

ALERT

Insurer's Contractual Right to Select Defense Counsel Upheld Where Insurer Had Incentive to Provide Vigorous Defense

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The United States District Court for the Northern District of Texas, applying Texas law, has held that a professional liability insurer's reservation of rights to deny coverage for the return of fees or for "costs arising from declaratory relief" did not create a conflict of interest superseding the insurer's contractual right to select defense counsel, concluding that the insurer had an incentive to provide a vigorous defense regardless of those policy provisions. *Coats, Rose, Yale, Ryman & Lee, P.C. v. Navigators Specialty Ins. Co.*, 2011 WL 5870066 (N.D. Tex. Nov. 21, 2011). The court also held that the policy's dishonesty exclusion did not create a conflict of interest because the insurer expressly disclaimed its rights under that exclusion. Wiley Rein LLP represented the insurer.

An insured law firm sought coverage for a legal malpractice action filed against it under the law firm's professional liability insurance policy. The policy provided that the insurer had the right to defend the insured, and further that the insurer "shall have the right to appoint counsel and to make such investigation and defense of a claim as is deemed necessary by the [insurer]." The insurer agreed to provide a defense under a reservation of rights, but the law firm, asserting that the insurer's selected counsel would have a conflict of interest, hired independent defense counsel. The insurer concluded there was no conflict of interest and therefore declined to pay independent counsel's fees. The law firm filed suit against the insurer seeking a declaration that the insurer was required to pay the costs of its chosen counsel, and moved for partial summary judgment to establish that a conflict of interest nullified the insurer's contractual

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right to select defense counsel. The insurer filed a cross-motion for partial summary judgment seeking a declaration that it had the exclusive right to select defense counsel in the malpractice action.

The court granted partial summary judgment in favor of the insurer. As an initial matter, the court held that only an “actual” conflict of interest, not a “potential” conflict of interest, triggered an insured’s right to select independent counsel. The court then rejected the law firm’s three arguments in support of its contention that a conflict of interest existed. First, the law firm argued that a conflict of interest arose out of the insurer’s future ability to reserve its rights under the policy’s dishonesty exclusion, explaining that the insurer would have the incentive to steer judgment toward a finding of fraud, as opposed to a finding of mere negligence. The insurer responded that it “has not and will not ever reserve” its rights under the dishonesty exclusion. Accordingly, the court held that, because the insurer had expressly disclaimed such rights, the law firm failed to establish a conflict of interest.

Second, the law firm asserted that a conflict existed because the policy covered compensatory damages but not the return of fees, which would discourage the insurer from resisting factual findings that would result in a return of fees award. The insurer argued that this did not constitute a conflict of interest because *any* factual concession would increase the likelihood of compensatory damages on either of the negligence or breach of fiduciary duty theories asserted by the claimants. The court agreed, explaining that a return of fees award would not be *in lieu* of compensatory damages, as the two types of awards are made on different bases and serve different purposes. Moreover, even if a return of fees award would affect the amount of compensatory damages, any concession of fact that would lead to a return of fees award would also, by acknowledging wrongdoing, increase the amount of a compensatory damages award.

Finally, the law firm argued that, because the policy did not cover “costs arising from declaratory relief,” the plaintiffs’ declaratory judgment claim in the malpractice action created a conflict of interest by incentivizing counsel to resolve the action on the declaratory judgment claim. The insurer contended that this argument misinterpreted the purpose of the declaratory judgment claim in the malpractice action, and the court agreed. The declaratory judgment claim asked the court to make twelve declarations as to the factual and legal basis for the malpractice and breach of fiduciary duty claims. Accordingly, the court held that an order granting declaratory judgment would only affect the insured’s liability under the other claims, and would not constitute an independent basis for liability precluded under the policy.