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The Relationship Between Defense Counsel, Policyholders, and Insurers: Nevada Rides *Yellow Cab* Toward “Two-Client” Model of Tripartite Relationship. Are *Cumis* Counsel and Malpractice Claims by Insurers Next?

By Professor Jeffrey W. Stempel

It happens constantly in civil litigation. An insurance company hires a lawyer to defend its policyholder from a third party’s claim of injury. But just who is the lawyer’s “client?” Is it the policyholder who is the named defendant in the case and is “represented” in court proceedings? Or is it the insurer who, in most cases, selected the attorney, pays the attorney, supervises the litigation, and has (by the terms of the liability insurance policy) the right to settle the case, even over the objections of the policyholder? Ordinarily, the liability insurer has both the duty to defend a policyholder sued by a third party and the right to control the defense and settlement of the case. In addition, the insurer has a “duty to settle” claims if this can reasonably be done for an amount at or below the policy limits.

For years, I have been telling students that Nevada followed a “one client” model of this three-part relationship between insurer, policyholder and lawyer. Three separate formal opinions of the State Bar Committee on Ethics and Professional Responsibility (Nos. 9, 26 and 28), spanning nearly 20 years, seemed to clearly adopt the view that the lawyer’s only “client” is the policyholder/defendant and that the insurer has only contract-based rights vis-à-vis the retained defense lawyer. *See, e.g.*, Formal Opinion No. 28 (Nov. 19, 2002) (“under Nevada law, the attorney’s client is the policyholder” while “insurer has the subordinate rights of a third party payer”). However, the insurer’s contract rights were substantial, both in law and as a practical matter, at least if the attorney wished to continued to receive future business from the insurer.

On March 8, the Nevada Supreme Court decided *Nevada Yellow Cab Corp. v. District Court*, 123 Nev. Adv. Rep. 6, 152 P.3d 737 (Nev. 2007), which will require some revisions for my next professional responsibility, insurance law, and civil procedure classes. In *Yellow Cab*, the court held that both the policyholder and the insurer are the defense attorney’s clients. The Supreme Court, like others following the two-client model, also stated that counsel’s “primary” client is the policyholder with the insurer as a secondary client. This portion of *Yellow Cab* means that there is no change in pre-*Yellow Cab* Nevada law (as reflected in formal ethics opinions 9, 26 & 28 and the general understanding of practicing lawyers) that when policyholder and insurer interests conflict, counsel must not betray the interests of the policyholder in favor of the insurer, no matter how steady a stream of business the insurer may provide to counsel and her law firm. For example, insurers typically demand regular reports on significant events in the litigation. Insurer-retained counsel defending the policyholder cannot, in the course of keeping the insurer informed, reveal ethically protected information (i.e., information acquired during the course of representing the policyholder) which could be used by the

insurer to deny coverage.

But *Yellow Cab* introduces a substantial new wrinkle in insurance defense practice by adopting the two-client model. Because both the policyholder/defendant and the insurer are “clients” of the lawyer, greater potential for disqualifying conflict of interest arises, a fact reflected in *Yellow Cab* itself. The court upheld a trial court’s disqualification of a prominent attorney and firm because a lawyer in the firm had previously been retained by the insurer in connection with a related matter.

In addition, adoption of the primary-secondary client model appears to equate Nevada with the approach to the “tripartite” relationship of insurer-policyholder-defense counsel used in California and in other states following the two-client model. Under California law, where there is concrete conflict between insurer and policyholder over coverage and the conduct of counsel may affect resolution of the coverage issue, the policyholder is permitted to select its own counsel, with the insurer providing payment of reasonable fees. In such situations, the policyholder need not accept the insurer-selected defense lawyer as its counsel. California’s jurisprudence in this area is particularly well known, stemming from *San Diego Federal Credit Union Ins. Co. v. Cumis*, 162 Cal. App.3d 358, 208 Cal. Rptr. 494 (Cal. Ct. App. 1984), which was modified and codified by statute in Cal. Civ. Code § 2860, discussed below.

