faith affect defense counsel's trial strategy involving weeding out claims?<sup>16</sup> how should defense counsel respond to a motion by the insurer to intervene to pose special interrogatories to the jury?<sup>17</sup> and what effect, if any, does the reservation of rights have on the insured's obligation to cooperate with the insurer?<sup>18</sup>

This Article explores these and related questions after providing an overview of the problems of defending cases with coverage questions and the *L & S Roofing* decision.

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8. *L & S Roofing Supply Co. v. St. Paul Fire & Marine Ins. Co.*, 521 So. 2d 1298, 1303 (Ala. 1987).

9. See *L & S Roofing*, 521 So. 2d at 1303. To meet the requirements of enhanced good faith, the insurance company must thoroughly investigate the insured's accident; retain competent defense counsel for the insured; keep the insured advised of developments in the liability suit and developments regarding coverage; acknowledge that defense counsel only represents the insured; and refrain from any conduct that demonstrates a greater concern for its interests than for the interests of the insured. *Id.*; see discussion *infra* text accompanying note 32.

10. See discussion *infra* section III.A.

11. See discussion *infra* section III.B.

12. See discussion *infra* section III.D.

13. See discussion *infra* section III.C.

14. See discussion *infra* section III.E.

15. See discussion *infra* section III.F.

16. See discussion *infra* section III.G.

17. See discussion *infra* section III.H.

18. See discussion *infra* section IV.

## II. THE DUTY-TO-DEFEND PROBLEM AND L & S ROOFING

When a complaint is filed against an insured, the insurance company must examine that complaint to see if any of the allegations fall within the scope of coverage of the policy.<sup>19</sup> If uncertainty exists as to whether the complaint invokes coverage, the insurance company must investigate to determine whether it must defend the insured.<sup>20</sup> Likewise, if the complaint is ambiguous, creating questions about whether coverage exists, the insurance company must defend.<sup>21</sup> This duty to defend arises from the obligation undertaken in the policy and the right reserved to control the defense.<sup>22</sup> As is often stated, the duty to defend is broader than the duty to pay.<sup>23</sup>

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19. See *American States Ins. Co. v. Martin*, 662 So. 2d 245, 247 (Ala. 1995); *Alfa Mut. Ins. Co. v. Jones*, 555 So. 2d 77, 78-79 (Ala. 1989); *Ladner & Co. v. Southern Guar. Ins. Co.*, 347 So. 2d 100, 102 (Ala. 1977); see also *Ajdarodini v. State Auto. Mut. Ins. Co.*, 628 So. 2d 312, 313 (Ala. 1993). For an in-depth discussion of determining the duty to defend, see Susan Randall, *Redefining the Insurer's Duty to Defend*, 2 CONN. INS. L.J. 221 (1997).

20. See *Blackburn v. Fidelity & Deposit Co. of Md.*, 667 So. 2d 661, 668 (Ala. 1995); *United States Fidelity & Guar. Co. v. Armstrong*, 479 So. 2d 1164, 1167 (Ala. 1985); *Ladner*, 347 So. 2d at 103. The Alabama Supreme Court has explained that: This court, however, has rejected the argument that the insurer's obligation to defend must be determined solely from the facts alleged in the complaint in the action against the insured . . . "[T]he court is not limited to the bare allegations of the complaint in the action against [the] insured but may also look to facts which may be proved by admissible evidence . . ."

*Ladner*, 347 So. 2d at 103 (quoting *Pacific Indem. Co. v. Run-A-Ford Co.*, 161 So. 2d 789, 795 (Ala. 1964)); see *Perkins v. Hartford Ins. Group*, 932 F.2d 1392, 1395 (11th Cir. 1991) ("When the insurer is uncertain what the complaint of the third-party is alleging, however, it has a duty to investigate the facts surrounding the incident in order to assess its duty to defend . . .") (citations omitted).

For an argument that the "four corners of the complaint" determine the duty to defend in Alabama, see Christopher Lyle McIlwain, *Clear as Mud: An Insurer's Rights and Duties Where Coverage Under a Liability Policy Is Questionable*, 27 CUMB. L. REV. 31, 32-34 (1997).

21. See, e.g., *Perkins*, 932 F.2d at 1395-96.

22. See *Jones*, 555 So. 2d at 78-79; *Tapscott v. Allstate Ins. Co.*, 526 So. 2d 570, 573 (Ala. 1988); *Burnham Shoes, Inc. v. West American Ins. Co.*, 504 So. 2d 238, 239-40 (Ala. 1987); *Ladner*, 347 So. 2d at 103; *Pacific Indem. Co. v. Run-A-Ford Co.*, 161 So. 2d 789, 795 (Ala. 1964).

23. See, e.g., *Howard v. Russell Stover Candies, Inc.*, 649 F.2d 620, 625 (8th Cir. 1981); *Burnham Shoes*, 504 So. 2d at 239-40 (quoting *Ladner*, 347 So. 2d at 102-03); *Village of Lombard v. Intergovernmental Risk Management Agency*, 681 N.E.2d 88, 92 (Ill. 1997).



To meet the obligation to defend while protecting the right to contest coverage, the prudent insurance company often defends under a reservation of rights to deny coverage, or a non-waiver agreement.<sup>24</sup> Indeed, undertaking the defense unconditionally waives the insurance company's right to challenge coverage.<sup>25</sup> However, this reservation-of-rights defense creates *at least a potential* conflict of interest between the insurance company and the insured.<sup>26</sup> Both the insured and the insurance company would benefit from a finding of no liability on the part of the insured. If the case is one of liability, however, the insured would prefer that the liability be for conduct that is protected by the insurance policy while the insurance company would prefer that the liability be outside the coverage of the policy so that it will not have to indemnify the insured.<sup>27</sup> Fur-

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24. See definitions of terms *supra* note 4.

25. See *Federal Ins. Co. v. X-Rite, Inc.*, 748 F. Supp. 1223, 1226 (W.D. Mich. 1990). The court explained:

To ensure such a reservation of rights is effective, notice must be timely given . . . . The potential conflict of interests is such that if the insurer has undertaken the defense without having given timely notice, it may be estopped to deny indemnification coverage, based upon a rebuttable presumption that the insured's defense would have been prejudiced.

*Federal Ins.*, 748 F. Supp. at 1226 (citation omitted); see also *Commercial Union Ins. Co. v. Roxborough Joint Venture*, 944 F. Supp. 827, 837 (D. Colo. 1996) ("Where an insurer defends its insured unconditionally and without any reservation of rights, it may be estopped to deny coverage.") (citations omitted); *Home Ins. Co. v. Rice*, 585 So. 2d 859, 861 (Ala. 1991) ("[I]t was incumbent upon [insurer] to preserve its rights by giving notice that its assumption of [insureds'] defense was not a waiver of its right to deny a duty to defend."); *United Serv. Auto. Assoc. v. Morris*, 741 P.2d 246, 249 (Ariz. 1987) ("An insurer with a coverage defense must defend its insured under a properly communicated reservation of rights or it will lose its right to later litigate coverage."); *Mutual Serv. Cas. Ins. Co. v. Luetmer*, 474 N.W.2d 365, 368 (Minn. Ct. App. 1991) ("If an insurer, with full knowledge of the facts of a claim, defends its insured without reserving its right to deny coverage, the insurer may be estopped later to deny coverage.") (citation omitted); JERRY, *supra* note 4, at 796.

26. See *L & S Roofing Supply Co. v. St. Paul Fire & Marine Ins. Co.*, 521 So. 2d 1298, 1303 (Ala. 1987).

27. As one court explained:

It is clear how a conflict of interest can develop in a situation like this. [The insurer] could conceivably offer only a token defense if it knows that it can later assert non-coverage. If an insurer does not think that the loss on which it is defending will be covered under the policy, the insurer may not be motivated to achieve the best possible settlement or result. . . . Furthermore, the insurer may be tempted to devote more effort into the non-coverage issue than into defending its insured.

*Kansas Bankers Sur. Co. v. Lyness*, 920 F.2d 546, 549 (8th Cir. 1990) (citation omit-

ther, when defending covered and potentially non-covered claims, the insurance company through defense counsel representing the insured may learn confidential information from the insured that could affect the coverage question.<sup>28</sup>

In the majority of jurisdictions, these potential conflicts create an absolute right to independent counsel, who is selected by various methods and paid for by the insurance company, to represent only the insured.<sup>29</sup>

The Alabama Supreme Court rejected the independent counsel approach followed in the majority of jurisdictions, and instead adopted the "enhanced obligation of good faith" standard utilized in Washington.<sup>30</sup> Under the enhanced good faith standard, the insurance company remains in control of the defense of the insured and hires defense counsel of its own choosing, but is obligated to perform its duties to the insured with enhanced good faith.<sup>31</sup>

To meet the enhanced good faith obligation, the insurance company must (1) thoroughly investigate the claims against the insured; (2) retain competent counsel to defend the insured; (3) acknowledge that defense counsel's only client is the insured; (4)

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ted) (applying South Dakota law). See generally JERRY, *supra* note 4, at 779.

28. See *Parsons v. Continental Nat'l Am. Group*, 550 P.2d 94, 97 (Ariz. 1976).

29. When the Alabama Supreme Court rejected this approach, it noted that counsel for the insured, who urged the independent counsel approach, referred to "[a]t least fifty different courts in a dozen jurisdictions" that allowed an insured to select independent counsel in a reservation-of-rights defense. *L & S Roofing*, 521 So. 2d at 1302, 1304 n.1; see, e.g., *Lynass*, 920 F.2d at 548 (applying South Dakota law); *American Family Life Assurance Co. v. United States Fire Co.*, 885 F.2d 826, 831 (11th Cir. 1989) (applying Georgia law); *Howard v. Russell Stover Candies, Inc.*, 649 F.2d 620, 625 (8th Cir. 1981) (applying Missouri law); *Union Ins. Co. v. Knife Co.*, 902 F. Supp. 877, 880 (W.D. Ark. 1995); *State Farm Mut. Auto. Ins. Co. v. Armstrong Extinguisher Serv. Inc.*, 791 F. Supp. 799, 801 (W.D.S.D. 1992); *Federal Ins. Co. v. X-Rite, Inc.* 748 F. Supp. 1223, 1227 (W.D. Mich. 1990); *Northland Ins. Co. v. Heck's Serv. Co.*, 620 F. Supp. 107, 108 (E.D. Ark. 1985); *CHI of Alaska, Inc., v. Employers Reinsurance Corp.*, 844 P.2d 1113, 1117 (Alaska 1993); *Magoun v. Liberty Mut. Ins. Co.*, 195 N.E.2d 514, 519 (Mass. 1964); *County of San Bernidino v. Pacific Indem. Co.*, 65 Cal. Rptr. 2d 657 (Cal. Ct. App. 1997); *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y*, 208 Cal. Rptr. 494, 506 (Cal. Ct. App. 1984), *superseded by statute as stated in* *Dynamic Concepts, Inc. v. Truck Ins. Exch.*, 71 Cal. Rptr. 2d 882 (Cal. Ct. App. 1998); *Pepper Constr. Co. v. Casualty Ins. Co.*, 495 N.E.2d 1183, 1184 (Ill. App. Ct. 1986); see also cases cited *supra* note 7.

30. *L & S Roofing*, 521 So. 2d at 1304 (following *Tank v. State Farm Fire & Cas. Co.*, 715 P.2d 1133 (Wash. 1986)).

31. *Id.* at 1302, 1303.

fully inform the insured regarding the coverage dispute and developments in the suit, including settlement offers; and (5) refrain from demonstrating greater consideration for its interests than for the insured's interests.<sup>32</sup>

The court in *L & S Roofing* also adopted standards for defense counsel in the reservation-of-rights defense that expand the ethical obligations of counsel. Alabama case law and Rules of Professional Conduct have long sanctioned the hiring of defense counsel by the insurance company to defend the insured.<sup>33</sup> Absent a coverage dispute, the defense counsel represents both the insured and the insurance company. When a coverage dispute arises, however, the insurance defense attorney no longer represents the insurance company, and her *only client is the insured*.<sup>34</sup>

The Alabama Supreme Court, in *L & S Roofing*, set out additional obligations that defense counsel owes to the insured: (1) the duty of complete loyalty to the insured/client; (2) the duty of complete disclosure of (a) potential conflicts, which must be resolved in favor of the insured, (b) all relevant information about the insured's defense, and (c) settlement offers.<sup>35</sup> The Court specifically noted that "*if the outcome of the trial would determine whether coverage exists, and an attorney hired by the insurer conducts a defense while in close communication with the insurer, the defense itself should be closely scrutinized.*"<sup>36</sup>

Defense counsel must always remember that the Alabama Rules of Professional Conduct also apply to this representation. Specifically, Rule 1.8(f) provides:

A lawyer shall not accept compensation for representing a client from other than the client unless:

- (1) The client consents after consultation *or the lawyer is appointed pursuant to an insurance contract*;
- (2) There is *no interference* with the lawyer's independence of

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32. *Id.* at 1303 (quoting *Tank v. State Farm Fire & Cas. Co.*, 715 P.2d 1133, 1137-39 (Wash. 1986)).

33. See *Mitchum v. Hudgens*, 533 So. 2d 194, 198 (Ala. 1988); ALABAMA RULES OF PROFESSIONAL CONDUCT Rule 1.8(f) & cmt. (1996).

34. *L & S Roofing*, 521 So. 2d at 1303.

35. *Id.*

36. *Id.* (emphasis by Alabama Supreme Court) (quoting *Tank v. State Farm Fire & Cas. Co.*, 715 P.2d 1133, 1137-39 (Wash. 1986)).

professional judgment or with the *client-lawyer relationship*; and  
(3) *Information* relating to representation of a client is protected  
as required by Rule 1.6.<sup>37</sup>

Thus, defense counsel, in compliance with Rule 1.8(f), must maintain her client's confidences<sup>38</sup> and must not allow the insurance company to interfere with the attorney's independent professional judgment regarding representation of the insured.<sup>39</sup>

Even with the admonitions of *L & S Roofing* and the Rules of Professional Conduct in mind, questions remain unanswered concerning how insurance companies and defense attorneys should proceed in certain circumstances to meet the enhanced obligation of good faith when defending the insured.

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37. ALABAMA RULES OF PROFESSIONAL CONDUCT Rule 1.8(f) (1996) (emphasis added). Notably, the Alabama version of Rule 1.8(f)(1) contains a phrase not present in the MODEL RULES OF PROFESSIONAL CONDUCT: "or the lawyer is appointed pursuant to an insurance contract." See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.8(f)(1) (1998). The ABA has expressed doubts that the mere appearance in an insurance policy of a provision that the insurance company will provide a defense itself constitutes sufficient informed consent by the insured. See ABA Comm. on Ethics and Professional Responsibility, Formal Op. 96-403, at 4 (1996) ("We cannot assume that the insured understands or remembers, if he ever read, the insurance policy, or that the insured understands that his lawyer will be acting on his behalf, but at the direction of the insurer without further consultation with the insured."). The Opinion suggests that the lawyer should send the insured a short letter explaining the terms and limitations of the defense. *Id.* Such practice certainly comports with the requirement of *L & S Roofing* that the attorney communicate with the insured about the representation and potential conflicts. See *L & S Roofing*, 521 So. 2d at 1303.

38. ALABAMA RULES OF PROFESSIONAL CONDUCT Rule 1.6(a) (1996). The Rule provides:

(a) A lawyer shall not reveal information relating to representation of a client unless the client consents after consultation, except for disclosures that are impliedly authorized in order to carry out the representation, and except as stated in paragraph (b).

*Id.*

39. See *id.* Rule 2.1. The rule provides:

In representing a client, a lawyer shall exercise independent professional judgment and render candid advice. In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation.

*Id.*; see also *id.* Rule 5.4(c):

(c) A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services.

ALABAMA RULES OF PROFESSIONAL CONDUCT Rule 5.4(c) (1996).

## III. UNANSWERED QUESTIONS

A. *A Third Kind of Bad Faith?*<sup>40</sup>

With the adoption of the enhanced duty of good faith that attaches in reservation-of-rights defenses, the Alabama Supreme Court created a third type of bad-faith action against insurance companies.<sup>41</sup> A comparison with the other two bad-faith causes of action helps clarify the *L & S Roofing* standard.

Bad faith as a separate tort action against an insurance company was first recognized in the context of an insurance company's refusal to settle a liability case against its insured.<sup>42</sup> This cause of action arose from the fiduciary obligations undertaken by the insurance company when it defends the insured under a policy of liability insurance. By the terms of the liability insurance contract, the insurance company retains the right to control the defense of the insured and to decide whether to settle the claim against the insured.<sup>43</sup> Those fiduciary duties support the duty to act in good faith toward the insured when evaluating settlement options.<sup>44</sup> Inherent in this duty of good faith is the obligation to adequately investigate the claims against the insured, hire competent counsel to defend the insured, and evaluate settlement options by giving at least equal consideration to the interests of the insured.<sup>45</sup> Because this cause of action involves the defense of the insured pursuant to a liability insur-

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40. A comprehensive discussion of the bad-faith causes of action is beyond the scope of this Article. For a practical discussion of Alabama bad-faith law, see Stephen D. Heninger & Nicholas Woodfield, *A Practitioner's Guide to Alabama's Tort of Bad Faith*, 57 ALA. LAW. 277 (1996). See also Ollie Blum, *The Tort of Bad Faith—A Defense Viewpoint*, 34 ALA. L. REV. 543 (1983).

