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Evaluating Valued Policy Law After Katrina

By Tina Garmon

Since first enacted in 1874 in Wisconsin, Valued Policy Law ("VPL") has become an important regulatory fixture in the insurance law of many states. At least 19 states have enacted some version of a traditional VPL. In its original formulation, VPL obliges an insurer that collected premiums for an insurable interest based on an assigned value to pay that predetermined value to the insured in the event of a total loss. That statutorily imposed obligation prevents insurers from collecting premiums on artificially inflated property values on the front end while paying insureds less than that amount after a total loss, based on actual values. VPL thus encourages insurers to investigate the actual value of the insurable interest and to collect premiums on that amount, thereby avoiding the hazards of over-insurance. Furthermore, by encouraging insurers to minimize variance between assigned values and actual values, VPL theoretically reduces insurance fraud by policyholders.

In recent years, however, multi-peril disasters, such as hurricanes, have strained the rationale behind VPL. In 2004, a Florida District Court sent shockwaves through the insurance industry when it decided *Mierzwa v. Florida Windstorm Underwriting Association*, 877 So.2d 774 (Fla. App. 2004). In *Mierzwa*, the court ruled that a policyholder's insurer had to pay its homeowner's policy limits for the constructive total loss of a home damaged by Hurricane Ivan even though a significant portion of the damage was caused by an uninsured peril — flood — and had already been paid for by a flood carrier. At that time, Florida's VPL provided in relevant part:

> In the event of the total loss of any building … insured by an insurer as to a covered peril … the insurer's liability, if any, under the policy for such total loss shall be in the amount of money for which such property was so insured as specified in the policy. §627.702(1), Fla. Stat. (2003).

The *Mierzwa* court reasoned that the VPL applied if only two facts were true: 1) a total loss occurred to certain property, and 2) that property was insured as to a covered peril. On that basis — wind — the covered peril, need not have been the covered peril that caused the entire loss. Arguably, under the *Mierzwa* interpretation, an insurer that may have covered a peril that merely contributed — no matter how slightly — to a total loss could be held liable for its policy limits even though the total loss was actually caused

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Fettering the Insurer's Privilege to Control the Defense It Is Duty-Bound to Provide

By Marc S. Mayerson

For more than 50 years, policyholders and their insurers have been struggling over the insurer's promise to defend and the insurer's control of the defense. Policyholders properly have been concerned that an insurance company that controls the defense of an action potentially covered by the carrier's duty to indemnify will use that control to avoid that very same indemnity obligation. In egregious cases where a lawyer hired by the carrier has abused his or her relationship with the insured — the client — so as to favor the lawyer's source of income — the insurance company — the courts have responded to protect the insured's interests. But most courts have ruled that such after-the-fact remedies are insufficient: They do not adequately compensate for the injury; meritorious claims are not pursued (in part because insureds may not discover the abuse); and the potential for this abuse alone undermines the dominant purpose of the insurance relationship — to afford protection and peace of mind for the insured.

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As a result, most jurisdictions have fashioned a number of rules affording remedies in cases of actual abuse — by allowing bad-faith actions to proceed against insurers, by barring insurers from using the fruits of the poisonous tree, by allowing malpractice claims against the lawyer, and other measures. But most have held that where there is a potential abuse, a prophylactic approach is appropriate; thus, the insured is permitted to select the lawyer who will defend it, and the carrier continues to have the obligation to pay for that defense. This is usually referred to as the "independent counsel" rule (or in California, the *Cumis* or 2860 rule).

Rarely do I, as a policyholder lawyer, see an insurance policy provision that expressly addresses this problem — something that is incomprehensible given that for more than two generations this struggle has been waged. Since at least the 1950s, the courts have made clear to insurers that because their policies do not set out how these circumstances should be handled, the courts themselves will fashion rules designed to balance the interests of policyholders and their insurers. In general, the courts have looked to the dominant promise of the insurance contract to defend (and to indemnify) the insured and have held that the correlative responsibility of the insurer to defend the insured can yield to safeguarding that dominant purpose of the insurance contract. In part, this problem stems from the contract drafting in which two words are used to define the carrier's rights and obligations — "right and"; they have the "right and duty to defend" (plus the insured's duty to cooperate set out in the boilerplate portion of the policy).

Because insurers are well aware of the rule that uncertainties in the contract will be construed against them and the rule in the overwhelming majority of jurisdictions that their right to defend and its entailed privilege of selection and control of counsel has to yield to protect the benefit of the bargain the insured struck to obtain both defense and indemnity, the courts generally have held that insurers forfeit their privilege of control.