In *Yellow Cab*, the court’s particular holding was that counsel previously retained by the insurer to defend a policyholder was disqualified from subsequently representing the policyholder in a bad faith claim against the insurer. The dispute had its roots in 1999, when Insurance Company of the West (“ICW”) retained the firm then known as Vannah, Costello, Canepa, Riedy & Rubino to defend Yellow Cab, an ICW policyholder, against a personal injury lawsuit by plaintiff Heather Nash, arising from an accident involving her vehicle and a Yellow cab. The ICW policy had limits of \$500,000, with Yellow Cab required to pay a self-insured retention of \$50,000 in accident cases. Vannah Costello partner Michael Rubino and associate Denise Cooper Osmond defended Yellow Cab from January 1999 to November 2002. During this time period, there was significant litigation activity, including document discovery and several depositions. *See* 152 P.3d at 738-39.

In November 2002, ICW discharged Vannah Costello and substituted a different law firm to defend Yellow Cab, which did not consent to the substitution. Just before trial, plaintiff Nash offered to settle her claim for the \$500,000 policy limits. ICW instructed the new defense counsel to reject the offer. During trial in March 2003, the case was settled for \$1.3 million, with Yellow Cab paying \$500,000 toward the settlement. *See id.* 739. Yellow Cab subsequently felt aggrieved by these developments and this settlement, asserting that ICW breached its duty to settle when it could have done so for substantially less money, saving Yellow Cab nearly half a million dollars and the burdens of trial.

Also in 2003, Vannah Costello split into two firms: Vannah Costello Vannah & Ganz, and Canepa Riedy & Rubino. Osmond stayed with the new Vannah Firm while Rubino joined the Canepa Firm as a name partner. In June 2003, Yellow Cab retained Robert

Vannah as counsel to prosecute a bad faith action against ICW, based on ICW's failure to settle the Nash claim within the Yellow Cab policy limits. After the original Vannah Firm split, Yellow Cab continued to be represented in the bad faith action by attorney Vannah and the new incarnation of the Vannah Firm. In turn, ICW retained counsel to represent it in the Yellow Cab bad faith case and then objected to Vannah's representation of Yellow Cab on conflict of interest grounds.

ICW took the position that it was a former "client" of the New Vannah Firm by virtue of the Old Vannah Firm's work on the *Nash v. Yellow Cab* case. Consequently, argued ICW, it was a "former client" of New Vannah in connection with a current matter (*Yellow Cab v. ICW*) which was substantially related to the matter (*Nash v. Yellow Cab*) on which the Old Vannah Firm had worked at the behest of ICW. The New Vannah Firm was now representing a client (Yellow Cab) within interests obviously adverse to those of the purported old client ICW. Vannah took the position that the Old Vannah Firm's work in *Nash v. Yellow Cab* had been for Yellow Cab as the "client" and that ICW was never a "client" of the Old Vannah Firm, but had simply contracted with the Old Vannah Firm to represent ICW's policyholder, Yellow Cab, as client. Under Vannah's theory of the case, ICW never enjoyed "client" status under the Rules of Professional Conduct, which in turn insulated the New Vannah Firm from charges of disqualifying conflict of interest under the "former client" provisions of Rule 1.9 (formerly SCR 159). Under ICW's theory of the case, both Nash and ICW enjoyed "client" status, which meant that ICW had standing and grounds for the disqualification of the New Vannah Firm in the *Yellow Cab v. ICW* case.

The trial court was persuaded by ICW's argument and disqualified Vannah. The Nevada Supreme Court affirmed. After finding no waiver by ICW due to mediation-related delays in bringing the disqualification motion, the court expressly adopted:

the majority rule that counsel retained by an insurer to represent its insured represents both the insurer and the insured in the absence of a conflict. Thus, the attorney-client relationship existed between ICW and the associate who had previously defended Yellow Cab, who was now employed by Vannah's new firm. As the district court did not manifestly abuse its discretion in determining that the disqualification was warranted, based upon this former representation, the substantial relationship between the two representations, and the adversity of Yellow Cab's and ICW's position in the bad faith case, we deny this petition [for mandamus seeking to reverse the trial court's disqualification of New Vannah].