41. See *Shelby Steel v. United States Fidelity & Guar. Ins. Co.*, 569 So. 2d 309, 312 (Ala. 1990).

42. See, e.g., *Crisci v. Security Ins. Co.*, 426 P.2d 173 (Cal. 1967); *Commune v. Traders & General Ins. Co.*, 328 P.2d 198 (Cal. 1958). Alabama recognized the good-faith obligation to settle cases against the insured in *Waters v. American Casualty Co.*, 73 So. 2d 524, 528 (Ala. 1953). See also *State Farm Mut. Auto. Ins. Co. v. Hollis*, 554 So. 2d 387 (Ala. 1989). For a complete discussion of the development of third-party bad faith, see JERRY, *supra* note 4, § 25G.

43. *Waters*, 73 So. 2d at 531; see *Crisci*, 426 P.2d at 176-77.

44. *Hollis*, 554 So. 2d at 389-90.

45. *Id.*; see *Waters*, 73 So. 2d at 531; *Hartford Accident & Indem. Co. v. Foster*, 528 So. 2d 255, 265 (Miss. 1988).



ance contract, it is known as "third-party bad faith" or "bad-faith failure to settle."<sup>46</sup>

A more recently recognized bad-faith cause of action<sup>47</sup> arises in the context of first-party<sup>48</sup> insurance coverage, such as life, health, and property. First-party bad faith, or bad-faith failure to pay a claim, requires a showing of the existence of an insurance contract that the insurance company breached by refusing to pay the claim without reasonably debatable grounds for denying the claim.<sup>49</sup> Alabama law requires that, in the ordinary case,<sup>50</sup> the insured must be entitled to a directed verdict on the contract claim to present the bad-faith claim to the jury.<sup>51</sup>

The claim of breach of the enhanced obligation of good faith under the *L & S Roofing* standard shares some common aspects with other bad-faith causes of action, but also is distinct. Although courts and lawyers sometimes confuse the distinctions between first-party bad-faith failure to pay and third-party bad-faith failure to settle, an attorney involved in a claim for violation of the enhanced obligation of good faith would do well to consider the distinctive nature of this new claim. The attorney should guide the court to see this claim as a third type of bad faith, particularly distinct from first-party bad-faith failure to pay a claim. Because the enhanced obligation of good faith attaches to a reservation-of-rights defense provided pursuant to a liability policy, it is most akin to third-party bad faith. The good-

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46. See generally JERRY, *supra* note 4, § 25G[b].

47. See, e.g., *Rawlings v. Apodaca*, 726 P.2d 565 (Ariz. 1986); *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032 (Cal. 1973). Alabama recognized first-party bad faith in *Chavers v. National Security Fire & Casualty Co.*, 405 So. 2d 1, 6 (Ala. 1981).

48. For a discussion of the distinction between first-party insurance and third-party insurance, see JERRY, *supra* note 4, § 13A[e].

49. *National Sav. Life Ins. Co. v. Dutton*, 419 So. 2d 1357, 1361 (Ala. 1982); *Gulf Atl. Life Ins. Co. v. Barnes*, 405 So. 2d 916, 924 (Ala. 1981); *Chavers*, 405 So. 2d at 7.

50. *Dutton*, 419 So. 2d at 1362.

51. *Id.*; see also *S & W Properties, Inc. v. American Motorists Ins. Co.*, 668 So. 2d 529, 531 (Ala. 1995); *Blackburn v. Fidelity & Deposit Co. of Md.*, 667 So. 2d 661, 668 (Ala. 1995); *Gilbert v. Congress Life Ins. Co.*, 646 So. 2d 592, 594 (Ala. 1994); *Thomas v. Principal Fin. Group*, 566 So. 2d 735, 742 (Ala. 1990); *Koch v. State Farm*, 565 So. 2d 226, 231 (Ala. 1990); *Kizziah v. Golden Rule Ins. Co.*, 536 So. 2d 943, 946-47 (Ala. 1988); *Continental Assurance Co. v. Kountz*, 461 So. 2d 802, 805-06 (Ala. 1984); *National Sec. Fire & Cas. Co. v. Coshatt*, 690 So. 2d 391, 394-95 (Ala. Civ. App. 1996).

faith duty to settle and the enhanced obligation of good faith both rest on the fiduciary obligations of the insurance company who undertakes control of the defense of the insured.<sup>52</sup> Because settlement frequently becomes an issue in reservation-of-rights cases, the good-faith standard for evaluating settlements in the third-party bad-faith cases applies to reservation-of-rights cases with some modifications.<sup>53</sup>

As expressed in *L & S Roofing*, an insurance company violates its enhanced obligation of good faith if it fails to keep the insured informed about all developments, including litigation proceedings, settlement offers, or developments regarding coverage.<sup>54</sup> Failure to fully investigate the claim against the insured also violates this obligation.<sup>55</sup> Here, the *L & S Roofing* bad-faith claim overlaps with the third-party bad-faith claim, because an inadequate investigation can indicate bad faith when an insurance company refuses to settle an appropriate case.<sup>56</sup> If the insurance company and/or the attorney hired by it to defend the insured under a reservation of rights fails to recognize that the attorney's only client is the insured, the insurance company violates the enhanced obligation of good faith.<sup>57</sup> This requirement regarding the undivided loyalty of the defense counsel is unique to the reservation-of-rights defense and, thus, has no counterpart in third-party bad faith.<sup>58</sup>

Unlike first-party bad faith, a claim for violation of the enhanced obligation of good faith does not require a finding that coverage in fact exists.<sup>59</sup> Indeed, if no genuine dispute existed

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52. See *L & S Roofing*, 521 So. 2d at 1303; see also *Beckwith Mach. Co. v. Travelers Co.*, 638 F. Supp. 1179, 1188 (W.D. Pa. 1986); *Beck v. Farmers Ins. Exch.*, 701 P.2d 795, 798 (Utah 1985); *Tank v. State Farm Fire & Cas. Co.*, 715 P.2d 1133, 1137 (Wash. 1986).

53. See discussion *infra* section III.D.

54. *L & S Roofing*, 521 So. 2d at 1303.

55. *Id.*

56. See generally *Waters v. American Cas. Co.*, 73 So. 2d 524, 531-32 (Ala. 1953).

57. *L & S Roofing*, 521 So. 2d at 1303-04.

58. Compare *L & S Roofing*, 521 So. 2d at 1303 (stating that the insured is the client and must be fully informed), with *Hartford Accident & Indem. Co. v. Foster*, 528 So. 2d 255, 270-276 (Miss. 1988) (stating that the insured and insurer are both clients).

59. Compare *National Sav. Life Ins. Co. v. Dutton*, 419 So. 2d 1357, 1362 (Ala. 1982) (requiring a directed verdict on the contract count), with *Shelby Steel v. Unit-*

concerning the insured's coverage, the insurance company should not defend under a reservation of rights and the enhanced obligation of good faith would not even attach. As discussed below,<sup>60</sup> the coverage question may not even be a viable defense to a refusal to settle in an appropriate case.<sup>61</sup> Applying the directed verdict standard of first-party bad-faith failure to pay to a violation of the enhanced obligation of good faith would emasculate the cause of action.<sup>62</sup> In fact, precluding the insurance company from raising defenses to coverage is one consequence for breaching the enhanced obligation of good faith.<sup>63</sup>

Although the counsel and court involved in a claim for violation of the enhanced obligation of good faith may understand its distinctiveness, questions still remain as to the application of its standards and the consequences of its violation.

### *B. Viability of Independent Counsel*

At the time *L & S Roofing* was decided, the insurance industry was aflutter about the effects of the California case of *San Diego Navy Federal Credit Union v. Cumis Insurance Society Inc.*<sup>64</sup> That case held that when the insurance company defended under a reservation of rights, the insured had the right to select counsel of its own choosing at the insurance company's expense.<sup>65</sup> The case imposed no restrictions as to the qualifications of independent counsel or the rates charged.<sup>66</sup> Chaos ensued.<sup>67</sup> Through court decisions and ultimately through legisla-

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ed States Fidelity & Guar. Ins. Co., 569 So. 2d 309, 312 (Ala. 1990) (creating coverage that otherwise did not exist because the carrier violated the enhanced obligation of good faith).

60. See discussion *infra* section III.D.

61. See, e.g., *Johansen v. California State Auto. Ass'n Inter-Ins. Bureau*, 538 P.2d 744, 746 (Cal. 1975).

62. For example, the insured in *Shelby Steel* would have been unable to meet the directed verdict standard and would never have been able to present the company's breach of the *L & S Roofing* standards. See *Shelby Steel*, 569 So. 2d at 312.

63. See discussion *infra* section III.C.2.

64. 208 Cal. Rptr. 494 (Cal. Ct. App. 1984), *superseded by statute as stated in* *Dynamic Concepts, Inc. v. Truck Ins. Exch.*, 71 Cal. Rptr. 2d 882 (Cal. Ct. App. 1998).

65. *Cumis*, 208 Cal. Rptr. 2d at 504.

66. See *id.* at 506.

67. See, e.g., *Sampson A. Brown & John L. Romaker, Cumis, Conflicts and the*

tion, California imposed some limitations on the insured's absolute right to independent counsel.<sup>68</sup> Those restrictions include the right of the insurer to require that the attorney selected by the insured have at least five years of experience in civil litigation with substantial experience in the subject at issue and that the attorney carry errors and omissions coverage, as well as the requirement that the rates charged by the attorney be limited to those actually paid to attorneys ordinarily retained by insurance companies.<sup>69</sup> Independent counsel and the insured must advise

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*Civil Code: Section 2860 Changes Little*, 25 CAL. W. L. REV. 45 (1988-89); Ronald E. Mallen, *A New Definition of Insurance Defense Counsel*, 53 INS. COUNS. J. 108 (1986); Mark Saxon, *Conflicts of Interest: Insurer's Expanding Duty to Defend and the Impact of "Cumis" Counsel*, 23 IDAHO L. REV. 351 (1986-87); Peter B. Lightstone, Note, *The Cumis Decision—What Has It Done to Insurance Policies?*, 23 CAL. W. L. REV. 125 (1986).

Commentators expressed the concerns felt by insurers that the companies had no control over the expenses and fees incurred or the experience and ability of the attorney selected by the insured. *E.g.*, Brown & Romaker, *supra*, at 63-64. For example, in *Center Foundation v. Chicago Insurance Co.*, 278 Cal. Rptr. 13, 15-16 (Cal. Ct. App. 1991), the insureds hired their business attorneys to defend dozens of intentional tort and medical malpractice cases against the insured. These attorneys were not experienced medical malpractice litigators; in fact, the lead attorney had never tried a jury case or taken a deposition before this assignment. *Center Found.*, 278 Cal. Rptr. at 15, 17. The billing practices included "creative billing" that the court noted involved charging the equivalent of over six months for one attorney's work on a summary judgment motion that was not well taken, well written, or even heard. *See id.* at 17-18 n.5. Other courts rejected the "extreme position" of *Cumis*. *E.g.*, *Mutual Serv. Cas. Ins. Co. v. Luetmer*, 474 N.W.2d 365, 368 (Minn. Ct. App. 1991); *see also* *American Home Assurance Co. v. Glenn Estess & Assoc.*, 763 F.2d 1237, 1240 (11th Cir. 1985).

68. *See, e.g.*, *Foremost Ins. Co. v. Wilks*, 253 Cal. Rptr. 596, 597 (Cal. Ct. App. 1988) (holding that defending under a reservation of rights because of a punitive damage claim did "not alone create a conflict between the insured and insurer and trigger the *Cumis* duty to provide the [insured] with independent counsel"); *United Pac. Ins. Co. v. Hall*, 245 Cal. Rptr. 99, 102 (Cal. Ct. App. 1988); *see also* CAL. CIV. CODE § 2860 (West 1993).

69. CAL. CIV. CODE § 2860(c) (West 1993). According to the statute:

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 civil 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 the 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.

*Id.*

the insurer of relevant information about the claim, but should not disclose privileged information about coverage disputes.<sup>70</sup> The legislation also limits the insured's right to independent counsel to situations of "true" conflict, such as cases in which the outcome of the liability case against the insured could determine the question of coverage.<sup>71</sup>

In rejecting the independent counsel approach, the Alabama Supreme Court did not foreclose the notion that a conflict between the insured and insurance company could be so great as to require the use of independent counsel in some instances:

The mere fact that the insurer chooses to defend its insured under a reservation of rights does not *ipso facto* constitute such a conflict of interest that the insured is entitled at the outset to engage defense counsel of its choice at the expense of the insurer. We hold that, if the insurer and the defense counsel retained by the insurer to represent its insured meet the specific criteria hereinabove adopted, the insurer has met its enhanced obligation of good faith, and the defense provided by the insurer may proceed under a reservation of rights. It is only when those criteria have not been met in whole or in part that the insured is entitled to retain defense counsel of its choice at the expense of the insurer.<sup>72</sup>

Thus, if the insurance company and/or defense counsel fail

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70. *Id.* § 2860(d). The statute requires that:

When independent counsel has been selected by the insured, it shall be the duty of that 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 . . . . Any information disclosed by the insured or by independent counsel is not a waiver of the privilege as to any other party.

*Id.*

71. *Id.* § 2860(b). This section provides:

For 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; 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 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.

CAL. CIV. CODE § 2860(b) (West 1993).

72. *L. & S. Roofing Supply Co. v. St. Paul Fire & Marine Ins. Co.*, 521 So. 2d 1298, 1304 (Ala. 1987).



to meet the requirements of the enhanced obligation of good faith, the insured would be entitled to select independent counsel at the insurance company's expense. The provision of independent counsel to the insured thereby becomes one of the consequences of breach of this enhanced obligation of good faith.<sup>73</sup> The holding in *L & S Roofing* likewise does not preclude insurance companies from providing in their policies for the selection of independent counsel when a conflict arises between the insured and insurance company.<sup>74</sup> Indeed, with appropriate guidelines, the use of independent counsel in reservation-of-rights situations may be preferable to the pitfalls of the *L & S Roofing* approach. The so-called "*Cumis* legislation" in California allows insurers to provide a method for selection of independent counsel in their policies<sup>75</sup> and establishes procedures for the selection of independent counsel that can provide guidance to an insurance company interested in the independent counsel approach.<sup>76</sup> Other insurance companies have included provisions in their policies about selection of independent counsel that have been upheld by courts.<sup>77</sup> An insurance company that finds the enhanced good faith standard of *L & S Roofing* replete with problems should consider joint selection of independent counsel as a viable option with safeguards to insure that a qualified attorney charging a reasonable rate will be selected.<sup>78</sup>

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73. See *L & S Roofing*, 521 So. 2d at 1304.

74. See *id.*

75. CAL. CIV. CODE § 2860(a) (West 1993).

76. See *id.* § 2860.

77. E.g., *New York State Urban Dev. Corp. v. VSL Corp.*, 738 F.2d 61 (2d Cir. 1984).

78. In a cursory opinion, the Washington Court of Appeals approved the provision of "independent legal services" to defend the insured under a comprehensive reservation of rights. *Farmers Ins. Co. of Wash. v. Edie*, 763 P.2d 454, 455 (Wash. 1988). The brief opinion does not indicate whether the "independent legal services" were provided by an independent counsel as that term is generally used to reflect counsel selected by the insured at the carrier's expense or by defense counsel selected by the insurance company. However selected, the court found the defense proper under *Tank. Edie*, 763 P.2d at 455.

### C. Consequences of Breach of the Duty of Enhanced Good Faith

Although the court in *L & S Roofing* did not address the consequences for breach, that question has been answered in part by subsequent Alabama and Washington cases.<sup>79</sup> Although the full ramifications of breach of the *L & S Roofing* requirements may not be clear, when an insurance company fails to meet this enhanced standard of good faith, it may find itself in serious trouble.

1. *Imposition of Coverage*.—One of the consequences of a breach of the duty of enhanced good faith is the creation of coverage for the allegations against the insured. In *Shelby Steel Fabricators, Inc. v. United States Fidelity & Guaranty Insurance Co.*,<sup>80</sup> USF&G lost the right to assert non-coverage under policy exclusions because it neglected to keep the insured advised of developments in the case in violation of the *L & S Roofing* standards.<sup>81</sup> When USF&G undertook the defense of Shelby Steel, it purported to do so under a non-waiver agreement;<sup>82</sup> however, the insured never signed the non-waiver agreement.<sup>83</sup> From the time of the issuance of the non-waiver agreement and the undertaking of the defense, USF&G and its attorney failed to keep Shelby Steel advised of the developments of the case for twenty-

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79. See, e.g., *Shelby Steel Fabricators, Inc. v. United States Fidelity & Guar. Ins. Co.*, 569 So. 2d 309 (Ala. 1990); *Safeco Ins. Co. of Am. v. Butler*, 823 P.2d 499 (Wash. 1992).