The paradigmatic circumstance where the insurer's privilege of control yields to its duty to defend, and to protecting the insured's expectations of coverage is where a complaint alleges more than one claim arising out of a single event and the case can be lost on either a covered basis or an uncovered one. Take as an example where, during a pickup basketball game, an elbow is thrown: If that occurred because of gross negligence, there will be coverage, but if it occurred because the player sought to intentionally injure the recipient, there won't be. Trial of the case involves the same facts and testimony either way, and ultimately it's up to the jury to weigh the testimony and the facts. The insurer, if it were to lose the case, would prefer to lose it on intentional-injury grounds, for then it won't have to pay the judgment.

Another example: Assume there is a technical defense available to the covered claim; should the lawyer file a motion for summary judgment on the covered claim, which will effectively terminate the carrier's ongoing obligation to defend (since the case no longer can eventuate in a judgment covered by the duty to indemnify)? Does the lawyer have an obligation to leave the weak claim hanging around just to preserve the defense or does the lawyer — whose bills are being paid by the insurer — have the obligation to clean out the dross and thus allow the carrier off the hook?

Twin City Fire Ins. Co. v. Ben Arnold-Sunbelt Beverage Co.

Insurers have pooh-poohed such concerns by contending that lawyers act ethically so the courts' concerns are unfounded. And the U.S. Court of Appeals for the Fourth Circuit — a court that has a penchant for wrongly predicting state insurance law by siding with insurance companies — recently agreed with the insurers in what should become carrier-side lawyers' favorite case to cite on these issues. In a well-written, well-analyzed, but erroneous ruling, *Twin City Fire Ins. Co. v. Ben Arnold-Sunbelt Beverage Co.* (4th Cir. Dec. 27, 2005), the Fourth Circuit rejected the argument that an insurer's reservation of the right to deny coverage called for prophylactic protection of the interest of the insured by allowing it to select defense counsel of its choice at the insurer's expense.

Of course, *Ben Arnold* involved a reasonably favorable set of facts for carriers and an overbroad argument by the policyholder, but the court's ruling is not so confined. The court sets up the question presented as follows:

> When a party with insurance coverage is sued, the insured notifies the insurance company of the suit. The insurance company, in turn, typically chooses, retains, and pays private counsel to represent the insured as to all claims. If the suit involves some claims that are covered under the insurance policy and some claims that are not covered, the insurance company typically will send a reservation of rights letter to the insured stating what claims the insurance company believes are covered and what claims it believes are not covered. In this case, we examine whether, under South Carolina law, such a reservation of rights letter automatically triggers a conflict of interest entitling the insured to reject counsel tendered by the insurance company and instead to choose and retain its own counsel and to have the insurance company pay for that counsel. Slip op. at 1.

The proposition offered by the insured was that any time an insurer issues a reservation-of-rights letter, the carrier is still required to provide a defense, but the policyholder gets to select counsel to defend it and to control the course of the defense.

The Fourth Circuit rejected the policyholder's argument, noting correctly that courts tend to require that the insured show a conflict of interest between it and the insurance company before wresting the defense from

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the carrier. This is sensible, of course, given that in the insurance policy the policyholder delegated to the insurance company the right to defend the case. Insurance companies issue reservation-of-rights letters in response to case law in the 1950s and 1960s that a carrier that defends a suit cannot turn around at the end of the case and tell the insured that it won't pay for the judgment — at least without alerting the insured of this possibility earlier; as a result, insurance companies issue reservations of rights to prevent the insured from having detrimental reliance (or claiming waiver). *National Mut. Ins. Co. v. McMahon & Sons*, 356 S.E. 2d 488, 493 (W. Va. 1987); *Safeco Ins. Co. v. Elllingshouse*, 725 P.2d 217, 221 (Mont. 1986); *Richmond v. Georgia Farm Bureau Mut. Ins. Co.*, 231 S.E.2d 245 (Ga. 1976); *Royal Ins. Co. v. Process Design Associates*, 582 N.E.2d 1234, 1239 (1st Dist. 1991).

But it is not the insurance company's fault that a suit may involve both covered and uncovered amounts, and coverage is not to be expanded beyond the terms of the policy through application of principles of waiver. As a result, it is entirely appropriate for an insurance company that is contractually obligated to provide a defense to a policyholder to alert the policyholder to the possibility that the judgment in the case might not be covered. *D.E.M. v. Allickson (North Star Mut. Ins. Co.)*, 555 N.W.2d 596 (N.D. 1996). In this way, the policyholder can act to protect its own interest, including in some states choosing to settle the lawsuit against it in a fashion that camouflages whether the payment is also on account of uncovered amounts or claims. *See generally Miller v. Shugart*, 316 N.W.2d 729 (Minn. 1982).

