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NEW TEXAS COVERAGE CASE ALERT – May 19, 2011

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Defense Offered Under Reservation of Rights Does Not Automatically Require Insurer to Pay Insured's Independent Defense Counsel

It is surprising that this issue, which comes up so often, has generated so little Texas case authority and virtually no case authority providing insurers and policyholders with any specific answers. Perhaps that is due to the practical reality that insurers and policyholders frequently end up simply negotiating terms of independent defense counsel arrangements that they can both live with instead of going to court over the issue. In a May 9, 2011 federal district court opinion, however, the court directly examined the issue and held that unless the coverage defenses that the insurer has reserved its rights on are issues subject to being steered by defense counsel in favor of the insurer and against the interests of the insured, the policyholder cannot reject the insurer's proffered defense and counsel, and then sue the insurer for the fees charged by policyholder-selected counsel. *Downhole Navigator, LLC v. Nautilus Ins.* Co., Civ. Action No. 4:10-0695 (May 9, 2011).

The case concerned alleged damage to an oil well allegedly caused by the insured, a directional drilling guidance company. The well owner sued the insured alleging that their mistakes had caused damage to the well. The insured tendered the suit to Nautilus. Nautilus agreed to defend through counsel it would assign, but only under reservation of rights to deny coverage under several exclusions, including a "testing" exclusion, "professional services" exclusion, and a "data processing" exclusion, each of which turned on the nature of the services provided by the insured that led to the damages. The insured rejected the proffered defense, asserting that Nautilus' reservation of rights created a conflict of interest that allowed the insured to continue to defend the case with its own counsel but hold Nautilus responsible for the bills. Nautilus disputed the insured's right to independent counsel and the insured then filed a declaratory judgment and breach of contract suit. Nautilus responded that its reservation of rights did not create a conflict of interest, that its offer of defense was proper, and therefore it was not responsible for the insured's defense costs incurred to independent counsel.

The court noted that an insurer's reservation of rights can give rise to an actual conflict of interest triggering the insured's right to independent counsel of the insured's choosing; but not necessarily. The court focused on language in a 2004 Texas Supreme Court decision, *Northern County Mut. Ins. Co. v. Davilos*, 140 S.W.3d 685 (Tex. 2004) where the court suggested that if the facts to be adjudicated in the underlying liability case are the same facts upon which coverage turns, the insurer may be precluded from controlling the defense. The court concluded that unless the outcome of the coverage issue can be controlled by defense counsel, there is no disqualifying conflict of interest. As an example of true conflict, the court cited *Housing Auth. of Dallas v. Northland Ins. Co*., 333 F.Supp.2d 595 (N.D. Tex. 2004) where willful, illegal employment practices were alleged and carrier had reserved rights based on a "willful violation of statute" exclusion.

By contrast, here the court noted that none of the factual matters that three exclusions cited by the insurer in its reservation of rights letter were going to turn on would be decided one way or the other by the jury in the underlying case. If the insured was negligent in the well service, it was going to be liable; if it was not, it would not. The jury would not be asked to determine if the insured's negligence was due

to its testing errors, professional negligence, or data processing activities. Accordingly, the insured was not entitled to reject Nautilus' defense but expect Nautilus to reimburse the fees anyway.

PRACTICE POINTERS: This case is one of just a handful of Texas cases that even discuss when and under what circumstances a reservation of rights requires an insurer to relinquish the defense to counsel chosen by the insured. Its holding is in line with case law from other jurisdictions, so it is not all that significant in that respect. As an addition to Texas jurisprudence that squarely addresses the right to independent counsel in a reservation of rights situation under Texas law, it is significant. It makes it clear that insurers cannot be forced to choose between waiving their coverage defenses or having to pay for independent counsel every time there is a reservation of rights. Indeed, under the test employed in this case, a true conflict of interest triggering a right to independent counsel will likely be the exception rather than the norm.

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