80. 569 So. 2d 309, 312 (Ala. 1990).

81. *Shelby Steel*, 569 So. 2d at 312.

82. A non-waiver agreement, while similar to a reservation-of-rights letter, requires that the insured sign the agreement. See *American Home Assurance Co. v. Glenn Estess & Assoc.*, 763 F.2d 1237, 1240 (11th Cir. 1985) (applying Alabama law). Both tools allow the insurance company to carry out its duty to defend the insured without waiving defenses to coverage it may have. See JERRY, *supra* note 4, at 793-94.

The grounds for USF&G's ultimate denial of coverage to Shelby Steel was the policy exclusion for products liability injuries or damages that occurred after the completion of the product. See *Shelby Steel*, 569 So. 2d at 309-10. The suit against Shelby Steel involved the collapse of a steel support structure that occurred a year after Shelby Steel had delivered the product. *Id.* at 310. Although USF&G defended the case for more than two years before denying coverage, its decision to deny coverage rested on the facts alleged in the complaint, not on subsequently discovered information. *Id.*

83. *Shelby Steel*, 569 So. 2d at 310.

nine months until it issued a denial of coverage for the claims against the insured.<sup>84</sup>

The Alabama Supreme Court found that the unsigned non-waiver agreement, coupled with a letter subsequently sent to Shelby Steel's attorney that referred to the non-waiver agreement, provided sufficient notice of USF&G's reservation of rights.<sup>85</sup> Because USF&G undertook the defense of Shelby Steel while reserving its rights to deny coverage, the enhanced obligation of good faith espoused in *L & S Roofing* attached to the defense.<sup>86</sup> The court quoted at length from *L & S Roofing* and concluded that the insurer "must meet its 'enhanced obligation of good faith' in order to deny coverage pursuant to a reservation of rights."<sup>87</sup> Because USF&G failed to keep Shelby Steel advised of developments in the case, the court held that USF&G "failed to meet its enhanced obligation to Shelby Steel and, therefore, that it must indemnify Shelby Steel for any liability in the underlying action."<sup>88</sup>

Thus, because of its failure to keep the insured advised of developments,<sup>89</sup> one of the requirements of the enhanced duty of good faith, USF&G was required to provide coverage that otherwise did not exist.<sup>90</sup>

**2. Estoppel to Deny Coverage.**—The Alabama Supreme Court in *Shelby Steel* did not use the term "estoppel" when it held that USF&G could not dispute coverage because it failed to comply

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84. *Id.* at 310, 312.

85. *Id.* at 311-12. Although the court found the notice "meager," it nevertheless sufficed as constructive notice. *Id.*

86. *Id.* at 312.

87. *Shelby Steel*, 569 So. 2d at 312.

88. *Id.*

89. In *L & S Roofing*, the court listed keeping the insured advised of all developments relevant to coverage and the lawsuit as a requirement for both the insurance company and defense counsel hired to defend the insured. *L & S Roofing*, 521 So. 2d at 1303. In *Shelby Steel*, defense counsel kept USF&G advised of developments, but did not consult Shelby Steel regarding the defense or keep it posted about developments. *Shelby Steel*, 569 So. 2d at 310, 312. The court did not address this failure as defense counsel's, but it held that USF&G had not met its obligation. See *id.* at 312. The duty imposed on the insurance company to keep its insured informed about developments in the case, thus, is a non-delegable duty. See *id.*

90. Bert Nettles, *Insurance Defense Practice and Murphy's Law*, 3 ATT'YS INS. MUT. OF ALA., INC. NEWSLETTER 1 (1993).

with the enhanced good faith standard.<sup>91</sup> Perhaps the omission of the term "estoppel," when the effect is the same, stems from the Alabama court's reluctance to use estoppel or waiver to create coverage.<sup>92</sup> However, Washington courts applying *Tank v. State Farm Fire & Casualty Co.*,<sup>93</sup> the case followed by the Alabama Supreme Court in *L & S Roofing*, have not hesitated to hold that the insurance company's breach of the enhanced good-faith duty results in estoppel to deny coverage.<sup>94</sup> If the Alabama Supreme Court examines the Washington cases applying *Tank*, it may lose its reluctance and recognize estoppel as appropriate when an insurance company violates its enhanced obligation of good faith.

In *Safeco Insurance Co. of America v. Butler*,<sup>95</sup> the Supreme Court of Washington, in an en banc decision, addressed several questions left unanswered by its decision in *Tank*. The first question the court answered was "whether the insured must show that the insurer's bad faith acts resulted in harm to state a cause of action for violation of *Tank*."<sup>96</sup> The court concluded that an insured must show harm as an essential element

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91. See discussion *supra* section III.C.1.

92. See, e.g., *Brown Mach. Works & Supply Co. v. Insurance Co. of N. Am.*, 659 So. 2d 51, 53-54 (Ala. 1995); *Henson v. Celtic Life Ins. Co.*, 621 So. 2d 1268, 1276 (Ala. 1993); *McGee v. Guardian Life Ins. Co.*, 472 So. 2d 993, 996 (Ala. 1985); *Home Indem. Co. v. Reed Equip. Co.*, 381 So. 2d 45, 50-51 (Ala. 1980); *Allstate Ins. Co. v. Moore*, 429 So. 2d 1087, 1089 (Ala. Civ. App. 1983).

93. 715 P.2d 1133 (Wash. 1986). *Tank* is the decision adopted by the Alabama Supreme Court in *L & S Roofing*, 521 So. 2d at 1304. Washington decisions applying *Tank*, thus, should provide some guidance as to how the Alabama Supreme Court might answer similar questions.

94. See *Safeco Ins. Co. of Am. v. Butler*, 823 P.2d 499, 505 (Wash. 1992); *Wickswat v. Safeco Ins. Co.*, 904 P.2d 767, 775 (Wash. Ct. App. 1995) (stating that the *Butler* holding that bad faith estopped the carrier to deny coverage only applies to violations of the enhanced good-faith duty imposed when defending under a reservation of rights); *Planet Ins. Co. v. Wong*, 877 P.2d 198, 201 (Wash. Ct. App. 1994). Other courts also have moved away from the historic reluctance to use estoppel or waiver to create coverage. See JERRY, *supra* note 4, § 61.

95. 823 P.2d 499 (Wash. 1992). This case involved, among other issues, the appeal of a denial of the insurer's motion for summary judgment on the insureds' allegations that the insurer acted in bad faith in violation of *Tank v. State Farm Fire & Casualty Co.* *Butler*, 823 P.2d at 501. The court affirmed the denial of summary judgment, finding that disputed questions of material fact precluded summary judgment on the issue of bad faith. *Id.*

96. *Id.* at 503.

of the tort of bad-faith handling of an insurance claim.<sup>97</sup> To avoid the "almost impossible burden" of proof,<sup>98</sup> the court adopted a rebuttable presumption of harm that attaches when the insured establishes bad faith.<sup>99</sup> The court reasoned that

[p]resuming prejudice once the insured establishes bad faith shifts the burden to the insurer to prove its acts did not prejudice the insured. The shifting of the burden ameliorates the difficulty insureds have in showing that a particular act resulted in prejudice. It also recognizes the fact that loss of control of the case is in itself prejudicial to the insured.<sup>100</sup>

The court in *Butler* then addressed another question left unanswered by *Tank*: what remedy lies for an insurance company's bad faith when defending the insured under reservation of rights?<sup>101</sup> The court held that the appropriate remedy for bad faith under a reservation-of-rights defense is that the insurer is estopped from denying coverage.<sup>102</sup> In arguing that estoppel should not be used to create coverage, Safeco Insurance relied on cases that stated this principle as a general rule but did not involve bad faith by the insurance company.<sup>103</sup> In rejecting Safeco's argument, the court noted several Washington cases in which insurance companies that acted in bad faith were estopped from denying coverage.<sup>104</sup> The court reasoned that the general principle prohibiting estoppel to create coverage did not apply in bad-faith cases for two reasons: first, a violation of the enhanced obligation of good faith sounds in tort and involves

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97. *Id.*

98. *Id.* at 504 (quoting A. WINDT, INSURANCE CLAIMS AND DISPUTES: REPRESENTATION OF INSURANCE COMPANIES AND INSURED § 2.09, at 40-41 (2d ed. 1988) ("The insured should not have the almost impossible burden of proving that he or she is demonstrably worse off because of [the insurer's actions].")).

99. *Butler*, 823 P.2d at 504.

100. *Id.* at 505 (citation omitted).

101. *Id.*

102. *Id.*

103. *Id.* Safeco relied on *Saunders v. Lloyd's of London*, 779 P.2d 249 (Wash. 1989), which stated the general rule that "estoppel cannot create liability contrary to the express provisions of the contract the parties made." *Butler*, 823 P.2d at 505 (citing *Saunders*, 779 P.2d at 252). The court dismissed *Saunders* as not being on point because it did not involve bad faith. *Id.*

104. *Id.* (citing *Greer v. Northwest Nat'l Ins. Co.*, 743 P.2d 1244, 1250 n.6 (Wash. 1987)); *Hamilton v. State Farm Ins. Co.*, 523 P.2d 193 (Wash. 1974); *Transamerica Ins. Group v. Chubb & Son, Inc.*, 554 P.2d 1080 (Wash. Ct. App. 1976)).



more than the contractual aspects of the relationship between the insurance company and its insured;<sup>105</sup> second, the purpose of recognizing a bad-faith cause of action would be thwarted if the insured were limited to a contractual remedy.<sup>106</sup> Such a limitation, the court reasoned, "would render *Tank* meaningless . . . . [A]n estoppel remedy, however, gives the insurer a strong disincentive to act in bad faith."<sup>107</sup>

The coverage question in *Butler* arose from the scope of coverage provision of the Safeco policy, which provided coverage for bodily injury "caused by an occurrence."<sup>108</sup> The policy defined occurrence as "an accident."<sup>109</sup> Because the insured, who intentionally fired his gun at an occupied truck, was well trained in the use of firearms and was aware of the possibility of ricochet, the court concluded that the injury was not an accident; because the injury did not qualify as an accident, the policy did not provide coverage.<sup>110</sup> If the insured prevailed on the bad-faith claim, however, the insurance company would be estopped from asserting lack of coverage.<sup>111</sup> Thus, under Washington law, estoppel operates to create coverage that otherwise would not exist when an insurance company violates its enhanced obligation of good faith while defending its insured under a reservation of rights.<sup>112</sup>

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105. *Butler*, 823 P.2d at 505.

106. *Id.* at 505-06.

107. *Id.* at 506.

108. *See id.* at 509.

109. *Id.*

110. *Butler*, 823 P.2d at 509.

111. *Id.*

112. *See also* *Wickswat v. Safeco Ins. Co.*, 904 P.2d 767, 775 (Wash. Ct. App. 1995) (refusing to estop the insurer's denial of coverage in a suit for bad-faith failure to pay an insured's first-party property claim where evidence existed of possible fraud by the insured). The court noted that the holding in *Butler*

is limited to those situations in which an insurer defends an insured's interests under a reservation of rights clause. Indeed, the court made clear that equitable estoppel is an appropriate remedy for an insurer's bad faith conduct in that context given the insurer's "enhanced obligation of fairness" toward the insured.

*Wickswat*, 904 P.2d at 775 (citations omitted); *Planet Ins. Co. v. Wong*, 877 P.2d 198, 201 (Wash. Ct. App. 1994) ("Where an insurer acts in bad faith in handling a claim under a reservation of rights, the insurer is estopped from denying coverage.") (dictum).

In a subsequent case, *Kirk v. Mt. Airy Insurance Co.*,<sup>113</sup> in which the insurer refused in bad faith to defend the insured, the Washington Supreme Court reiterated its position that estoppel from denying coverage is an appropriate remedy for bad faith.<sup>114</sup> The court noted: "When dealing with an insurance contract, we cannot focus solely on the contractual aspect of the relationship, and we must take into account the purpose of creating a bad faith cause of action."<sup>115</sup> The court emphasized that bad faith by the insurer changes the rules: "The bad faith requires us to set aside traditional rules regarding harm and contract damages because insurance contracts are different."<sup>116</sup> The court thus recognized that bad faith by an insurer creates an exception to the general rule that coverage should not be created by estoppel.<sup>117</sup>

While Alabama adheres to the traditional doctrine that coverage cannot be created or enlarged by estoppel or waiver,<sup>118</sup> Alabama courts have recognized certain exceptions. For example, an exception arises when the policy creates an ambiguity as to coverage, or when waiver or estoppel applies to a forfeiture provision.<sup>119</sup> Without discussing waiver or estoppel, the

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113. 951 P.2d 1124 (Wash. 1998).

114. *Kirk*, 951 P.2d at 1127.

115. *Id.* at 1128.

116. *Id.* at 1127.

117. *See id.* at 1127-28.

118. *E.g.*, *McGee v. Guardian Life Ins. Co.*, 472 So. 2d 993, 995-96 (Ala. 1985); *Allstate Ins. Co. v. Moore*, 429 So. 2d 1087, 1089 (Ala. Civ. App. 1983); *see Mooradian v. Canal Ins. Co.*, 130 So. 2d 915, 918 (Ala. 1961). In an often quoted portion of *Home Indemnity Co. v. Reed Equipment Co.*, the court stated:

Although the doctrine of waiver may extend to practically every ground on which an insurer may deny liability based on forfeiture, the doctrine is not available to bring within the coverage of a policy risks not covered by its terms or risks expressly excluded therefrom. Thus, coverage under an insurance policy cannot be created or enlarged by waiver or estoppel and, if there is no ambiguity, it is the duty of the court to enforce the policy as written.

381 So. 2d 45, 50-51 (Ala. 1980) (citations omitted) (emphasis added).

For a good discussion of the general rule of no coverage created by waiver or estoppel, see *Turner Liquidating Co. v. St. Paul Surplus Lines Insurance Co.*, 638 N.E.2d 174 (Ohio Ct. App. 1994). For further discussion of the trend away from the general rule, see JERRY, *supra* note 4, § 61[a].

119. *See, e.g.*, *Brown Mach. Works & Supply v. Insurance Co. of N. Am.*, 659 So. 2d 51, 58 (Ala. 1995) (recognizing an exception to the general rule that coverage cannot be created or enlarged by estoppel because the insurer failed to comply with the statutory mandate of ALA. CODE § 27-14-19 (1995)); *Henson v. Celtic Life Ins.*

court in *Shelby Steel* recognized that one consequence of the breach of the enhanced obligation of good faith is the insurer's ability to deny coverage.<sup>120</sup> The difference seems to be one of semantics. Both approaches create coverage that otherwise would not exist.<sup>121</sup> However, couching the consequence of bad faith in terms of preventing a contest of coverage instead of using the equitable term of estoppel may actually be a less problematic way of reaching the appropriate remedy. Estoppel generally requires a finding of a representation or action on which the insured reasonably and detrimentally relied.<sup>122</sup> While the Washington courts have not completely explained how those components of estoppel are met, the rebuttable presumption of harm that arises from the insurer's bad faith<sup>123</sup> would presumably supply the requirement of detrimental reliance for estoppel. The apparent Alabama approach treats compliance with the enhanced good-faith standard as a condition precedent to the insurer's right to challenge coverage.<sup>124</sup> The Washington approach, by clearly acknowledging an exception to the general

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Co., 621 So. 2d 1268, 1276-77 (Ala. 1993) (waiver applied either because the purported coverage provision was ambiguous or because the provision constituted a condition or forfeiture provision that could be waived); *Reed Equip.*, 381 So. 2d at 50-51.

In *Home Insurance Co. v. Rice*, 585 So. 2d 859 (Ala. 1991), the court stated that "it would be unfair to subsequently permit [an] insurer to deny coverage, when, without reservation and with knowledge, it assumes exclusive control of the defense of an action." *Rice*, 585 So. 2d at 861 (citations omitted).

The court in *Reed Equipment* noted:

Where an insurer specifically disclaims liability because of one ground of forfeiture, it waives all other grounds of forfeiture which might have been stated but were not. Similarly, an insurer who disclaims liability solely on a theory on noncoverage thereby waives his [sic] defenses with respect to any grounds of forfeiture which might have been raised.

381 So. 2d at 50 (citations omitted). The court held that waiver did not apply to that case because the policy provision at issue dealt with coverage and could not be waived "if the provision is without ambiguity." *Id.* at 51.

120. *Shelby Steel*, 569 So. 2d at 312.