So, unless some other interest or question is involved, the mere fact that an insurer sends a reservation-of-rights letter should not alter the parties' pre-existing rights and powers (since all the insurer is trying to do is to avoid the application of waiver/estoppel based on its assuming the defense).

Against this background, the Fourth Circuit rejected the notion that a reservation-of-rights letter *per se* creates some sort of conflict between the interests of the insured and its insurer such that the insurer is divested of its contractually bargained-for right to defend. But the court went on to recognize that there are circumstances where the interest of the insured and the insurer in the development of the defense can diverge, which has led most courts to express concern about insurer-appointed and insurer-directed counsel.

The *Ben Arnold* court reviewed the law in a number of jurisdictions (having found that South Carolina law applies and was without governing precedent) and concluded that some courts allow the insured to select counsel paid contemporaneously by the insurer whereas other courts permit the insurer to select "independent" counsel who in turn may have heightened professional duties to safeguard the insured's interest. Because a strong undercurrent in those cases vesting the choice of counsel in the hands of the insured questions the ethical integrity of the insurance-defense bar, *e.g., Howard v. Russell Stover Candies, Inc.*, 649 F.2d 620, 625 (8th Cir. 1981) (requiring independent counsel for fear that counsel for insurer "would be inclined, albeit acting in good faith, to bend his efforts, however unconsciously" in insurer's favor), the Fourth Circuit was highly reluctant to impugn with such a broad brush the integrity of an entire swath of the bar. Slip op. at 11 ("We are equally unable to conclude that the Supreme Court of South Carolina would profess so little confidence in the integrity of the members of the South Carolina Bar. Rigorous ethical standards govern South Carolina attorneys.").

The Fourth Circuit concluded that the ethical rules and discipline, "coupled with the threat of bad faith actions or malpractice actions if a lawyer violates these rules, provide strong external incentives for attorneys to comply with their ethical obligations." Slip op. at 12. Accordingly, the *Ben Arnold* court refused to find that, where there was a conflict of interest between the insured and the insurer in the development of the facts at issue in the liability case, the insured had a right to counsel of its choice, paid for contemporaneously by the insurer.

The court also adopted a strict forfeiture rule in this regard, finding that if an insured rejected counsel tendered by an insurance company, it forfeited the right to defense coverage. In other words, the policyholder is precluded from seeking coverage even if the insurance company cannot show that it was in any way harmed by the policyholder's selection of counsel (*eg*, competent counsel at the same rate, for example, who obtains an outstanding result). The court rejected the policyholder's contention that the insurers must show substantial injury or prejudice or at least some detriment in order to be excused from providing the policyholder any of the benefit of the bargain. Slip op. at 13-15.

Ben Arnold is sure to be relied on by insurance companies as a cogent statement of their position in favor of rejecting the policyholder's selection of counsel of its choice. Nevertheless, the court need not have reached out to proclaim its own, pro-insurer prophylactic rule because the facts of the case and the conduct of the insurers at issue merit no such prolegomenon.

In *Ben Arnold*, the insurers retained qualified counsel to defend the covered counts and *also offered to pay for separate counsel to represent the insured's interests with respect to uncovered counts.* Moreover, with respect to a *different* insured in the case where there *was* a conflict of interest in the development of the facts, both the trial court and the Fourth Circuit found that independent counsel was required to be appointed at the carriers' expense. And even with respect to the principal insured for which there was no conflict at issue in the development of the underlying facts, the trial court recognized that at the time of settlement independent counsel might be required due to the conflict that then would be manifest. 2004 WL 2165971 (D.S.C. July 26, 2004), at n. 14.

What is lamentable about the Fourth Circuit's opinion is that the

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court could easily and more properly have held that given the absence of a conflict of interest between the insured and insurer in the development of the underlying facts, independent counsel was not required and, in any event, the insurers satisfied their obligations by offering to pay for two sets of counsel. This is the rule in "independent counsel" states where most courts recognize that merely sending a reservation-of-rights letter — without more — is insufficient to oust the insurer of the control of the defense. *National Union Fire Ins. Co. v. Hilton Hotels Corp.*, 1991 WL 405182 (N.D. Cal. 1991). In fact, wresting control whenever a reservation of rights is sent ironically defeats the purpose of sending the reservations letter in the first place.