See 152 P.3d at 739.

The court stated that when an insurer retains counsel to defend its policyholder, counsel "represents both the insurer and the insured in the absence of a conflict," citing case law from six states taking this approach, including California. *See* 152 P.3d at 741. According to the court, this approach:

[r]equires that the primary client remains the insured, but counsel in this situation has

duties to the insurer as well... ...[W]hile the insured is the primary client, counsel generally learns confidential information from both the insured and the insurer and thus owes both of them a duty to maintain this confidentiality; and since counsel generally offers legal advice to both the insured and the insurer, counsel owes a duty of care to both... [Joint representation is permitted] when no actual conflict is present [and is] permissible as long as any conflict remains speculative.

See 152 P.3d at 741 (footnotes omitted).

The *Yellow Cab* court was particularly concerned about the danger that confidential information acquired by counsel in the first matter could subsequently be used to a former client's disadvantage in the second matter. *See id.* at 743. In addition, the court was reviewing a trial court's decision to disqualify, which was subject to some degree of deference to the trial court's exercise of discretion and assessment of the facts, including the degree of danger that ICW as a "former client" could be injured by facing a former lawyer and law firm in a subsequent action. *See id.* at 743.¹

Had the trial court denied disqualification, it is not at all clear that the Supreme Court would have insisted on disqualification, even though it affirmed that result on appeal. For example, in a separate concurrence, Chief Justice Maupin described the matter as a "close case." *See id.* at 743 ("because the issue is close, and because the district court could reasonably conclude that ICW's former insurance defense counsel gained some knowledge generally about ICW's internal claims policies, I cannot conclude that the district court manifestly abused its discretion in its ruling of disqualification").

Regarding disqualification generally, *Yellow Cab* and earlier Nevada precedent suggest that doubts should generally be resolved in favor of disqualification. *See* 152 P.3d at 743. This approach makes sense as a means of reducing the risk that lawyers and their new clients might take advantage of parties who had previously used the lawyer's services. Although litigants have a general right to counsel of their choice, it is unlikely that disqualification of a particular lawyer or firm will significantly impair the client's ability to successfully pursue its claim for relief. Although attorney Vannah and the Vannah firm are particularly prominent, there are many good Nevada lawyers capable of competently prosecuting an insurance bad faith claim.

As the *Yellow Cab* court noted, the presence of a conflict changes the complexion of the two-client model or tripartite relationship. The existence of an actual (not merely speculative) conflict essentially destroys the two-client model or converts it into a one-client model in which counsel's client is the policyholder in conflict with the insurer while the insurer must still pay the reasonable legal fees required to adequately defend the policyholder and attempt to settle the case.

In practice, it may not be all that important whether or not the insurer is seen as having "mere" contract rights or having "client" rights, vis-à-vis counsel, so long as the policyholder is the primary client and is protected in cases of conflict. Arizona and Utah use the two-client approach and protect policyholder interests in cases of conflict. *See*

Spratley v. State Farm Mut. Auto. Ins. Co., 78 P.3d 603, 607 (Utah 2003) (“where no actual conflict exists or is foreseeable, an attorney will ordinarily represent both the interests of the insured and the insurer. However, where actual conflict exists or is likely to arise, the attorney’s allegiance is to the insured because of an insurer’s duty to provide a defense in good faith.”); *Paradigm Insurance Co. v. Langerman Law Offices*, 200 Ariz. 146, 151, 24 P.3d 593, 598 (2001) (in absence of conflict, attorney has two clients, insurer and policyholder). Further, failure of insurer-selected counsel to properly protect policyholder interests “constitutes a waiver of any policy defense [to coverage and] the insurance company is estopped as a matter of law from disclaiming liability under an exclusionary clause in the policy.” See *Parsons v. Continental Ins. Co.*, 113 Ariz. 223, 228; 550 P.2d 94, 98 (1976).