121. See *Allstate Ins. Co. v. Moore*, 429 So. 2d 1087, 1089 (Ala. Civ. App. 1983) (rejecting plaintiff's attempt to create coverage where none existed by applying waiver or estoppel to the insurable interest provision of the policy); cf. *Shelby Steel*, 569 So. 2d at 312 (holding that an insurer must meet its "enhanced obligation of good faith" in order to deny coverage pursuant to a reservation of rights).

122. See JERRY, *supra* note 4, at 148.

123. See *Safeco Ins. Co. of Am. v. Butler*, 823 P.2d 499, 503 (Wash 1992).

124. See *Shelby Steel*, 569 So. 2d at 312.

rule that no coverage can be created by estoppel, uses legal terms with recognized meaning. Both approaches reach the correct result: additional deterrence to bad faith by imposing coverage. The Alabama approach provides a more streamlined means to achieving that result while the Washington approach may be more intellectually honest: calling the effect of estoppel an estoppel.

*3. Compensatory and Punitive Damages.*—Little doubt exists that the insured, whose insurance company acted in bad faith while defending him, can recover compensatory damages; in appropriate cases, punitive damages are also available. The insured who relies on the insurance company to properly defend him may suffer more than the traditional measure of damages breach of contract may allow, such as mental anguish and attorney fees to enforce the obligation. Because a bad-faith cause of action sounds in tort, solid ground exists for arguing that these damages should be included in the measure of compensatory damages awarded for violating the enhanced obligation of good faith.

The range of recoverable damages is illustrated by the award in *Carrier Express v. Home Indemnity Co.*<sup>125</sup> In that case, the insurance company that violated the enhanced good faith obligation in numerous ways received a verdict against it of \$2.5 million in compensatory damages and \$4.8 million in punitive damages.<sup>126</sup> The compensatory damages amount included the portion of the settlement paid by the insured in excess of its policy limits to resolve its portion of liability in an \$8,025,000.00 settlement of five wrongful death lawsuits and two personal injury lawsuits.<sup>127</sup> The compensatory award also included the amount of attorney fees incurred by the insured when it retained counsel to represent its interest after trying to "fire" defense counsel hired by the insurance company.<sup>128</sup> The court did not discuss the validity of the insurance company's challenge to coverage, presumably because Home Indemnity

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125. 860 F. Supp. 1465 (N.D. Ala. 1994) (applying Alabama law).

126. *Carrier Express*, 860 F. Supp. at 1472. The exact figures were \$2,463,959.60 in compensatory damages and \$4,812,500.00 in punitive damages. *Id.*

127. *See id.* at 1468, 1472, 1473.

128. *See id.* at 1472.

never pursued the coverage defense that it asserted in its reservation-of-rights letter.

The *Carrier Express* case catalogues the most egregious ways an insurance company can violate its obligation of good faith to the insured. The trial court noted:

In more than forty-six years of experience at bench and bar, the court has never seen a more egregious example of bad faith than the one presented in this case. It was a textbook case of bad faith refusal to settle, an astonishingly complete catalogue of ways for an insurer to breach its duty to its insured. Only by attending the trial or by reading the entire trial transcript can one grasp the extensiveness and utter outrageousness of the wrongdoing on the part of Home.<sup>129</sup>

Some of the ways in which the court found that Home Indemnity violated its good faith obligation to its insured included the following: Home performed a shoddy and tardy investigation of the claims against the insured;<sup>130</sup> Home failed to meet its duty of apprising the insured of developments in the case and instead actually concealed information from its insured;<sup>131</sup> Home did not reveal to the insured the nature of telephone conversations between it and defense counsel in which defense counsel, who was hired to defend the insured, rendered legal advice to Home to the detriment of the insured;<sup>132</sup> Home treat-

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129. *Id.* at 1475.

130. *Carrier Express*, 860 F. Supp. at 1481. Home assigned this fiery, multiple-death case to an inexperienced claims person with minimum settlement authority; did not know of the existence of a "grisly and graphic" videotape taken of the accident scene until a few months before trial and did not review it until a few days before the trial date; relied on poorly conducted research of Alabama law on several key points; did not obtain information regarding verdicts in similar cases until after the opportunity to settle for policy limits had expired; did not consider hiring an accident reconstructionist until two years after the accident and three months before trial. *Id.*

131. *Id.* at 1481. The insured never received critical pieces of correspondence between defense counsel and Home, including letters which evaluated the case in terms of likelihood of success ("we do not feel that we will be successful" on summary judgment), disclosed unfavorable deposition testimony, anticipated a settlement value of the cases in excess of the combined limits of liability coverage of all the defendants, and recommended a reserve of \$500,000 of the one million dollars in coverage. *Id.* at 1481-82. Although defense counsel disclosed to Home, but not the insured, that the insured faced tremendous potential exposure in excess of policy limits, defense counsel inexplicably under-estimated the settlement value of the insured's portion of liability to be \$500,000. *Id.* at 1482.

132. *Carrier Express*, 860 F. Supp. at 1482. The court pointed out that the hand-



ed the decision about settlement "as solely its own, placing its interests above those of its insured and heedlessly disregarding the position of financial peril in which the underlying cases placed its insured;"<sup>133</sup> "Home made a dishonest, unsound, incompetent, subjective, self-serving decision in refusing to settle the underlying cases . . . [and] recklessly gambled with the continued existence of its insured."<sup>134</sup> These acts of bad faith, the court found, justified the imposition by the jury of the \$4,812,500.00 punitive damage award.<sup>135</sup>

On post-trial motion, the court imposed prejudgment interest on the amount of the compensatory damages for the settlement of the claims against the insured.<sup>136</sup> Thus, under the *Carrier Express* precedent, an appropriate award of compensatory damages for breach of the enhanced obligation of good faith includes the amounts the insured paid to settle a case against it, and attorney fees<sup>137</sup> paid to counsel to represent its interests when defense counsel hired by the insurance company violated the obligations to represent the insured;<sup>138</sup> punitive damages

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written file notes made by the adjuster of her conversations with defense counsel established defense counsel's role as counsel to Home and that the advice given protected Home's interest at the expense of the insured's interests. *Id.* Quoting at length from defense counsel's testimony, the court demonstrated counsel's confusion over his role and who he represented. *Id.* The court noted the correct role of defense counsel:

[C]ounsel retained by Home to represent [the insured] under the reservation of rights, were Home's agents as to knowledge and responsibility for wrongdoing. That is, breaches of duty on the part of these attorneys were attributable to Home in this context. Although retained by Home on behalf of [the insured], these attorneys were ethically bound to represent [the insured's] and only [the insured's] interests in the underlying litigation.

*Id.* at 1481. The court's finding that counsel violated this duty is an understatement.

133. *Id.* at 1483. The court noted that under *L & S Roofing*, in a reservation-of-rights defense, "it is the insured who must make the ultimate choice regarding settlement." *Carrier Express*, 860 F. Supp. at 1483 (quoting *L & S Roofing Supply Co. v. St. Paul Fire & Marine Ins. Co.*, 521 So. 2d 1298, 1303 (Ala. 1987)). Recognizing that the insurance company does not have to comply with every settlement request, the court stated that "the insurer must act as a prudent insurer in like circumstances." *Id.* The court then found that "all circumstances which bore on the welfare of the insured militated in favor of tender" of the policy limits to settle the case. *Id.*

134. *Id.* at 1484.

135. *Id.* at 1484-87.

136. *Carrier Express*, 860 F. Supp. at 1487-88.

137. *Id.* at 1486.

138. See *id.* at 1481.

that bear a reasonable relationship to the "potential and actual harm and to the high degree of reprehensibility of the defendant's conduct,"<sup>139</sup> and prejudgment interest.<sup>140</sup>

A potential component of compensatory damages for breach of the *L & S Roofing* standards that Alabama courts have not addressed involves the recoverability of attorney fees incurred by the insured in forcing the insurance company to adhere to its enhanced duty of good faith. While attorney fees are generally not a recoverable item of damages, when the insurer fails to meet its obligation to its insured, attorney fees to enforce those obligations form a reasonably foreseeable element of damages and should be recoverable.<sup>141</sup> The Washington Supreme Court recognized attorney fees as an appropriate item of recoverable damages whenever an insurance company forces an insured to incur attorney fees to enforce the insurance company's obligations to the insured.<sup>142</sup>

In *Olympic Steamship Co. v. Centennial Insurance Co.*,<sup>143</sup>

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139. *Id.* at 1487.

140. *Id.* at 1487-88.

141. See, e.g., *Green v. J.C. Penney Auto. Ins. Co.*, 806 F.2d 759, 765 (7th Cir. 1986) (applying Illinois law) ("[W]here an insurer breaches its duty to defend its insured and thereby forces the insured to bear the burden of initiating a declaratory judgment action against the insurer, the insured can recover attorneys' fees incurred from bringing the declaratory judgment action."); *Beckwith Mach. Co. v. Travelers Indem. Co.*, 638 F. Supp. 1179, 1189-90 (W.D. Pa. 1986); *Independent Sch. Dist. v. St. Paul Fire & Marine Ins. Co.*, 515 N.W.2d 576, 581 (Minn. 1994); *Olympic Steamship Co. v. Centennial Ins. Co.*, 811 P.2d 673 (Wash. 1991); *Aetna Cas. & Sur. Co. v. Pitrolo*, 342 S.E.2d 156, 159-61 (W. Va. 1986). But cf. *Hilde v. United States Fire Ins. Co.*, 362 S.E.2d 69, 71-72 (Ga. Ct. App. 1987) (indicating that "damages in the form of court costs and attorney fees should flow only from a determination that the company had in bad faith denied its contractual obligation" and refusing to award such damages incurred in defense of a legitimate request for a declaration of rights through the use of a declaratory judgment action).

For discussion of recoverability of attorney fees in the context of wrongful refusal to defend, see Karon O. Bowdre, "Litigation Insurance": *Consequences of an Insurance Company's Wrongful Refusal to Defend*, 44 *DRAKE L. REV.* 743, 766-69 (1996).

142. See *Olympic Steamship Co. v. Centennial Ins. Co.*, 811 P.2d 673, 681 (Wash. 1991); see also *Gossett v. Farmers Ins. Co.*, 948 P.2d 1264, 1274-78 (Wash. 1997) (holding that award of attorney fees to an insured who prevails in a coverage dispute withstands constitutional challenge); *Leingand v. Pierce County Med. Bureau*, 930 P.2d 288, 293-96 (Wash. 1997) (holding that insured was entitled to attorney fees from a health insurer who forced litigation of coverage); *McGreevy v. Oregon Mut. Ins. Co.*, 904 P.2d 731 (Wash. 1995) (reaffirming *Olympic Steamship*).

143. 811 P.2d 673 (Wash. 1991).

the Washington Supreme Court applied equitable principles to hold that "an award of fees is required in any legal action where the insurer compels the insured to assume the burden of legal action, to obtain the full benefit of his insurance contract, regardless of whether the insurer's duty to defend is at issue."<sup>144</sup>

The Washington Supreme Court elaborated on its reasoning for allowing such an award of attorney fees in *McGreevy v. Oregon Mutual Insurance Co.*<sup>145</sup> The court reaffirmed *Olympic Steamship* and pronounced that awarding attorney fees to insureds who are forced to litigate to obtain the insurance benefits for which they purchased insurance does not violate the traditional American rule on attorney fees.<sup>146</sup> Indeed, the court determined that allowing fees in such a circumstance "is consistent with the long-standing rule that an award of fees may be based on recognized grounds of equity."<sup>147</sup> Those equitable grounds on which the court relied include that insurance contracts differ from other contracts<sup>148</sup> because of the "disparity of bargaining power between an insurance company and its policy-

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144. *Olympic Steamship*, 811 P.2d at 681, *overruling in part* *Farmers Ins. Co. v. Rees*, 638 P.2d 580 (Wash. 1982). In reaching this conclusion, the court stated:

We also extend the right of an insured to recoup attorney fees that it incurs because an insurer refuses to defend or pay the justified action or claim of the insured, regardless of whether a lawsuit is filed against the insured. Other courts have recognized that disparity of bargaining power between an insurance company and its policyholder makes the insurance contract substantially different from other commercial contracts. When an insured purchases a contract of insurance, it seeks protection from expenses arising from litigation, not "vexatious, time-consuming, expensive litigation with his insurer." Whether the insured must defend a suit filed by third parties, appear in a declaratory action, or as in this case, file a suit for damages to obtain the benefit of its insurance contract is irrelevant. In every case, the conduct of the insurer imposes upon the insured the cost of compelling the insurer to honor its commitment and, thus, is equally burdensome to the insured. Further, allowing an award of attorney fees will encourage the prompt payment of claims.

*Id.* at 681 (citations and footnote omitted).

145. 904 P.2d 731 (Wash. 1995).

146. *McGreevy*, 904 P.2d at 735. The court noted that "[t]he American Rule on attorney fees is that attorney fees are not recoverable by the prevailing party as costs of litigation unless the recovery of such fees is permitted by contract, statute, or some recognized ground in equity." *Id.* at 735 n.8 (citation omitted).

147. *Id.* at 735.

148. *Id.* at 736 (citing *Olympic Steamship*, 811 P.2d at 673).

holder"<sup>149</sup> and the desire of the purchaser of insurance to obtain "protection from expenses arising from litigation, not 'vexatious, time-consuming, expensive litigation with his insurer."<sup>150</sup> These reasons, the court concluded, supported the creation of an equitable remedy "that follows from the special fiduciary relationship that . . . [exists] between an insurer and insured."<sup>151</sup> The court then discussed the enhanced obligation of good faith recognized in *Tank* as growing out of that fiduciary relationship.<sup>152</sup> The fiduciary relationship gives rise to the enhanced obligation of good faith that requires that an insurance company "must deal fairly with an insured, giving equal consideration in *all matters* to the insured's interests."<sup>153</sup> The court, therefore, concluded that

when an insurer unsuccessfully engages an insured in litigation to deny coverage, it can be said that the insurer not only delays the benefit of the bargain of the insurance contract to the insured, but also that the insurer acts in contravention to its enhanced fiduciary obligations. Providing a remedy for this inequitable situation is at the bottom of the rule announced in *Olympic Steamship*.<sup>154</sup>

Bad faith by the insurer did not factor into the decisions in *Olympic Steamship* or *McGreevy*.<sup>155</sup> Had the insurance companies engaged in bad faith, the court noted that "the existence of bad faith alone would support the invocation of the court's equitable powers to award attorney fees . . . ."<sup>156</sup>

An insured can thus make a viable argument that an insurance company that breaches its enhanced obligation of good faith, thereby forcing the insured to incur attorney fees to enforce that obligation, should be responsible for reimbursing those fees. Whether the Alabama Supreme Court will agree remains

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149. *Id.* (quoting *Olympic Steamship*, 811 P.2d at 673).

150. *McGreevy*, 904 P.2d at 736 (quoting *Olympic Steamship*, 811 P.2d at 673 (quoting *Hayseeds, Inc.*, 352 S.E.2d at 79)).

151. *Id.*

152. *Id.* (citing *Tank v. State Farm Fire & Cas. Co.*, 715 P.2d 1133 (Wash. 1986)).

153. *Id.* (quoting *Tank*, 715 P.2d at 1136).

154. *Id.* (footnote omitted).

155. See *Olympic Steamship*, 811 P.2d at 673; *McGreevy*, 904 P.2d at 736-37.

156. *McGreevy*, 904 P.2d at 737 (citing *Miotke v. Spokane*, 678 P.2d 803 (Wash. 1984)).

one of the unanswered questions in the *L & S Roofing* mine field.

#### *D. Evaluation of Settlement Options*

1. *The Insurance Company's Dilemma.*—Several decades ago, courts recognized that an insurance company defending its insured must meet the good faith obligation to settle an appropriate case.<sup>157</sup> Failure to settle a case that involves significant liability exposure to the insured can result in a suit against the insurance company for negligence or bad-faith failure to settle.<sup>158</sup> The obligation of good faith in defending the insured arises from the control that the insurance company retains by contract over the defense and settlement of claims against the insured and from the fiduciary obligation thus created. In fact, breach of this duty of good faith in evaluating settlement led to the recognition of the first cause of action for bad faith against an insurance company.<sup>159</sup> How this principle of good faith in evaluating settlement opportunities plays out in reservation-of-rights cases remains unclear in Alabama.

When an insurance company defends under reservation of rights, it faces particular problems regarding its independent obligation to settle appropriate cases. If the case against the insured should be settled because of potential exposure to an excess judgment against the insured, the insurer faces a quandary: settle and waive the right to challenge coverage,<sup>160</sup> or refuse to settle and be sued for bad-faith failure to settle.<sup>161</sup>

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157. See, e.g., *State Farm Mut. Auto. Ins. Co. v. Hollis*, 554 So. 2d 387 (Ala. 1989); *Waters v. American Cas. Co.*, 73 So. 2d 524 (Ala. 1954); *Crisci v. Sec. Ins. Co.*, 426 P.2d 173 (Cal. 1967); *Rova Farms Resort, Inc. v. Investors Ins. Co. of Am.*, 323 A.2d 495 (N.J. 1974).