But *Ben Arnold* should not be rejected just because it is overly broad, for even if the facts matched the very broad rule adopted, that rule still would be ill advised and erroneous under the principles of insurance law and of contract law. Perhaps because the issue has been in dispute for so long (half a century), the footings of the independent-counsel rule seem to have become beclouded.

The Flaws of *Ben Arnold*

Let's look first at the consequences of the *Ben Arnold* court position. The court makes clear that, while there might be a perception that the policyholder is uncomfortable as a result of the carrier's selected lawyer being in charge (and thus having the ability to steer the defense toward uncovered grounds), the insured's interest is adequately protected because of legal-ethics rules, attorney-malpractice liability, and insurance bad-faith principles. This rejoinder to the policyholder position really does not withstand scrutiny.

The Fourth Circuit's remedies render nugatory the peace of mind and security the insured is supposed to receive by paying a premium to the insurance company for the broad protection afforded by insurance policies. *See Rawlings v. Apodaca*, 151 Ariz. 149, 154-55 (1986) ("Although the insured is not without remedies if he disagrees with the insurer, the very invocation of those remedies detracts significantly from the protection or security which was the objective of the transaction."). The court envisions requiring policyholders to endure bad faith or ethical breaches, and then seeking recovery only at the end of the underlying litigation by suing for legal malpractice or bad faith. *Ben Arnold* thus replaces the security that insurance is supposed to provide with a *chose in action* against the insurer-appointed lawyer, requiring the policyholder to (a) sue for legal malpractice, requiring a showing both of breach of the standard of care and a showing that the outcome would have been different (the "trial within the trial" of such malpractice actions), (b) undertake that action at its own expense (since the insurer is not paying, and there's no attorneys' fees recovery in malpractice cases), (c) front the money to satisfy an adverse judgment that exceeds policy limits or the entire judgment if it is based on an uncovered claim (and subsequently, if successful, refund to the carrier in subrogation any amounts recovered after the policyholder was made whole), and (d) expose itself to an uncollectible judgment because the lawyer may not have assets sufficient to cover the judgment that resulted from his malpractice.

The *Ben Arnold* solution to the conundrum of insurer-appointed counsel would also do substantial injury to the attorney-client relationship; not only would the insured find it difficult to confide in counsel assigned to it, but counsel's effectiveness would be undermined by its knowledge that the carrier has set it up for an impending malpractice action. And the same problems apply regarding suing the carrier for bad faith for some misconduct of the insurer-appointed lawyer or suing for negligent performance of the duty to defend by providing inadequate counsel.

The proposed remedy that the *Ben Arnold* court contemplates is a feeble substitution for the security and protection that the policyholder thought it was paying for. And if one looks at the cases decided 40 or 50 years ago, these courts found it salient that the insurers' policies did not spell out how this conflict situation would be handled. Standard insurance policies then (as now) were not written to state plainly and unambiguously that: 1) interference with the right to defend forfeits coverage or 2) the right to defend constitutes a material part of the consideration of the overall insurance transaction (which would be an overreach anyway given the aleatory nature of insurance contracts; that is, that the policyholder has fully performed its principal obligation of paying the premium).

Thus, the courts have applied the ordinary rules that where the policy language was uncertain and the insurer was in a position to clarify by drafting a provision clearly, the policy is construed in favor of coverage to achieve its purpose of indemnifying the insured, especially bearing in mind the reasonable expectations of insureds and avoiding the appearance of unseemliness from insurer-appointed counsel's being in the position to steer the case to favor his or her source of future business. *E.g., Employers' Fire Ins. Co. v. Beals*, 240 A.2d 397, 402 (R.I. 1968); Magoun *v. Liberty Mut. Ins. Co.*, 195 N.E.2d 514 (Mass. 1964); *Prashker v. United States Guarantee Co.*, 136 N.E.2d 871 (N.Y. 1956); *see also CHI of Alaska, Inc. v. Employers Reinsurance Corp.*, 844 P.2d 1113, 1116 (Alaska 1993). As a result, most courts ruled that the carriers' right to control the defense — an ancillary part of the insurance contract — must yield to the predominate purpose of the contract to provide the policyholder a defense and to safeguard the policyholder's peace of mind. *See Jacobs & Youngs, Inc.*, 129 N.E. 889, 891 (N.Y. 1921) (Cardozo, J.) ("There will be no assumption of a purpose to visit venial faults with oppressive retribution."). That carriers have not fixed their policy language after 50 years of litigation and instead require that the law be developed in each state and locality smacks of ineptitude or bad faith or some synergistic combination of the two. Nevertheless, one dissembling rejoinder to this would be to

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contemplate a situation where the policyholder does erroneously reject the carrier's offered defense (which approximates the actual facts in *Ben Arnold*). In that circumstance, so the argument goes, if the carrier remains responsible for funding the defense, the carrier that offers to perform properly is no better off than is the carrier that breaches its contract by refusing to provide a defense at all. In other words, a carrier that breaches its duty to defend by erroneously denying coverage is liable to pay the reasonable costs of defense; and according to this argument, a carrier that offers counsel that is rejected by the policyholder is still obligated to pay the reasonable costs of defense.

