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NEW TEXAS CLIENT ALERT– February 7, 2012

Texas Federal Court Addresses When Reservation of Rights by Insurer Entitles Insured to Control Its Own Defense Through Independent Counsel

This is one of the most hotly debated and disputed issues between insureds and insurers. California, of course, fairly early on dealt with this issue via its "*Cumis* doctrine" and related *Cumis* statutes. By contrast, Texas and many other jurisdictions have largely left the issue to the courts to deal with on a case-by-case basis without much clear guidance. Historically in Texas, at least according to several old decisions, any time that the liability insurer was defending under a reservation of rights to deny coverage, the insured had the right to reject the insurer's proffered defense counsel, and defend the case with its own lawyers and send the bills to the carrier for payment. Only relatively recently have Texas courts begun to back off of that old rule and to focus, instead, on whether the liability case will adjudicate the "same facts" upon which coverage turns thereby creating an actual disqualifying conflict of interest. Even so, there are still just a handful of reported Texas decisions on the issue.

A January 20, 2012 federal district court opinion, however, has now tackled head-on what the "same facts" test means and how to apply it. It confirms the previously starting-to-emerge trend from a few previous cases: Texas courts will impose a relatively high burden on the insured to show a "same facts" conflict of interest before allowing the insured to reject the insurance defense counsel hired by the insurer. *Partain v. Mid-Continent Spec. Ins. Services*, *Inc.*, Civ. Action No. H-10-2580 (S.D. Tex. Jan. 20, 2012).

Partain involved a copyright infringement suit filed against multiple parties who were insureds or potential insureds under the policy. The Plaintiff architect accused the defendant homebuilder and several related individuals of infringing upon the architect's copyrighted home plans and designs. The claim thus potentially involved Coverage B of the standard CGL policy. The insurer agreed to defend under a reservation of rights through its own chosen defense firm. The insurer's reservation of rights letter raised several potential coverage issues: (1) the exclusion for "knowing violation of the rights of another," (2) the exclusion for publications of material that took place prior to the policy period, (3) the Coverage B exclusion for "contractual liability," (4) the separate "breach of contract" exclusion under Coverage B, (5) the exclusion for "copyright, patent, trademark, trade secret or other intellectual property rights" unless such occurred in an "advertisement" and (6) whether one of the defendants qualified as an "insured" on the policy at all (as "partner" in the named insured). In response, the insureds' personal counsel asserted that there was a conflict of interest and demanded that the carrier recognize the insured's right to defend the case with its own counsel, *i.e.*, him. The insurer rebuffed the insured's claims and insisted on its own defense counsel. The insureds then sued.

After noting that the insurer generally has the right to control the insured's defense pursuant to the terms of the policy, the court also noted that such right must yield to the insured's right to control the defense if there is a disqualifying conflict of interest. However, the court held that not every reservation of rights to deny coverage gives rise to such a disqualifying conflict. It is only where "the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends" that a disqualifying conflict arises; but the court also correctly pointed out that the Texas Supreme Court has never clarified what was meant precisely by the "same facts"

analysis or how it was to be applied. So, the court set out to do so and held that *the facts upon which coverage depends must be facts that will be actually ruled upon by the fact finder (court or jury) in the underlying case*. The court then looked at each coverage issue raised by the carrier to see if it met that test.

While the jury in the case would determine whether the infringement occurred, it would not be called upon to determine if such infringement occurred in an "advertisement" or not. On the "policy period" issue, while there was a statute of limitations issue in the case, liability could be imposed based upon infringements that either occurred or were discovered within the statute of limitations and thus the resolution of the statute of limitations issue would not determine whether, in fact, some infringements were committed prior to the policy period for purposes of the exclusion. Next, as to the "knowing violation" exclusion, while "willfulness" was one ground upon which the court could base a discretionary award of enhanced statutory infringement damages, the plaintiff had not alleged "willfulness" as a basis for statutory damages. As to the "partner"/"Insured" issue, the court noted that the jury charge to be submitted would simply ask whether the individuals were vicariously liable for the infringement and would not ask specifically whether they were "partners" in the company. Accordingly, the court found no disqualifying conflict of interest.

Practical Pointers—Whether a disqualifying conflict of interest exists in any particular case must be determined on a case-by-case basis and is totally dependent on the coverage issues involved and the substantive law applicable to the underlying liability case. The parties should consider exactly what the jury charge will ask the jury to determine and then whether those determinations affect coverage. Unless there is significant overlap, then as this case demonstrates, the courts will likely be reluctant to deprive the carrier of its policy right to control the defense. If, however, there is a clear conflict of interest, then the carrier may have to decide whether its conflict-creating coverage defenses are important enough to outweigh the loss of control over the defense. If the defense costs to be incurred in the insured-controlled defense potentially exceed the amount of avoidable indemnity obligation that coverage defenses represent, then the insurer may be easily better off controlling the liability defense and waiving the potential coverage issue, especially if the coverage defense is tenuous or only potential. Even if the coverage issue is so significant as to justify relinquishing control of the defense to the insured, the carrier is only responsible for reimbursement of "reasonable and necessary" attorney's fees, although what is "reasonable" may be significantly higher than what the carrier would pay to even one of its very best panel defense counsel. Often, the carrier and the insured can work out a negotiated fee payment split to avoid litigation later in any event.

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