158. See, e.g., *Hollis*, 554 So. 2d at 389-90; *Waters*, 73 So. 2d at 529; *Crisci*, 426 P.2d at 177; *Rova Farms Resort*, 323 A.2d at 505; see also Karon O. Bowdre, *Conflicts of Interest Between Insurer and Insured: Ethical Traps for the Unsuspecting Defense Counsel*, 17 AM. J. TRIAL ADVOC. 101, 128-42 (1993).

159. See JERRY, *supra* note 4, § 25G[b].

160. *Employers Mut. Liab. Ins. Co. v. Sears, Roebuck & Co.*, 621 F.2d 746 (5th Cir. 1980) (applying Louisiana law and holding that insurer's settlement of claim without reserving its rights or obtaining a non-waiver agreement waived the defenses to coverage).

161. See, e.g., *Carrier Express, Inc. v. Home Indem. Co.*, 860 F. Supp. 1465 (N.D. Ala. 1994); cases cited *supra* note 157.



Some insurance companies seem to believe that the contest of coverage insulates them from liability for failure to settle. Taking such a position, however, can be dangerous.

For example, in *Carrier Express, Inc. v. Home Indemnity Co.*,<sup>162</sup> one of the ways Home violated its obligation to the insured was in refusing to settle for policy limits when it could do so.<sup>163</sup> The court noted that, under the *L & S Roofing* standard, because the insured may ultimately have to pay any judgment or settlement, the insured "must make the ultimate choice regarding settlement."<sup>164</sup> Instead of heeding the numerous written demands from the insured to settle the case

Home treated this decision as solely its own, placing its interests above those of its insured and heedlessly disregarding the position of financial peril in which the underlying cases placed its insured. While an insurance company is not bound to comply with every demand for tender by an insured, the insurer must act as a prudent insurer in like circumstances.<sup>165</sup>

Judge Guin instructed the jury that it could consider numerous factors in evaluating whether the refusal to settle by the insurance company constituted bad faith.<sup>166</sup> Not included in

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162. 860 F. Supp. 1465 (N.D. Ala. 1994).

163. *Carrier Express*, 860 F. Supp. at 1482-83.

164. *Id.* at 1483 (quoting *L & S Roofing Supply Co. v. St. Paul Fire & Marine Ins. Co.*, 521 So. 2d 1298, 1303 (Ala. 1987)).

165. *Id.* at 1483.

166. Judge Guin instructed the jury to consider the following queries in evaluating whether Home acted in good faith:

- (1) Was there a full investigation of the facts of the case?
- (2) Was there an incompetent or dishonest evaluation of the underlying case?
- (3) Did Home properly analyze the strength of its insured's position in the underlying cases from both a liability and damages standpoint?
- (4) In deciding not to enter into settlement negotiations before the summary judgment hearing [when the policy limits settlement offer would expire], did Home place its interests ahead of the interests of [the insured]?
- (5) Was the refusal of Home to settle related in any way to the existence of reinsurance? . . . [Home reinsured one-half of its million dollars of coverage.]
- (6) Did Home establish appropriate reserves to settle the case?
- (7) Did Home (a) fail to respond to settlement offers, or (b) delay responding to settlement offers, or (c) fail to explore settlement possibilities when it would have been prudent to do so? . . .
- (8) Was there an opportunity to settle the case within policy limits?
- (9) Did the insured . . . request settlement within the policy limits? . . .
- (10) Did Home fail to keep the insured advised of relevant facts and developments?

those factors was whether Home relied on its dispute of coverage in refusing to settle.<sup>167</sup>

The standard Judge Guin used to instruct the jury was the same standard employed by the Alabama Supreme Court to evaluate a failure to settle by an insurance company that provided a complete defense.<sup>168</sup> That standard includes whether the insurance company applied its expertise to consider all the factors in evaluating the wisdom of settlement "for the protection of the insured."<sup>169</sup> The factors regarding settlement include the evaluation by the carrier and defense counsel as to liability; the anticipated range of an adverse verdict; the strengths and weaknesses of all the evidence; the history of verdicts in the particular jurisdiction; and the relative appearances and credibility of the parties and witnesses.<sup>170</sup> Advice of defense counsel is one of many factors, but the insurance company owes an independent duty to its insured to exercise honest judgment in evaluating settlement in a reservation-of-rights case.<sup>171</sup> Thus, the insur-

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(11) Was the amount of risk to the insured, . . . if the case was not settled, disproportionately large when compared to the risk to the insurer? . . .

(12) Did Home heed or listen to or take its own counsel's advice?

(13) Did Home act in an arbitrary, inflexible manner, indifferent to the consequences to the insured?

(14) Did Home properly react to adverse developments?

(15) Was Home negligent? Although inadequate by itself to prove bad faith, evidence of the insurer's negligence, in failing to settle the case may be considered by you in determining the issue of bad faith.

(16) Did Home request some third party to contribute to the settlement before it offered its own policy limits?

(17) Was Home defending the [insured] under a reservation of rights? . . . [Undisputed in this case.]

(18) Any other factors tending to establish or disprove bad faith or negligence on the part of the insurer.

*Id.* at 1479-80.

167. *See id.*; *Parsons v. Continental Nat'l Am. Group*, 550 P.2d 94, 100 (Ariz. 1976) ("In the instant case the further fact that the carrier believed there was no coverage under the policy and so refused to give any consideration to the proposed settlements did not absolve them [sic] from liability for the entire judgment entered against the insured." (citation omitted)); *Johansen v. California State Auto. Ass'n Inter-Ins. Bureau*, 538 P.2d 744, 746 (Cal. 1975).

168. *Cf. State Farm Mut. Auto. Ins. Co. v. Hollis*, 554 So. 2d 387, 390-92 (Ala. 1989).

169. *Hollis*, 554 So. 2d at 391 (quoting *Shearer v. Reed*, 428 A.2d 635, 638-39 (Pa. 1981)).

170. *Id.*

171. *City of Orange Beach, Ala. v. Scottsdale Ins. Co.*, 166 F.R.D. 506, 508, 510,

ance company that disputes coverage finds itself between a rock and a hard place in this *L & S Roofing* mine field when it desires to contest coverage but, without the reservation of rights, should settle the case.

2. *Possible Options.*—Some courts have specifically addressed the effect of an insurer's belief that it owes no coverage upon its refusal to settle a claim against the insured. The fact that an insurance company believes that it has no coverage and thereby owes no duty to indemnify does not absolve it from liability for failure to settle the case against the insured when coverage is found to exist.<sup>172</sup> The only considerations in evaluating settlement should be the victim's injuries, the probable liability of the insured, and the likelihood that the ultimate judgment will exceed policy limits.<sup>173</sup> As one court noted, "[s]uch factors as the limits imposed by the policy, a desire to reduce the amount of future settlements, or a belief that the policy does not provide coverage, should not affect a decision as to whether the

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511 (S.D. Ala. 1996), *aff'd*, 113 F.3d 1251 (11th Cir. 1997); *Hollis*, 554 So. 2d at 390-91.

172. See, e.g., *Parsons*, 550 P.2d at 100; *Johansen*, 538 P.2d at 746; *Camelot* by the Bay Condominium Owners' Ass'n v. Scottsdale Ins. Co., 32 Cal. Rptr. 2d 354 (Cal. Ct. App. 1994). But cf. *Mowry* v. Badger State Mut. Cas. Co., 385 N.W.2d 171 (Wis. 1986) (holding that the insurance company did not act in bad faith in refusing to settle based on a debatable coverage issue). Although in *Universal Underwriters Insurance Co. v. East Central Alabama Ford-Mercury, Inc.*, 574 So. 2d 716, 726 (Ala. 1990), the Alabama Supreme Court cited *Mowry* favorably in dicta, two important distinctions exist between Alabama and Wisconsin law that raise questions about the appropriateness of reliance on Wisconsin case law. First, Wisconsin allows direct actions by third parties against the tortfeasor's insurance company. See WISC. STAT. § 803.04 (1994). The *Mowry* case involved a direct action. 385 N.W.2d at 176. Alabama law specifically prohibits such a direct action. See ALA. R. CIV. P. 18(c). Second, Wisconsin does not impose on insurers an enhanced obligation of good faith when defending under a reservation of rights. See *Mowry*, 385 N.W.2d at 176. Thus, this statement from *Mowry* cited by the Alabama Supreme Court in dicta in *Universal Underwriters* does not provide a sound basis for concluding that a coverage question, even a reasonably debatable one, insulates an insurer from bad faith in refusing to settle a claim against the insured under the *L & S Roofing* standard. Under *L & S Roofing*, the insured has the right to decide whether to settle. 521 So. 2d at 1303.

173. *Johansen*, 538 P.2d at 748-49. See generally *Guidroz* v. State Farm Mut. Auto. Ins. Co., 698 So. 2d 967, 970-71 (La. Ct. App. 1997) (holding that the insurer refused to settle in bad faith, but not a case involving a reservation of rights).

settlement offer in question is a reasonable one."<sup>174</sup> The Alabama Supreme Court exacerbated the dilemma when it stated in *L & S Roofing*: "In a reservation-of-rights defense, it is the insured who may [ultimately] pay any judgment or settlement. Therefore, it is the insured who must make the ultimate choice regarding settlement."<sup>175</sup>

Neither the Alabama Supreme Court nor the Washington Supreme Court has elaborated on just how an insured is to "make the ultimate choice regarding settlement." And whose money does the insured spend when making that "ultimate choice regarding settlement"? Insureds and insurance companies have followed several options when trying to resolve this problem.

For example, in *Mt. Airy Insurance Co. v. Doe Law Firm*,<sup>176</sup> the carrier, who was defending under a reservation of rights, settled the claim against the insured law firm, then sought to recover the amount it paid by filing a declaratory judgment action seeking a determination of no coverage.<sup>177</sup> The Alabama Supreme Court held that the company acted as a volunteer and, therefore, was precluded from seeking reimbursement.<sup>178</sup> If the insurance company had secured a written agreement from the insured that the settlement did not waive the company's right to continue contesting coverage (which the insured refused to do),<sup>179</sup> or if the insurer had obtained a court order allowing it to settle without waiving its rights, the settlement would have provided an efficient way to protect the insured from a potential judgment, to honor the insurance company's obligation to settle, and to preserve the question of coverage for a declaratory judgment action.<sup>180</sup>

In fact, the California Supreme Court suggested such a procedure in *Johansen v. California State Automobile Association Inter-Insurance Bureau*.<sup>181</sup> The court rejected the insur-

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174. *Johansen*, 538 P.2d at 748-49 (emphasis added).

175. 521 So. 2d at 1303 (emphasis omitted) (quoting *Tank v. State Farm Fire & Cas. Co.*, 715 P.2d 1133, 1137-39 (Wash. 1986)).

176. 668 So. 2d 534 (Ala. 1995).

177. *Mt. Airy*, 668 So. 2d at 536.

178. *Id.* at 538.

179. *Id.*

180. *See id.*

181. 538 P.2d 744, 750 (Cal. 1975).

ance company's argument that a ruling that the dispute about coverage did not insulate the insurance company from bad faith would require an insurance company to settle all cases irrespective of coverage.<sup>182</sup> Instead, the court noted that an insurer who challenges coverage

retains the ability to enter an agreement with the insured reserving its right to assert a defense of noncoverage even if it accepts a settlement offer. If, having reserved such rights and having accepted a reasonable [settlement] offer, the insurer subsequently establishes the noncoverage of its policy, it would be free to seek reimbursement of the settlement payment from its insured.<sup>183</sup>

Another option allows the insured to effectuate a settlement with the plaintiff and seek coverage and reimbursement from the insurance company.<sup>184</sup> A financially resourceful insured may actually be able to fund a settlement, but other insureds will need to seek a covenant not to execute and an assignment of their rights against the insurance company.<sup>185</sup> A covenant not to execute allows the insured to settle the claims against it without being subject to execution on its property to satisfy the settlement. The assignment of the insured's claim against the in-

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182. *Johansen*, 538 P.2d at 750.

183. *Id.* at 750; see JERRY, *supra* note 4, § 112[e], at 773. The author explains:

If the insurer is defending the lawsuit under a reservation of rights (which means that the insurer reserves the right to later contest coverage in the event a judgment is entered against the insured or the lawsuit is settled on terms involving payment to the plaintiff), it is ordinarily the insured who pays the amount of any settlement or judgment. Thus, in this situation, the ultimate choice of whether to settle belongs not to the insurer, but to the insured, regardless of the language of the policy. Otherwise the insurer would be taking inconsistent positions: it would be asserting its right under the policy to control settlement, while simultaneously taking the position (or preparing to do so) that it has no obligations under the policy (and concomitantly no rights either) with respect to the particular claim.

JERRY, *supra* note 4, at 773 (footnote omitted).

If the insurer is defending the lawsuit, the insurer cannot refuse to settle the lawsuit because it believes no coverage exists. Refusing to settle puts the insured at risk of an excess judgment. In this situation, it is more appropriate for the insurer to settle the action against the insured subject to a reservation of rights to seek indemnification from the insured should the non-existence of coverage later be established.

184. See, e.g., JERRY, *supra* note 4, at 773, 754-55; *Presrite Corp. v. Commercial Union Ins. Co.*, 680 N.E.2d 216, 217 (Ohio 1996).

185. See, e.g., *Associated Wholesale Grocers, Inc. v. Americold Corp.*, 934 P.2d 65, 82-83 (Kan. 1997); cases cited *infra* notes 186-89.



insurance company for bad faith in refusing to settle provides one valuable aspect of the consideration that the plaintiff receives in exchange for agreeing not to execute against the insured's property.

Although insurance companies sometimes assert that such a settlement violates the terms of the policies,<sup>186</sup> most courts hold that the insured can act to protect his interest when the insurance company has denied coverage or is defending with a reservation of rights and refuses to settle.<sup>187</sup> Indeed, efforts by an insurance company to thwart an insured's efforts to settle, when the insurance company has refused to do so, runs counter to the admonition in *L & S Roofing* that the insured "must make the ultimate choice regarding settlement"<sup>188</sup> in a reservation-of-rights case. In subsequent proceedings to determine the insurance company's obligation to pay, the insurance company can contest coverage and the reasonableness of the settlement; if coverage exists and the settlement is reasonable, the settlement binds the insurer absent a showing of collusion.<sup>189</sup>

Another option sometimes attempted by the insurance company is to settle only the covered claims, while leaving the insured to defend the remaining claims. The Tenth Circuit, in *Magnum Foods, Inc. v. Continental Casualty Co.*,<sup>190</sup> recognized that the mere presence of claims for non-covered punitive dam-

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186. See, e.g., *Gates Formed Fibre Prods., Inc. v. Imperial Cas. & Indem. Co.*, 702 F. Supp. 343, 345 (D. Me. 1988); *Presrite Corp.*, 680 N.E.2d at 220.

187. See, e.g., *McNicholes v. Subotnik*, 12 F.3d 105, 108-09 (8th Cir. 1993); *Insurance Co. of N. Am. v. Spangler*, 881 F. Supp. 539, 544-45 (D. Wyo. 1995); *United Servs. Auto. Ass'n. v. Morris*, 741 P.2d 246, 253-54 (Ariz. 1987); *Granite State Ins. Co. v. Nord Bitumi United States, Inc.*, 422 S.E.2d 191, 194 (Ga. 1992) (answering certified questions from the Eleventh Circuit); *Red Giant Oil Co. v. Lawlor*, 528 N.W.2d 524, 532-33 (Iowa 1995); *Associated Wholesale Grocers*, 934 P.2d at 82-83; *Presrite Corp.*, 680 N.E.2d at 220. But see *Gates Formed Fibre Prods.*, 702 F. Supp. at 347-48. While acknowledging the precarious position of an insured being defended under a reservation of rights and his right to protect himself by settling the case, the court held that the insured breached the cooperation clause of the insurance contract by failing to notify the insurance company of the opportunity to settle. *Id.*

188. *L & S Roofing*, 521 So. 2d at 1303 (emphasis omitted) (quoting *Tank v. State Farm Fire & Cas. Co.*, 715 P.2d 1133, 1138 (Wash. 1986)).

189. E.g., *McNicholes*, 12 F.3d at 109-10; *Spangler*, 881 F. Supp. at 545-46; *Evanston Ins. Co. v. Treister*, 794 F. Supp. 560, 572 (D.V.I. 1992); *Morris*, 741 P.2d at 253-54; *Chaussee v. Maryland Cas. Co.*, 803 P.2d 1339, 1342 (Wash. Ct. App. 1991) (plaintiff had burden to prove that the settlement was reasonable).

