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California Court of Appeal Expands the Right to Independent Counsel

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CCN Client Alert

When an insurance company retains counsel to represent its insured in the defense of a claim by a third party, there is an inherent conflict of interest because the defense counsel has ethical obligations to both the insurance company who retained him or her, and to the insured he or she was retained to defend. However, California courts frequently do not view that conflict as sufficiently serious to give rise to the right to independent, or *Cumis*, counsel. The California Court of Appeal's decision in *Schaefer v. Elder*, 217 Cal.App.4th 1, 157 Cal.Rptr.3d 654 (2013) represents a departure from that approach. In *Schaefer*, the court held that if there might be a finding in the third party action that would favor the insurer and be detrimental to the insured, there is a right to *Cumis* counsel. This decision should make it easier for insureds to compel their insurance carriers to pay for the retention of independent counsel.

It is well established under California law that an insurance company must defend its insured whenever an action against the insured is **potentially** covered by the insurance policy. That usually imposes an obligation on the part of the insurance carrier to retain defense counsel to represent the insured in the third party action. Defense counsel has ethical duties to both the insurance company who retained him or her **and** the insured they have been retained to defend, but in many instances California law sanctions this inherent conflict of interest. Typically, California courts have ruled that the insured is only entitled to use independent counsel of its own choosing, paid for by the insurance company, when the conflict is **significant, not merely theoretical, and actual, not merely potential**. Courts have held that the insurance company is not

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required to pay for independent counsel, unless it can be shown in a **specific** way that defense counsel retained by the insurer could control the outcome of a coverage issue to the detriment of the insured, or has some incentive to do so.

In *Schaefer*, the insured, a builder, was sued by the owner who hired him to design and build a home. The insurer agreed to defend the builder under a reservation of rights and appointed counsel of its choice to defend the builder, but it also filed a declaratory relief action against the builder seeking a determination as to whether the claims were covered. The insurer alleged (among other reasons) that there was no coverage because the builder had not complied with the policy's "Contractors Special Condition." This provision required the builder to obtain an indemnity agreement and certificate of insurance from any independent contractor who worked on the job. It raised the question of whether the workers who performed the allegedly defective work were the builder's employees or independent contractors. If they were employees, the Contractors Special Condition would not apply. If they were independent contractors and the builder had not obtained the required documentation, there would be no coverage.


Obviously, the builder's interests in the coverage dispute were best served if it was determined in the third party action that the workers were employees. But it was in the insurance company's interest to establish that the work was done by independent contractors. It was not disputed that the situation gave rise to a potential conflict of interest, but the insurance company refused to provide independent counsel, arguing that there was **no actual conflict** creating a right to *Cumis*, because whether an employee or an independent contractor did the work made no difference to the builder's potential liability for the alleged defects. The implication of the insurance company's position was that defense counsel would play a neutral role on this issue and the objective facts would prevail.

California courts have generally not found **actual** conflicts creating the right to independent counsel in similar situations. Courts often deny independent counsel unless the insured can identify **specific** ways defense counsel retained by the carrier can control the outcome of the issue giving rise to the conflict, to the detriment of the insured. But in *Schaefer*, the Court of Appeal found that the insurance company and its insured were at odds as to the preferred outcome of the "employee versus independent contractor" issue, meaning that defense counsel was at the center of an **actual** conflict which triggered the right to *Cumis*. The court held as follows:

"Put simply, [defense counsel] had an ethical duty to [the insured] to try to establish that the workers were employees and, at the same time, had an ethical duty to [the insurance company] to try to establish that the workers were independent contractors. That conflict supported the trial court's determination that [the insured] has the right to independent counsel."

217 Cal.App.4th at ___, 157 Cal.Rptr.3d at 659.

The *Schaefer* decision recognized the reality that the way that defense counsel defends a case may have a profound



impact on coverage disputes. One federal court has recognized, “the assertion that ‘immutable facts’ will determine the outcome of the coverage issues regardless of [defense counsel’s] conduct -- is counterintuitive at best and disingenuous at worst.” *Scottsdale Ins. Co. v. The Housing Group*, 1995 U.S. Dist. LEXIS 8781 (N.D. Ca. 1995). Given the ethical duty owed by insurer-retained defense counsel to both the insurance company and the insured, and counsel’s ability to influence the outcome of issues that may be central to coverage, the *Schaefer* court correctly found that there was a right to independent counsel.

Assuming it is not reversed by the California Supreme Court, insureds will attempt to use the decision in *Schaefer* to compel insurance companies to provide independent counsel whenever there is a **potential** for defense counsel to influence facts that may determine coverage. At the same time, insurance companies may think twice before asserting broad sweeping reservations of right that, in light of the decision in *Schaefer*, are more likely to trigger the right to *Cumis* counsel, at their expense.

If an insurance company does not offer to provide independent counsel when it agrees to provide a defense to its insured, the insurer’s reservations of right must be carefully scrutinized to determine if the right to *Cumis* has in fact been triggered.