Although *Yellow Cab* does not expressly embrace the California approach or California’s *Cumis* statute (Cal. Civ. Code § 2860) or line of cases, it would appear that Nevada will follow California’s lead in this regard. Failure to do so would open up the two-client model for abuse and inadequate protection of policyholders. Other states following the two-client model, such as Arizona, mandate that the defense attorney’s loyalty lies with the policyholder-defendant in cases of conflict with the insurer, even though they do not specifically invoke the *Cumis* line of California precedents. In cases where the conflict is sufficiently pronounced and where the attorney’s conduct of the defense may affect insurance coverage, it seems only logical that the policyholder be permitted to select defense counsel with undivided loyalties. California permits the policyholder to give a written waiver of its *Cumis* rights after disclosure of the risks of conflicted counsel. See § 2860(a).

Under *Cumis* and similar law in other states, the insurer must pay the reasonable counsel fees of the independent defense attorney, but the insurer’s duty to pay is not limitless. Although the insurer must pay for *Cumis* counsel, the policyholder is generally not permitted to force the insurer to pay for independent counsel which charges much higher rates than those ordinarily paid by the insurer to its regularly utilized defense counsel. California Civil Code § 2860(c) specifically limits the insurer’s payment obligation to “rates which are actually paid by the insurer to attorneys retained by it in the ordinary course of business in the defense of similar actions in the community where the claim arose or is being defended.”

Other states are less clear about the extent of the insurer’s financial obligation. In these states, the policyholder may not be restricted solely to the insurer’s normal payment schedule (which courts realize is often quite low due to the market power of insurers in retaining defense counsel). There are, however, some obvious implicit limits on the insurer’s financial obligations to pay independent counsel. For example, if the attorneys usually retained by the insurer charge \$200 per hour for defense of automobile accident claims, most courts would not require the insurer to pay all of the legal fees incurred by the policyholder that retains a \$750-per-hour lawyer in the matter involving a conflict. However, if the regular insurer rate is \$100 per hour or a similarly low rate, the insurer could be held responsible for reasonable policyholder expenditures exceeding this rate,

particularly if the underlying claim is complex or presents substantial risk to the policyholder (and perhaps to the insurer as well because of the difficulty in evaluating settlement in cases where a judgment in excess of policy limits is a realistic possibility).

In addition to the prospect of Nevada's eventual adoption of a *Cumis*-like approach to issues of conflict in the tripartite relationship, *Yellow Cab* and the two-client model of insurance defense counsel raises the issue of whether or not an insurer may sue defense counsel for malpractice. Other two-client model states permit malpractice actions by the insurer as well as the policyholder. *See, e.g., Paradigm Insurance Co. v. Langerman Law Offices*, 200 Ariz. 146, 151, 24 P.3d 593, 598 (2001). In California, the insurer can also insist that policyholder-selected independent counsel have malpractice insurance. *See* § 2860(c). However, a policyholder generally cannot sue the insurer for "malpractice" if the insurer controlling the defense errs. *See, e.g., State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625 (Tex. 1998). Instead, the policyholder's remedy is a bad faith action against the insurer and perhaps a separate malpractice action against defense counsel.

Professor Stempel is a 1981 graduate of Yale Law School, where he was an editor of the Yale Law Journal and co-founder of the Yale Law and Policy Review. Before becoming a professor at Boyd School of Law he served on the faculty at Brooklyn Law School and the Florida State University College of Law. He has numerous publications to his credit, including books, treatise chapters and supplements, and law review articles. At Boyd he teaches Civil Procedure/Alternative Dispute Resolution, Evidence, Professional Responsibility and Insurance Law.

Footnotes:

1 In what can be viewed as a clarification of mandamus doctrine making mandamus more difficult to obtain in disqualification cases, the Court stated that mandamus is available to overturn a disqualification only when the trial court has "manifestly abused its broad discretion" over disqualification motions. A "simple" abuse of discretion is not sufficient to support mandamus. *See id.* at 743, n. 26.