190. 36 F.3d 1491 (10th Cir. 1994).

ages did not absolve the insurance company from its duty to act in good faith with the insured to try to settle the whole case.<sup>191</sup> The court commented that

[i]f an insurer fails to act cooperatively to reach a settlement—for example, by refusing to make a reasonable offer to settle *at least the insured portion of the claim*—then the insurer's conduct may be reasonably perceived as tortious, and the trial court may submit the issue of bad faith to the jury.<sup>192</sup>

Such an approach of only settling covered claims offers practical problems and may not comport with the insurance company's duty of good faith. A wiser approach may be for the insurance company to place a value on the covered claims and offer to settle for a bit more than that amount to effectuate a full release of the insured. When the carrier factors in the costs to defend the liability case plus the costs of any declaratory judgment action to determine coverage, as well as the possibility of a bad-faith claim against it by the insured, the company may be able to justify adding enough into a settlement offer to resolve the case.

Perhaps the most efficient and feasible way to navigate the settlement mine field involves cooperation among the insurance company, the insured, defense counsel, coverage counsel, and the insured's counsel. By agreement, the parties can work out a settlement arrangement that allocates the settlement payment between covered, or potentially covered, and non-covered counts. The insurance company then contributes the amount allocated to covered claims, and the insured pays to settle the non-covered claims.<sup>193</sup> Such cooperation benefits both the insurance company and the insured. The insured has the liability claim against it resolved without the risk of an excess verdict; the insurance company fulfills its obligation to protect the interests of the insured by settling an appropriate case. Both avoid additional litigation expenses to resolve the coverage question.<sup>194</sup>

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191. *Magnum Foods*, 36 F.3d at 1506.

192. *Id.* at 1508 (emphasis added).

193. If the insurance company and the insured cannot reach a compromise on the coverage questions, they still have available the option suggested by the California court as discussed *supra* text accompanying note 183.

194. From discussions with defense counsel, the author concluded that this approach of cooperation is the favored and most frequently used method to settle cases

Another favored option involves submission of the liability case and the coverage dispute to mediation.<sup>195</sup> A mediator familiar with insurance coverage disputes can help the insurance carrier and the insured come to an agreement about allocation of settlement amounts, or can help construct another method for resolving the liability case and preserving the coverage dispute.

While the Alabama Supreme Court has not sanctioned any of these options, one fact remains clear: an insurer who refuses to settle a case that by all objective standards should be settled acts at its own peril because it has demonstrated a greater concern for its own interest in contesting coverage than for the insured's interest in being protected against the liability judgment.<sup>196</sup>

*3. The Insurance Defense Counsel's Obligations.*—The insurance defense counsel cannot rest easy in a reservation-of-rights defense when the case should be settled to protect the insured. He may well be caught between the proverbial rock and a hard place: the insurer does not want to pay a claim that it may not owe, and the insured does not want to be left with an uncovered or excess verdict. The Alabama Rules of Professional Conduct and cases give some convoluted guidance for the attorney in such a situation.

The insurance policy modifies at least one rule of professional conduct. Under Rule 1.2(a), a lawyer "shall abide by" the client's decision regarding settlement.<sup>197</sup> Under most insurance policies, the insurance company retains the right to control settlement. Because the insured has contracted away the right to decide whether to settle a case, the attorney, in the ordinary insurance defense case,<sup>198</sup> no longer has to abide by the cli-

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that are defended under a reservation of rights.

195. See Mike Maddox, Alternative Dispute Resolution: Coverage Issues, Cumberland Continuing Legal Education Program, Insurance Law: An Update on Traditional Issues and a Look at Emerging Questions and Theories, Sept. 19, 1997.

196. See *L & S Roofing*, 521 So. 2d at 1303.

197. ALABAMA RULES OF PROFESSIONAL CONDUCT Rule 1.2(a) (1996) (emphasis added).

198. The Alabama Supreme Court has recognized that the insurance contract language reserving to the insurance company the right to control settlement trumps the insurance defense attorney's obligation to allow the insured/client to control settlement. See *Mitchum v. Hudgens*, 533 So. 2d 194, 198-202 (Ala. 1988). However, the

ent/insured's decision.<sup>199</sup> The defense attorney should make sure that the insured/client understands the ramifications of the insurance company's control of the defense on the settlement issue. Also, *L & S Roofing* requires that counsel advise the insured of all settlement offers; failure to do so results in a violation of the enhanced duty of good faith.<sup>200</sup>

If, however, the insured may still have a financial interest in the settlement, such as a deductible or retention, or *when a possibility exists of no coverage*, the insured still has the right to decide whether to settle.<sup>201</sup> If an attorney in such a situation actively participates in a settlement against the wishes of the insured, he may find himself facing a malpractice claim.<sup>202</sup>

Because the insurance company may ultimately be responsible for indemnification of any judgment or settlement against the insured, and because under the *L & S Roofing* standard the insurance company does not relinquish control of the defense,<sup>203</sup> the insurance defense counsel still owes the responsibility to keep the insurance company apprised of developments in the case against the insured. The insurance company relies on the insurance defense counsel's evaluation of the case against the insured in making its decision about settlement.<sup>204</sup> The defense counsel's evaluation of the case should include the likelihood of success, the appearance and credibility of witnesses and parties, history of verdicts in the jurisdiction of the trial, etc.<sup>205</sup>

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*Mitchum* case did not involve a reservation-of-rights defense. *L & S Roofing* changed the obligations the insurance company and defense counsel owe the insured concerning settlement choices when the insurance company defends under a reservation of rights. See *L & S Roofing*, 521 So. 2d at 1303.

199. *Mitchum*, 533 So. 2d at 196-202; see ABA Comm. on Ethics and Professional Responsibility, Formal Opinion 96-403 (1996).

200. See *L & S Roofing*, 521 So. 2d at 1303.

201. See *id.*; *St. Paul Fire & Marine Ins. Co. v. Edge Mem'l Hosp.*, 584 So. 2d 1316, 1326 (Ala. 1991).

202. See *Rogers v. Robson, Masters, Ryan, Brummund & Belom*, 392 N.E.2d 1365, 1372 (Ill. App. 1979), *aff'd*, 407 N.E.2d 47 (Ill. 1980); *Lieberman v. Employers Ins.*, 419 A.2d 417, 425 (N.J. 1980).

203. See *L & S Roofing*, 521 So. 2d at 1302-03.

204. See *Carrier Express, Inc. v. Home Indem. Co.*, 860 F. Supp. 1465, 1479 (N.D. Ala. 1994); *City of Orange Beach, Ala. v. Scottsdale Ins. Co.*, 166 F.R.D. 506, 510-11 (S.D. Ala. 1996), *aff'd*, 113 F.3d 1251 (11th Cir. 1997); *State Farm Mut. Auto. Ins. Co. v. Hollis*, 554 So. 2d 387, 391 (Ala. 1989).

205. *Hollis*, 554 So. 2d at 391; *Hartford Accident & Indem. Co. v. Foster*, 528 So. 2d 255 (Miss. 1988); *Rova Farms Resort, Inc. v. Investors Ins. Co. of Am.*, 323 A.2d

Defense counsel must relay settlement offers to the insurance company as well as to the insured. Whether defense counsel can do more than merely point out to the company that the settlement offer is in the insured's best interest is a matter in dispute.<sup>206</sup> At the very least, counsel must refrain from taking action that contravenes the best interest of the insured, his *only* client.

4. *The Role of Separate Counsel.*—One obligation that the insurance defense counsel should undertake consists of advising the insured of his right to consult separate counsel at his own expense.<sup>207</sup> The reservation-of-rights letter usually conveys this information, but defense counsel would be wise to reiterate the benefits of such consultation. The benefits to the insured and defense counsel of consultation with separate counsel become important during settlement negotiations. Although separate counsel may be able to do little more than request the insurance company to settle—something the insured could do equally as well—having separate counsel make the demand to the insurer may lend additional weight to the request.<sup>208</sup> Also, defense counsel has some degree of insulation when working with separate counsel to effectuate a settlement in the insured's best interest.

The most important aspect of separate counsel's role lies in the advice she gives the insured on matters where the interest

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495, 503-04 (N.J. 1974); *Shearer v. Reed*, 428 A.2d 635, 638-39 (Pa. 1981).

206. See cases discussed in *Foster*, 528 So. 2d at 272-73.

207. "Separate counsel" refers to the attorney hired by the insured to advise the insured at the insured's expense when the insurance company defends under a reservation of rights, or when a possibility of an excess judgment exists and the insured wants advice about settlement.

208. See generally *Delancy v. St. Paul Fire & Marine Ins. Co.*, 947 F.2d 1536, 1538-43 (11th Cir. 1991) (futility of separate counsel's efforts); *Fulton v. Woodford*, 545 P.2d 979, 982 (Ariz. 1976) (separate counsel unable to protect insured's interest); *Rova Farms Resort*, 323 A.2d at 507-08. In *Rova Farms*, the court stated:

[S]eparate representation usually amounts to nothing more than independent legal advice to the assured, since control of the litigation remains in the hands of the carrier. Control of the defense of the lawsuit cannot be split, and independent legal advice to the assured cannot force the carrier to accept a settlement offer it does not wish to accept. In this instance the normal legal remedy of separate representation is an inadequate solution to the conflict in interest.

*Id.*



of the insurance company and the insured conflict. At the settlement stage, separate counsel can insist that the insurance company honor its obligation to settle within policy limits if the case warrants settlement. Separate counsel can also advise the insured about options available to him if the company refuses to settle. Separate counsel could negotiate a settlement with the plaintiff that includes an agreement not to execute against the insured in exchange for an assignment of the insured's rights against the insurance company.

In sum, separate counsel must look out for the best interests of the insured and work to see that those interests are protected through the conduct of the defense and settlement negotiations.

### *E. Confidential Information Gleaned from the Insured*

Although defense counsel still must keep the insurance company advised about the suit against the insured,<sup>209</sup> defense counsel must be very careful to stay clear of any matters affecting coverage.<sup>210</sup> Under Rule 1.6, the attorney must maintain the confidences of the client.<sup>211</sup> Anything learned from the in-

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209. See Nancy J. Moore, *Ethical Issues in Third-Party Payment: Beyond the Insurance Defense Paradigm*, 16 REV. LITIG. 585, 592 (1997) (noting that the insurance policy entitles the insurance company to receive information regarding the representation); Debra A. Winiarski, *Walking the Fine Line: A Defense Counsel's Perspective*, 28 TORT & INS. L.J. 596, 600 (1993); see also *Kansas Bankers Sur. Co. v. Lynass*, 920 F.2d 546, 549 (8th Cir. 1990) (holding that a conflict of interest existed where the insurer provided a defense when it knew it could later contest coverage); *Parsons v. Continental Nat'l Am. Group*, 550 P.2d 94, 98-99 (Ariz. 1976) (holding that an attorney could not disclose information detrimental to the insured); *Medical Mut. Liab. Ins. Soc'y v. Miller*, 451 A.2d 930, 934 (Md. 1982) (holding that continued dual representation after a conflict arose estopped the insurer from disclaiming liability).

210. See *State Farm Mut. Auto. Ins. Co. v. Walker*, 382 F.2d 548, 551-52 (7th Cir. 1967); Winiarski, *supra* note 209, at 597. The author states:

Under no circumstances can defense counsel ethically divulge facts that may result in the denial of insurance coverage by the insurer to the insured. Indeed, a lawyer's breach of this tenet can result in not only discipline for breach of the ethical rules, but also malpractice liability, and even the insurer's loss of coverage defenses.

Winiarski, *supra* note 209, at 597 (footnotes omitted).

211. ALABAMA RULES OF PROFESSIONAL CONDUCT Rule 1.6 (1996); see *supra* note

sured about the coverage question to which the precept of client confidentiality applies must not be revealed to the insurance company.<sup>212</sup> If an attorney uses the confidential relationship with the insured to gather information about the coverage dispute then passes that information along to the insurance company, the insurer will be estopped from denying coverage and will be held to have waived any policy defense.<sup>213</sup> Not only will the insurance company face consequences, but the attorney will also be subject to discipline and malpractice liability for violating the duties of client confidentiality and loyalty.<sup>214</sup>

To further complicate the matter, defense counsel must also remember that the duty of confidentiality and loyalty to the insured has limits. As in all lawyer/client relationships, the Alabama Rules of Professional Conduct prohibit an attorney from assisting a client in the perpetration of a crime or fraud.<sup>215</sup> If an attorney learns that the insured he is defending is actually engaged in fraud against the insurance company, the attorney should consider whether withdrawal is necessary.<sup>216</sup>

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212. See *Parsons*, 550 P.2d at 98-99; Moore, *supra* note 209, at 592-93 (noting that even when insurance company and insured enjoy the status of co-clients, that relationship does not allow the attorney to pass along confidential information); Winiarski, *supra* note 209, at 597.

213. *Parsons*, 550 P.2d at 99.

214. See ABA Comm. on Ethics and Professional Responsibility, Informal Op. 1476 (1981); Winiarski, *supra* note 209, at 597.

215. See ALABAMA RULES OF PROFESSIONAL CONDUCT Rules 1.2(d), 1.16(a)(1), 4.1 (1996).

216. See *id.* Rule 1.16(a)(1). That rule provides that "a lawyer shall not represent a client or, where representation has commenced, shall withdraw from the representation of a client, if: (1) the representation will result in violation of the Rules of Professional Conduct or other law." *Id.* The most relevant ethics rule that could be violated in this context would be Rule 1.2(d), which provides that an attorney "shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client." *Id.* Rule 1.2(d) (emphasis added).

The Comment to Rule 1.16(a)(1) clarifies that the attorney does not have to withdraw "simply because the client suggests such a course of conduct." *Id.* Rule 1.16(a)(1) cmt. Indeed, the attorney may be able to talk the client out of fraudulent conduct. If unsuccessful, the attorney should then withdraw so as not to be viewed as assisting the client in fraudulent conduct. See ALABAMA RULES OF PROFESSIONAL CONDUCT Rule 1.2(d) (1996); JERRY, *supra* note 4, at 814; Winiarski, *supra* note 209, at 599. The Comment to Rule 1.6 provides that the lawyer can give notice of withdrawal and "may also withdraw or disaffirm any opinion, document, affirmation, or the like." ALABAMA RULES OF PROFESSIONAL CONDUCT Rule 1.6 cmt. (1996). Although

Even if the attorney withdraws from the representation, he cannot disclose to the insurance company information learned from the insured in confidence that adversely affects insurance coverage, unless the insured consents.<sup>217</sup> Consent by the insured would be highly unlikely if the matter has progressed to the point where the attorney has to withdraw.

A puzzling Comment to Rule 1.6 of the Alabama Rules of Professional Conduct specifically addresses disclosure to the insurance company of information relevant to coverage:

When coverage is or may be disputed, a lawyer representing an insured pursuant to an insurance contract may disclose any information pertinent to the issue of coverage to the insurer as well as to the insured. Although the insurer in such a situation is not the appointed attorney's client, as opposed to the situation in a normal insurance defense relationship, such disclosure is impliedly authorized in order to carry out the representation. However, the lawyer should avoid disclosing information to the insurer that the lawyer knows would adversely affect insurance coverage for the insured, unless either such disclosure is approved by the insured or the lawyer has assurances that the insurer will not use the information to the insured's disadvantage.<sup>218</sup>

This Comment poses troubling questions and seems to conflict with Rule 1.8(f),<sup>219</sup> the intent of Rule 1.6,<sup>220</sup> and the enhanced obligations imposed on defense counsel by *L & S Roofing*.<sup>221</sup> One possible way to resolve the apparent conflicts is to read the Comment narrowly. An appropriate interpretation of the Comment, in light of the other rules and *L & S Roofing*, would be to allow disclosure of information relevant to the defense of the in-

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the Comment to Rule 1.6 sanctions a "noisy withdrawal," such a practice is only appropriate when another party would continue to rely on the attorney's past work for the client that turned out to be fraudulent. See *id.* Unless the attorney has made some representation to the insurance company that later turns out to be fraudulent, the attorney need not disavow prior work. Because defense counsel should not be involved in the coverage dispute, a noisy withdrawal should rarely be appropriate.

217. See ALABAMA RULES OF PROFESSIONAL CONDUCT Rule 1.6 & cmt. (1996); JERRY, *supra* note 4, at 814 and cases cited therein.

218. ALABAMA RULES OF PROFESSIONAL CONDUCT Rule 1.6 cmt. (1996).

219. *Id.* Rule 1.8(f); see Rule 1.8(f), *supra* text accompanying note 37.