This is a false counter, because *it misstates the damages that are to be paid by a breaching carrier* (that is, the contract-law damages it owes for breach of the duty to defend). It is not precise to say that a breaching insurer owes the reasonable costs of defense; rather, under *Hadley v. Baxendale*, the insurer owes all foreseeable damages. In the circumstances, the policyholder proffers in its *prima facie* case all defense costs it incurred (that were caused in fact by the carrier's failure to perform), and the carrier may argue by way of affirmative defense (and for which it has the burden of proof) that the costs were so unreasonable as to constitute unforeseeable damages (which when framed correctly is a difficult standard for the carrier to meet, especially in the light of the fact that the insured had every economic incentive to incur only reasonable costs since, at the time, it was paying them out of its own pocket with no certainty of recovery from the carrier). Moreover, a breaching carrier is not just liable for defense costs; it is liable for all damages incurred by the insured from the breach. *Beck v. Farmers Insurance Exchange*, 701 P.2d 795, 801 (Utah 1985).

Contrast this situation to that of the carrier that does offer a defense but which is rejected by the policyholder on the ground that independent counsel is required — though in this illustration the policyholder is wrong to do that. In that circumstance, the concepts of material versus immaterial breach are key (as are dependent versus independent covenants). Here, the carrier has not breached, but the policyholder has. But the policyholder's breach — by interfering with the carrier's right of control — exposes the policyholder to the carrier's set-off claim because it is an immaterial breach of the overall contract. In other words, the carrier is still required to perform its contract — for the policyholder's breach is not a material breach of the contract excusing the carrier's obligation (especially when the policyholder has probably already paid the full premium). *See generally Steakhouse, Inc. v. Barnett*, 65 So.2d 736, 738 (Fla.1953) (defining dependent covenants). But because the policyholder did breach the contract, the carrier is entitled to show its damages from the policyholder's breach. In this context, what that means is the additional cost of the defense that would not have been incurred had the policyholder not breached (*ie,* not been in charged). So, if the defense counsel the insurer would have appointed charged only $300 an hour (because of say a bulk deal with the carrier) and the policyholder's selected lawyer charges $400 an hour, the carrier is not obligated to pay the $100-an-hour difference. (Unlike *Ben Arnold* where the carriers' to their mirth owe nothing.) Importantly, this is in contrast to the *breaching* carrier that is unlikely to be able to show that the $100-an-hour delta is such an unreasonable cost differential as to constitute unforeseeable damages under *Hadley v. Baxendale.* Moreover, the carrier that properly offered counsel is *not* exposed to paying the insured's *full* damages (sometimes pejoratively characterized as "consequential damages" (*Machan v. Unum Provident Ins. Co.*, 2005 UT 37 (Utah June 17, 2005)), because it did not breach.

> ***[I]f the carrier remains responsible for funding the defense, the carrier that offers to perform properly is no better off than is the carrier that breaches its contract by refusing to provide a defense at all.***

Thus, a carrier that properly tenders performance that is incorrectly rejected is not in the same (disadvantaged) position as is a carrier that breaches its contract. Accordingly, under this analysis, all involved are put in the position they would be in had the contract been properly performed — the benefit of the bargain is preserved.

Conclusion

Until such time, therefore, that insurers revise their contracts to specify that even in a conflict of interest situation the insurer still gets to appoint counsel (or whatever method it would propose, such as allowing the insured to pick from a list of five counsel suggested by the insurer), the uncertainty of the contract, and the disproportionality of the proposed remedy contemplated by the *Ben Arnold* court, confirms the rightness of the independent-counsel rule. *See generally* Restatement (2d) Contracts §§197, 229 (2004). If insurers do revise their contacts, then: 1) insurance regulators would be in the position to weigh in, 2) policyholders would know expressly what the process is for dealing with a conflict situation if they purchase the particular insurance policy, and 3) policyholders could choose to purchase policies from other insurers that offer more generous terms. But it is folly to believe that policyholders contemplate the remedial scheme adopted by the *Ben Arnold* court. *See* Restatement (2d) Contracts §211(3).

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