220. See *id.* Rule 1.6; *supra* note 38.

221. *L & S Roofing*, 521 So. 2d at 1303.

sured that may also be relevant to coverage and that does not adversely affect the insured's coverage. Such disclosure should properly be limited to non-confidential information that has been disclosed or learned through discovery. Such information would no longer be protected by the attorney-client privilege. The attorney, in disclosing such information, probably should not draw attention to it or comment on its relevance to coverage. The defense attorney, whose only client is the insured,<sup>222</sup> should not take action adverse to the client and should not help the insurance company build its case for denying coverage.<sup>223</sup>

#### *F. Effects on the Attorney-Client Privilege*

When defense counsel defends the insured without a reservation of rights, the attorney has two clients—the insured and the insurance company—who share common interests in the defense of the case.<sup>224</sup> Communications from defense counsel to the insurance company about information learned from the insured fall within the common interest doctrine.<sup>225</sup> Generally, when information protected by the attorney-client privilege is shared with a third party, such sharing of information waives the attorney-client privilege; the common interest doctrine acts as an exception to that waiver of privilege and protects from disclosure to third parties privileged information shared with those with common interests.<sup>226</sup>

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222. See *id.*

223. See *id.*; *Parsons v. Continental Nat'l Am. Group*, 550 P.2d 94, 99 (Ariz. 1976); cases cited *supra* note 205.

224. See Bowdre, *supra* note 158, at 103-06 and cases cited therein.

225. See *Nationwide Mut. Ins. Co. v. Smith*, 194 So. 2d 505 (Ala. 1966); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 126 (Proposed Final Draft No. 1, 1996). For a thorough discussion of this doctrine, see James M. Fischer, *The Attorney-Client Privilege Meets the Common Interest Arrangement: Protecting Confidences While Exchanging Information for Mutual Gain*, 16 REV. LITIG. 631 (1997).

226. See Fischer, *supra* note 225, at 637. The common interest doctrine operates most often as a shield to protect disclosure to third parties, but it has occasionally operated as a sword to force disclosure of privileged information with another who shared an interest in the matter. *Id.* at 637-44; see also *Pittston v. Allianz Ins. Co.*, 143 F.R.D. 66, 69 (D.N.J. 1992); *Emons Indus., Inc. v. Liberty Mut. Ins. Co.*, 747 F. Supp. 1079, 1082 (S.D.N.Y. 1990); *Waste Management, Inc. v. International Surplus Lines Ins. Co.*, 579 N.E.2d 322, 328 (Ill. 1991) (using common interest doctrine to force disclosure to the insurance company of privileged information shared between

However, when the carrier undertakes a reservation-of-rights defense, the interests of the insured and the insurance company are not totally the same.<sup>227</sup> The insurance company and the insured, however, do still share an interest in an effective defense of the lawsuit against the insured. In a reservation-of-rights defense situation, are communications between the insured and defense counsel subject to discovery by the carrier? Does the fact that defense counsel makes reports to the insurance company act as a waiver of the attorney-client privilege as to third parties?

Alabama has not addressed these precise questions,<sup>228</sup> and the sparse authority from other jurisdictions does not provide definitive answers.<sup>229</sup> The majority rule appears to be that when the insurance company defends under a reservation of rights, the common interest doctrine no longer operates to allow the company to discover information revealed by the policyholder to the attorney because the insured and insurer have an adversarial relationship as to coverage, and the privilege applies to thwart disclosure to the insurance company.<sup>230</sup> However, the lack of totality of interest between insured and insurer should not act to remove the protection of the common interest doctrine as a shield to disclosure to third parties when the communica-

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insured and defense counsel).

227. See cases cited *supra* note 5.

228. See generally *International Bhd. of Teamsters v. Hatas*, 252 So. 2d 7, 27-28 (Ala. 1971) (addressing the application of the attorney-client privilege to communications in which a third party who is interested in the legal matter is also present).

229. E.g., *Eureka Inv. Corp., N.V. v. Chicago Title Ins. Co.*, 743 F.2d 932, 936-38 (D.C. Cir. 1984); *First Pac. Networks, Inc. v. Atlantic Mut. Ins. Co.*, 163 F.R.D. 574, 581 (N.D. Cal. 1995) (stating that because the insurance company and the policyholder were not joint defendants in actual litigation, the doctrine did not apply); *Northwood Nursing & Convalescent Home, Inc. v. Continental Ins. Co.*, 161 F.R.D. 293 (E.D. Pa. 1995); *Vermont Gas Sys., Inc. v. United States Fidelity & Guar. Co.*, 151 F.R.D. 268 (D. Vt. 1993); *Remington Arms Co. v. Liberty Mut. Ins. Co.*, 142 F.R.D. 408 (D. Del. 1992); *North River Ins. Co. v. Philadelphia Reinsurance Corp.*, 797 F. Supp. 363, 366-68 (D.N.J. 1992). But cf. *Waste Management*, 579 N.E.2d at 328 (following the minority rule and allowing the insurer discovery of privileged information based on the common interest doctrine).

230. See *First Pac. Networks*, 163 F.R.D. at 578-79 (stating that because the carrier had reserved its rights to contest coverage, no common interest existed and their interests were adversarial; thus, the doctrine did not apply to force disclosure); *Remington Arms*, 142 F.R.D. at 417-18 (noting that the common interest doctrine does not apply if the attorney never personally represented the interest of the party seeking disclosure).



tion between the insurance company and the insured advances their mutual interest in the defense of the insured.<sup>231</sup>

The Alabama Rules of Professional Conduct provide another reason for asserting that the attorney-client privilege continues to exist between defense counsel and the insured. Rule 2.3<sup>232</sup> provides that the attorney may make reports to third parties on behalf of the insured without waiving the attorney-client privilege. Defense counsel must, of necessity, report matters concerning the defense of the case to the insurance company. Defense counsel, likewise, must keep privileged communications confidential.<sup>233</sup> These rules bolster the argument that the attorney-client privilege should remain inviolate in spite of the change in relationships caused by the reservation-of-rights defense. Even in a reservation-of-rights defense, under *L & S Roofing*, the insurance company does not relinquish control over the defense of the case.<sup>234</sup> Thus, these communications between

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231. See Fischer, *supra* note 225, at 642; see also *Rockwell Int'l Corp. v. Superior Court*, 26 Cal. App. 4th 1255, 1264 (Cal. Ct. App. 1994) (holding that disclosure of information to the insurer does not waive the privilege as to any other party).

232. ALABAMA RULES OF PROFESSIONAL CONDUCT Rule 2.3 (1996). That Rule reads:

(a) A lawyer may undertake an evaluation of a matter affecting a client for the use of someone other than the client if:

(1) the lawyer reasonably believes that making the evaluation is compatible with other aspects of the lawyer's relationship with the client; and  
(2) the client consents after consultation.

(b) Except as disclosure is required in connection with a report of an evaluation, information relating to the evaluation is otherwise protected by Rule 1.6.

*Id.* Although the Comments to Rule 2.3 do not specifically refer to the insurance defense situation, an evaluation of the claim against the insured must be relayed to the insurance company for the benefit of the insured so that the insurance company can properly evaluate the defense of the case and whether to settle, etc. See *id.* Rule 2.3 cmt. Thus, such a report is "an evaluation of a matter affecting a client" and is "compatible with other aspects of the lawyer's relationship with the client." See *id.* Rule 2.3. Therefore, matters disclosed to the insurance company by defense counsel should not lose the protection of Rule 1.6. See *id.*

233. ALABAMA RULES OF PROFESSIONAL CONDUCT Rule 1.6 (1996). See generally *Parsons v. Continental Nat'l Am. Group*, 550 P.2d 94, 97 (Ariz. 1976) (explaining that legal ethics requires undeviating fidelity of the lawyer to his client; no exceptions can be tolerated).

234. In *First Pacific Networks, Inc. v. Atlantic Mutual Insurance Co.*, 163 F.R.D. 574, 580 (N.D. Cal. 1995), one reason the court found the common interest doctrine did not protect disclosure of some communications between the insured, *Cumis* counsel, and the insurer was that "the insured and its *Cumis* counsel retain full control

defense counsel and the insurance company that are necessary to the defense of the insured do not waive the attorney-client privilege so as to require disclosure of privileged information shared by the insured with defense counsel to the insurer or third parties.

### G. Effects on Trial Strategy

The Court in *L & S Roofing* cautioned that "if the outcome of the trial would determine whether coverage exists, and an attorney hired by the insurer conducts a defense while in close communication with the insurer, the defense itself should be closely scrutinized."<sup>235</sup> One potential pitfall for defense counsel that may give the appearance of conducting a defense for the benefit of the insurance company may arise if defense counsel seeks dismissal of certain counts of the complaint. Traditional wisdom encourages defense counsel to dispose of as many claims against the client as possible. In a reservation-of-rights defense, however, counsel should proceed with caution if the effort could result in the dismissal of covered counts and the retention of only non-covered counts. Such an action could subject the entire defense to close scrutiny and may result in a finding of breach of good faith.<sup>236</sup>

If defense counsel honestly believes that eliminating certain claims—even if covered, and possibly leaving non-covered ones—increases the client's chances for a defendant's verdict, he should consult the insured/client *before* filing such a motion. The attorney should fully explain why he recommends filing the motion and all the consequences, including the possibility of non-covered claims remaining. Defense counsel should strongly

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over the defense of the underlying action—in other words, they control the character of the legal representation and, as a matter of law, they control the character of that representation independent of the views of the carrier who has reserved its rights to deny coverage." *Id.* (citations omitted). The court also held that the insured did not have to disclose communications between it and *Cumis* counsel that were privileged when made even though they were later disclosed to the insurer. *Id.* at 583-84.

235. *L & S Roofing*, 521 So. 2d at 1303 (emphasis omitted) (quoting *Tank v. State Farm Fire & Cas. Co.*, 715 P.2d 1133, 1137-39 (Wash. 1986)).

236. *See id.*

encourage the insured to seek separate counsel for advice. The role of separate counsel becomes important here for the insured and for the defense counsel. The ultimate decision must rest with the insured. If the insured agrees to seeking dismissal of covered claims, the defense attorney should confirm such an agreement in writing.

If the insurance company pushes counsel to file such a motion against counsel's advice, or against the wishes of the insured, defense counsel should remember the exhortation of Rule 1.8(f)(2): the one paying for the defense must not interfere "with the lawyer's independence of professional judgment or with the client-lawyer relationship."<sup>237</sup> Allowing the insurance company to control decisions about such trial tactics would violate both Rule 1.8(f) and the *L & S Roofing* standards.

#### *H. Insurer's Motion to Intervene*

Another common problem that arises in a reservation-of-rights defense occurs when the insurance company retains coverage counsel and attempts to intervene to propose special interrogatories or seek a bifurcated trial.<sup>238</sup> The insurance company

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237. ALABAMA RULES OF PROFESSIONAL CONDUCT Rule 1.8(f) (1996).

238. See generally *Universal Underwriters Ins. Co. v. East Cent. Ala. Ford-Mercury, Inc.*, 574 So. 2d 716 (Ala. 1990); *Alabama Hosp. Ass'n Trust v. Mutual Assurance Soc'y of Ala.*, 538 So. 2d 1209 (Ala. 1989); *Lowe v. Nationwide Ins. Co.*, 521 So. 2d 1309 (Ala. 1988).

In *Universal Underwriters*, the insurance company, who was defending its insureds in several cases under reservation of rights, sought to intervene in those actions to propound special interrogatories or special verdict forms to the juries. *Universal Underwriters*, 574 So. 2d at 718. Although the Alabama Supreme Court affirmed the trial courts' denials of intervention, finding no right to intervene, the court remanded for consideration of a new method it proposed for permissive intervention: intervention by the insurance company and a bifurcated trial by the same jury that determined liability to determine the coverage dispute. *Id.* at 727. The court noted that this new method of intervention, like the "old" permissive intervention, rests in the discretion of the trial court and would not be reversed absent abuse of discretion. *Id.*

The utility of such a bifurcated trial process has been questioned since its first suggestion. See *id.* at 727-28 (Jones, J., dissenting). Indeed, such a practice seems rarely used. No reported Alabama decisions were found that follow this approach. In discussions with numerous insurance defense lawyers, the author found no experience with a court granting such a request, or even granting a simple request to intervene to pose interrogatories.

seeks intervention to submit special interrogatories to the jury so that it can determine whether the jury's verdict falls within or outside the scope of coverage when some allegations may be covered and others may be excluded from coverage. A general verdict could prohibit a subsequent determination of coverage because no way would exist to prove whether the jury based its verdict on covered conduct.<sup>239</sup> The defense attorney, whose sole loyalty lies with the insured,<sup>240</sup> cannot represent the insurance company's interest by requesting special interrogatories or special verdicts.<sup>241</sup> Thus, the insurance company hires coverage counsel to represent it in seeking to intervene in the suit against the insured to submit special verdicts or special interrogatories to help resolve the coverage dispute.<sup>242</sup>

While the insurance company has the right to take this action in a timely manner,<sup>243</sup> it creates problems for defense counsel in representing the insured, her only client. Again, if the insurance company tries to influence the position defense counsel takes, counsel must remember the duty of independent professional judgment required by Rule 1.8(f)(2),<sup>244</sup> and that under *L & S Roofing* her only client is the insured.<sup>245</sup>

The general wisdom seems to mandate that defense counsel, whose only client is the insured to whom she owes a duty of loyalty, must oppose such a motion by the insurance company who pays her.<sup>246</sup> When the insurance company controls the defense, even under a reservation of rights, it should bear the burden of proving the basis of the jury's damage award. However, whether the jury verdict disposes of the coverage question will depend on a variety of factors. An examination of cases that

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239. See *Alabama Hosp. Ass'n Trust*, 538 So. 2d at 1212.

240. *L & S Roofing*, 521 So. 2d at 1303.

241. *Universal Underwriters*, 574 So. 2d at 719.

242. See *id.*

243. *Id.* at 724, 727 ("[T]he insurer must file its motion to intervene in a bifurcated action *within a reasonable time* of its determination that insurance coverage disputes may exist.") (emphasis added). Just what constitutes "within a reasonable time" is unclear. However, because the time must be reasonable from the point when the insurer determines a coverage question exists, waiting until a few days or weeks before trial would appear to be an unreasonable delay that should work against a permissive intervention.

244. ALABAMA RULES OF PROFESSIONAL CONDUCT Rule 1.8(f)(2) (1996).

245. *L & S Roofing*, 521 So. 2d at 1303.

246. See *id.*

have looked at the effect of a jury verdict on subsequent determinations of coverage may help defense counsel ascertain an appropriate strategy.

For example, in *Alabama Farm Bureau Mutual Casualty Co. v. Moore*,<sup>247</sup> the insurer had not defended the insured because of allegations of intentional conduct.<sup>248</sup> Before submission to the jury, the plaintiff in the underlying case dismissed the claims of assault, and the case went to the jury on negligence alone with the jury returning a general verdict against the insured.<sup>249</sup> In the subsequent declaratory judgment action filed by the insured seeking coverage, the trial court held that the insurance company was bound by the jury's finding of negligence.<sup>250</sup> The Alabama Supreme Court, however, reversed, holding that collateral estoppel did not preclude the insurance company from litigating whether the insured's conduct fell within the policy exclusion for injury intentionally caused by the insured.<sup>251</sup>

The court, in grappling with the issue before it, recognized the complexity of the matter of determining the effect of the jury verdict on a determination of the intentional injury exclusion before it:

We also have problems deciding exactly what was decided in the *Strickland v. Moore* decision other than the extent of Moore's liability. The assault and battery count was dropped immediately before trial (without notice to Farm Bureau). Does that, by deduction, mean that an intentional tort was not committed? Is a jury, or in this case a judge, going to say that Moore is not liable because he intended the act, a possibility not within the liability charged?

Assume for the moment that the assault and battery count was left in the complaint and a jury awarded a general verdict. Is the insurance company liable?

Assume further that the negligent count is dropped leaving only the assault and battery count, and Moore again loses. Would Farm Bureau automatically be excluded from liability? Possibly

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247. 349 So. 2d 1113 (Ala. 1977).

248. *Moore*, 349 So. 2d at 1114.

249. *Id.* at 1115.

250. *Id.* at 1114.

251. *Id.* at 1117.



not. While Moore may have intended to push Strickland, he may not have intended or expected the bodily injury.

"... The exclusion of intentional injury is somewhat unique with respect to the problem of coverage. The usual coverage issue depends upon status, time, place, identity of the instrumentality, and the like. But in the case of the exclusion of intentional injuries, the injuries, which otherwise are within the coverage, are excepted therefrom because of a state of mind, and indeed a state of mind which the injured claimant may but need not allege or prove, to prevail against the insured. Since a claimant who charges intentional injury may thus recover even though the intent to injure is not proved, his complaint, on its face, is simultaneously within both the basic covenant to pay and the intentional-injury exclusion from that coverage."<sup>252</sup>

From this discussion, an argument emerges that the question of an insured's intent cannot necessarily be determined from a jury's verdict on the underlying case. This case, however, did not address the issue of coverage when the jury addresses both a negligence count and an intentional injury count, and only imposed liability for the negligence count. In such a scenario, the question of the insured's intent has been determined by a jury. The same issue as in the coverage dispute has thus been resolved; will the insurance company be precluded from relitigating that question? Possibly. A different result may be obtained if the jury returns a general verdict after receiving both the intentional and negligence counts. Such a scenario falls within one of the questions raised by the court in *Moore* and, because the court cannot determine what the jury determined on the issue of intent, the matter presumably would be subject to relitigation.<sup>253</sup>

The court in *Moore* reasoned that collateral estoppel did not apply because the parties were not in privity, and the identical point, whether the injury was expected or intended by the insured, was not at issue in the underlying action.<sup>254</sup> One should

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252. *Id.* at 1115-16 (citations omitted) (quoting *Burd v. Sussex Mut. Ins. Co.*, 267 A.2d 7, 12 (N.J. 1970)).

253. *Moore*, 349 So. 2d at 1115.

254. *Id.*; see also *Butler v. Michigan Mut. Ins. Co.*, 402 So. 2d 949 (Ala. 1981) (refusing to bind defendant to a prior action to which it was not a party); *James v. State Farm Fire & Cas. Co.*, 405 So. 2d 712 (Ala. Civ. App. 1981) (holding that a question of whether harm was intended prevented summary judgment).

note that in *Moore* the insurance company did not participate in the defense of the insured and, therefore, could not be said to have had an "identity of interest" in the underlying action.<sup>255</sup> When the insurance company controls the defense and the jury clearly addresses the question of the insured's intent, the insurance company should be precluded from relitigating that issue.

An interesting case regarding determination of coverage in subsequent litigation is *Alabama Hospital Association Trust v. Mutual Assurance Society of Alabama*.<sup>256</sup> The case involved a subrogation claim by the carrier for Lloyd Noland Hospital against the insurer of several doctors. AHAT claimed that the verdict against Lloyd Noland rested on the negligence of MASA's insured doctors, and, therefore, MASA should reimburse it for the judgment.<sup>257</sup> AHAT attempted to prove that the verdict was based on the negligence of the doctors by submission of an affidavit from the jury foreman.<sup>258</sup> The trial court refused to allow the verdict to be explained by such evidence secured three years after the trial, and held that AHAT, thus, could not prove that the verdict was within the scope of MASA's policy.<sup>259</sup> On appeal, the Alabama Supreme Court adopted Judge Cherner's opinion.<sup>260</sup> In so doing, the court, quoting Judge Cherner, stated:

"Counsel representing Lloyd Noland and supplied by AHAT could have asked the Court to require the jury to make special findings of fact at the time the case was submitted to the jury. AHAT and Lloyd Noland elected not to do so. They cannot now ask this Court to determine from the affidavits of the jurors or the other evidence submitted at the trial whether the verdict against Lloyd Noland was based on the negligence of [MASA's insured doctors] or whether the verdict against Lloyd Noland was based on evidence concerning the negligence of other physicians or employees of Lloyd Noland.

... "However, it has not been established and cannot be established at this point whether the jury's verdict was based on

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255. See generally *Moore*, 349 So. 2d at 1114, 1115 (noting that the insurer decided not to defend its insured because the injury was allegedly intentional).

256. 538 So. 2d 1209 (Ala. 1989) [hereinafter referred to as *AHAT v. MASA*].

257. *AHAT v. MASA*, 538 So. 2d at 1209.

258. *Id.* at 1211.

259. *Id.* at 1212-13, 1215.

260. *Id.* at 1209.

the conduct of Lloyd Noland's chief executive officer or members of its governing body, all of whom are provided coverage under the AHAT policy. It has not been established whether the jury's verdict was based on the conduct of Lloyd Noland's non-physician employees, all of whom are also provided coverage under the AHAT policy.<sup>261</sup>

Because AHAT could not establish primary coverage for the jury's verdict under the MASA policy, the court granted summary judgment for MASA, which was affirmed on appeal.<sup>262</sup>

Two particularly interesting observations arise from *AHAT v. MASA*. First, the quoted language has encouraged insurance companies to seek intervention to propound special interrogatories to the jury.<sup>263</sup> Second, AHAT sought, on behalf of its insured, to prove coverage under the MASA policy for the verdict.<sup>264</sup> The one seeking coverage bears the burden to prove the existence of coverage for the claim.<sup>265</sup> The insurance company, however, bears the burden of proof that an exclusion prohibits coverage of the loss or claim.<sup>266</sup> Because AHAT, who bore the

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261. *Id.* at 1213 (quoting the trial court's opinion).

262. *AHAT v. MASA*, 538 So. 2d at 1215, 1216. The court specifically noted:

"The difficulty with AHAT's position in this case is that AHAT now seeks a determination by this Court that the death of Lepo May in August 1978 was caused only by the negligence of [MASA insured doctors], physician employees of Lloyd Noland. However, the claims asserted against Lloyd Noland as a result of the death of Lepo May have already been resolved by a jury verdict and judgment. The question presented is whether the jury verdict against Lloyd Noland was based in whole or in part on Lloyd Noland's failure to have a pediatric ventilator available for use in its Intensive Care Unit at the time of Lepo May's death. This Court has determined that evidence was presented which would support a jury verdict on this theory. Since no special interrogatories were submitted to the jury, it is not possible for this Court to now determine what was the basis for the jury verdict finding Lloyd Noland liable."

*Id.* at 1215 (emphasis added) (quoting the trial court's opinion).

263. See *Universal Underwriters Ins. Co. v. East Cent. Ala. Ford-Mercury, Inc.*, 574 So. 2d 716 (Ala. 1990).

264. *AHAT v. MASA*, 538 So. 2d at 1211.

265. *E.g.*, *Roberson v. Gulf Life Ins. Co.*, 655 So. 2d 953, 956 (Ala. 1995) (stating that insured's beneficiary had the burden of proving that insured's death fell within coverage); *Barnes v. Tarver*, 360 So. 2d 953, 956 (Ala. 1978) ("Every jurisdiction which has considered the issue holds that the burden of proving entitlement to coverage under an uninsured motorist endorsement is upon the claimant."); *Colonial Life & Accident Ins. Co. v. Collins*, 194 So. 2d 532, 535 (Ala. 1967); *National Life & Accident Ins. Co. v. Mixon*, 282 So. 2d 306, 308 (Ala. Civ. App. 1972), *aff'd*, 282 So. 2d 308 (Ala. 1973).

266. *E.g.*, *Fleming v. Alabama Farm Bureau Mut. Cas. Ins. Co.*, 310 So. 2d 200,

burden of proof regarding coverage, could not prove the basis of the jury's verdict, AHAT failed to meet its burden of proof that MASA's policy provided primary coverage for the verdict.<sup>267</sup> The form of the verdict becomes crucial when one considers who bears the burden of proof in the coverage dispute.

For example, in *Knutilla v. Auto-Owners Insurance Co.*,<sup>268</sup> the Alabama Court of Civil Appeals held that the one seeking coverage under a surety bond had the burden of proving the allocation of compensatory (covered) damages and punitive (non-covered) damages.<sup>269</sup> Because the insured did not meet that burden, no coverage existed for the jury verdict.<sup>270</sup>

Although distinguishing the case is easy, defense counsel should consider it in evaluating how to respond to requests for special interrogatories or special verdict forms.<sup>271</sup> If the only coverage question surrounds punitive damages, the defense counsel should consider whether the best interest of the insured may be furthered in not opposing—or perhaps even seeking—special verdict forms to allocate punitive and compensatory damages so that at least the compensatory damages would be covered. Counsel should also remember the general principle that the insured has the burden of proving coverage while the insurance company has the burden of proof regarding an exclusion.<sup>272</sup> If the dispute involves a question as to whether the allegations fall within the scope of coverage, the insured, who bears the burden of proof, might be thwarted in the declaratory judgment action if he cannot prove that the verdict rested on a covered count. On the other hand, if the insurance company relies on an exclusion to question coverage, a general verdict could

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202 (Ala. 1975) ("[U]ltimate burden of proof as to the applicability of the exclusionary clause rests with the [insurer]."); *Fidelity & Cas. Co. v. Bank of Commerce*, 234 So. 2d 871, 878 (Ala. 1970) (holding that the insured's failure to produce sufficient evidence of forgery or alteration was a bar to recovery); *Bankers Fire & Marine Ins. Co. v. Bukacer*, 123 So. 2d 157, 164 (Ala. 1960) (stating that the burden of proof that loss was excluded from coverage rests on insurer).

267. *AHAT v. MASA*, 538 So. 2d at 1216. The Alabama Supreme Court specifically held that the "trial court correctly placed the burden on AHAT as the one seeking coverage to prove that coverage existed within the terms of the policy." *Id.*

268. 578 So. 2d 1359 (Ala. Civ. App. 1991).

269. *Knutilla*, 578 So. 2d at 1361.

270. *Id.* at 1361-62.

271. See *AHAT v. MASA*, 538 So. 2d at 1212-14.

272. See cases cited *supra* at note 265-66.

arguably work to the insured's benefit because the insurance company could not meet its burden of proving that the verdict fell within the exclusion.<sup>273</sup> However, the court in *Moore* indicated that a general verdict that did not resolve the coverage question would not preclude litigation.<sup>274</sup>

Taken together, *AHAT v. MASA*, *Moore* and *Knutilla* could be viewed as precluding an insured from relitigating the basis of the jury's verdict and, hence, coverage in a subsequent declaratory judgment action while an insurance company would not be similarly limited.<sup>275</sup> Such an outcome suggests that issue preclusion presents a greater risk to the insured who seeks coverage than to the insurer who seeks to avoid it. Therefore, before taking action on the insurance company's motion to intervene, defense counsel should consider the possible effects of issue preclusion, should consult with the insured and separate counsel, and should fully explain to the insured the ramifications of counsel's proposed response.

#### IV. EFFECTS OF *L & S ROOFING* ON THE INSURED'S DUTY TO COOPERATE

The insurance policy imposes on the insured two duties that sometimes come into play in the reservation-of-rights defense. The first duty rests in the two-way duty of good faith inherent in all insurance policies.<sup>276</sup> The second obligation is the duty to cooperate with the insurance company.<sup>277</sup> Most insurance policies require that the insured cooperate with the insurance company in the defense of the insured. The cooperation required is honest cooperation. "Honest cooperation involves telling the truth."<sup>278</sup> Insurance companies have asserted that the insured

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273. See generally cases cited *supra* note 238 (discussing the inability of defense counsel to request special interrogatories or special verdicts because of the duty owed to the insured).

274. *Moore*, 349 So. 2d at 1115-16.

275. *AHAT v. MASA*, 538 So. 2d at 1215; *Moore*, 349 So. 2d at 1216-17; *Knutilla*, 578 So. 2d at 1362.

276. See *Chavers v. National Sec. Fire & Cas. Co.*, 456 So. 2d 293, 294 (Ala. 1984).

277. See *JERRY*, *supra* note 4, §§ 85, 110.

278. *Wildrick v. North River Ins. Co.*, 75 F.3d 432, 436 (8th Cir. 1996) (citations omitted).



has violated those obligations primarily in two ways: entering into settlements with the plaintiff and refusing to disclose information to the insurer.<sup>279</sup>

The most commonly asserted ground for a violation of the insured's obligation to the insurer arises when the insured enters a settlement with the plaintiff.<sup>280</sup> Often, but not always, the settlement releases the insured from personal liability through a covenant not to execute, and the insured assigns any rights under the policy or claims against the insurance company to the plaintiff.<sup>281</sup> The Alabama Supreme Court has not yet addressed whether such a settlement violates the cooperation provision of the policy, thus voiding any coverage. Other jurisdictions have addressed this issue, with the majority holding that insureds can negotiate the best deal possible to protect their interest when the insurance company asserts a coverage question and refuses to settle.<sup>282</sup> These courts recognize that the scope of the cooperation clause narrows when the insurance company asserts a defense to coverage, and this narrowing allows the insured to take reasonable measures for his own protection.<sup>283</sup>

A less-litigated area of potential problem in a reservation-of-rights defense arises when the insured does not want to disclose information to the insurance company, and the company asserts that the cooperation clause requires disclosure of such information. The Fifth Circuit decision in *Lafarge Corp. v. Hartford Casualty Insurance Co.* provides some guidance.<sup>284</sup>

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279. See, e.g., *McNicholes v. Subotnik*, 12 F.3d 105, 107 (8th Cir. 1993); *Gates Formed Fibre Prods., Inc. v. Imperial Cas. & Indem. Co.*, 702 F. Supp. 343, 345 (D. Me. 1988).

280. See, e.g., *Gray v. Grain Dealers Mut. Ins. Co.*, 871 F.2d 1128, 1131-32 nn.2 & 5 (D.C. Cir. 1989); *Greer v. Northwestern Nat'l Ins. Co.*, 743 P.2d 1244, 1251 (Wash. 1987); *State Farm Mut. Auto. Ins. Co. v. Paynter*, 593 P.2d 948, 953 (Ariz. Ct. App. 1979).

281. See cases cited *supra* notes 279-80.

282. See, e.g., *McNicholes*, 12 F.3d at 110; *Insurance Co. of N. Am. v. Spangler*, 881 F. Supp. 539, 545 (D. Wyo. 1995); *Evanston Ins. Co. v. Treister*, 794 F. Supp. 560, 574 (D. Vir. Is. 1992); *Gates Formed Fibre Prods.*, 702 F. Supp. at 348-49; *United Services Auto. Ass'n v. Morris*, 741 P.2d 246 (Ariz. 1987); *Greer*, 743 P.2d at 1252.

283. *Spangler*, 881 F. Supp. at 545 (quoting *Morris*, 741 P.2d at 252); see *Greer*, 743 P.2d at 1251.

284. 61 F.3d 389 (5th Cir. 1995) (applying Texas law).

In *Lafarge*, Hartford asserted that the insured's failure to cooperate in Hartford's effort to determine whether coverage existed relieved Hartford of its duty to defend.<sup>285</sup> The court quickly rejected Hartford's argument.<sup>286</sup> The court noted that the cooperation clause guarantees that insurance companies will be able to adequately prepare their defenses of the liability claims against their insureds.<sup>287</sup> The court opined that "with respect to the issue of coverage . . . as opposed to the issue of liability . . . Hartford may not even invoke the cooperation clause here."<sup>288</sup> The court concluded, however, that even if the cooperation clause were applicable, the insured did not breach it.<sup>289</sup> Because Hartford filed a declaratory judgment action against its insured challenging coverage, the court concluded that "once the insurer sues the insured and contests coverage, the insurer cannot rely on the cooperation clause to gain access to information that any other party to any other lawsuit would be required to obtain through ordinary discovery methods."<sup>290</sup>

The question remains whether an insured, who the carrier is defending under a reservation of rights, has an obligation to cooperate with the insurance company on coverage matters when the company has not yet filed a declaratory judgment action. Because the cooperation clause operates for the benefit of the insurance company that undertakes the defense of the insured and aligns itself with the insured's interests,<sup>291</sup> a strong argument can be made that the duty ceases, or at least constricts, when the insured and the carrier become adversaries on the question of coverage. The reservation of rights, which notifies the insured that the insurance company contests coverage, should create sufficient adversity of interest regarding the coverage question that the narrowed scope of the cooperation clause should not require the insured to voluntarily disclose information relevant only to coverage. The logic of the courts in the set-

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285. *Lafarge*, 61 F.3d at 397.

286. *Id.*

287. *Id.* (quoting *Martin v. Travelers Indem. Co.*, 450 F.2d 542, 553 (5th Cir. 1971)) (construing Mississippi law).

288. *Id.*

289. *Id.* at 397-98.

290. *Lafarge*, 61 F.3d at 397-98.

291. *See id.* at 398 n.13.

tlement cases should apply. Those courts recognize that the scope of the insured's obligation to cooperate narrows in the face of the insurance company's asserted coverage defense.<sup>292</sup> With a narrowing of scope, an insured can argue that he does not have to cooperate to the extent of disclosing information that would help the insurance company build its case against coverage. As to the question of coverage, the insured and insurance company are adversaries, and the insured should not have to voluntarily disclose information relating to the coverage question. Such a position entails great risk, however, if the Alabama Supreme Court concludes that it breaches the cooperation duty, resulting in no coverage under the policy.

## V. CONCLUSION

An insurance company and defense counsel facing these unanswered questions would be wise to evaluate all options available in the given circumstance and proceed with caution. Until the Alabama Supreme Court resolves some of these questions, a mine field awaits those who do not tread carefully. The effectiveness of the enhanced obligation of good faith approach rests largely on the shoulders of defense counsel. Guided by the Alabama Rules of Professional Conduct and judicial pronouncements, defense counsel must remember that only the insured is the client. Similarly, the insurance company must remember that it cannot demonstrate greater concern for its own interest than for the interests of the insured.<sup>293</sup> Cooperation among the insurance company, the insured, and all counsel should be a primary goal to achieve the common good. Together, by walking carefully and in step with the interests of the insured, the mine field can be safely traversed.

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292. See cases cited *supra* note 283.

293. *L & S Roofing Supply Co. v. St. Paul Fire & Marine Ins. Co.*, 521 So. 2d 1298, 1303 (Ala. 1987).

