TORTS AND LIABILITY INSURANCE SEMINAR

LORMAN EDUCATION SERVICES, APRIL 12, 2005

FINDING COVERAGE, AVOIDING COVERAGE, AND ACTING AS "CUMIS" COUNSEL

Authors:

Brent W. Huber
Heather E. Bolejack

Ice Miller
One American Square, Box 82001
Indianapolis, Indiana 46282-0002
(317) 236-2100
E-mail: brent.huber@icemiller.com
heather.bolejack@icemiller.com

These materials are intended for general information purposes only and are not intended to constitute legal advice. The reader must consult with legal counsel or undertake an independent legal investigation to determine how laws or decisions discussed herein apply to the reader's specific circumstances. The views expressed herein do not necessarily represent the views of Ice Miller or its clients.

TABLE OF CONTENTS

Introduction

A. Duty to Defend: What Triggers An Insurer's Duty to Defend?

1. Examining Indiana Supreme Court's Decision in *Kopko*: Duty Based on Complaint Only

2. Beyond the Complaint: Insurer's Duty to Conduct a Reasonable, Independent Investigation under Indiana Law

B. The Insured's Strategy: Practical Tips for Seeking Coverage

1. Notice Early, Often, and Every Potential Insurer.

2. The Proof Is In The Pleading

C. The Insurer's Strategy: Practical Tips for Evaluating Coverage

1. Evaluation of Duty to Defend and Indemnify

2. Defending Under Reservation of Rights and Denying Coverage

D. Declaratory Judgment Actions: Advantages and Disadvantage

1. Generally Defined

2 Courts have Discretion in Hearing Declaratory Judgment *Volkswagenwerk*

3 Practical Tips for Insurers and Insureds Seeking Declaratory Judgment

a. Declaratory Judgment as an Effective Tool
b. Summary

E. Hot Button Issues that Arise When the Insurer's Reservation of Rights Creates a Conflict of Interest

1. Insured's Right to Counsel of Its Choice When Reservation of Rights Creates a Conflict of Interest

2. Privilege Issues

a. Background
b. Nature of the Attorney-Client and Work Product Privileges

c. Does Sharing of Privileged Information Among Lawyer, Insurer and Insured Constitute a Waiver
d. Does Disclosure of Legal Bills to an Outside Auditor Result in a Waiver?
e. Privileges and the Insured's Duty of Cooperation

Introduction

In recent years, Indiana has become a forum of choice for policyholders to litigate disputes related to insurance coverage. Many Indiana courts have been willing to find ambiguities in insurance policies and to construe these ambiguities in favor of coverage as a matter of law. The construction of policy language, therefore, is particularly relevant to business torts which may involve allegations of an insured's intentional acts to which exclusionary policy language could apply. Insurance proceeds are often the source of funds for the defense, settlement and/or payment of liability associated with such claims. Consequently, the skilled drafter pleads into an insured's coverage, thus potentially triggering the insurer's duty to defend and indemnify against such causes of action. When faced with significant liabilities, policyholders large and small are looking to the Indiana courts for favorable declaratory judgments regarding their policies. Is an insurer's duty to defend determined solely by the four corners of the complaint? Under what circumstances have Indiana courts looked beyond the underlying complaint to the facts to determine an insurer's duty to defend? Filings raising these issues have generated a growing body of reported decisions that illustrate a number of important litigation concerns that litigants in all types of insurance disputes should consider in determining the appropriate course of action.

These materials address several of these issues. Sections A, B, and C discuss issues related to the duty to defend, and practical considerations for insureds seeking coverage and insurers evaluating coverage. Section D addresses declaratory judgment actions generally and practical considerations for insureds and insurers seeking declaratory judgments. Section E addresses two current issues that have been receiving increasing attention in insurance disputes around the nation, but which have not been addressed squarely by the Indiana courts. The first is whether an insured is entitled to independent counsel of its choice when an insurer's agreement

to provide a defense subject to a reservation of rights creates a conflict of interest. A related issue arises when such an insurer requests information from the policyholder that is protected by the attorney-client or work product privilege: does the disclosure waive the privilege or, conversely, does the policyholder's refusal to make the requested disclosure because the information is privileged breach the "duty to cooperate" with the insurer? A similar question arises when an insurer that agrees to provide a defense attempts to share its insured's legal defense bills with a third party for auditing purposes. Different jurisdictions are reporting widely varying decisions on these issues, and the Indiana courts just beginning to provide guidance to insurers, policyholders and attorneys, all of whom may have a great deal at stake.

A. Duty to Defend: What Triggers An Insurer's Duty to Defend?[1]

Often the first notice to the insurer of a claim for defense and indemnity is through receipt of a complaint or other pleading against the insured. As a general rule, an insurer's duty to defend the insured is determined primarily by the pleadings in the underlying lawsuit, without regard to their veracity, what the parties know or believe the alleged facts to be, the outcome of the underlying case, or the merits of the claim.[2] Whether an insurance company has a duty to defend is a question of law for the Court to decide.[3] The duty to defend is broader than the duty to indemnify.[4] Whereas the duty to indemnify may depend on the merits of the claim against the

---

[1] The research in these materials was completed in January, 2005; *see also* Brent W. Huber, *Litigating Insurance Coverage In Indiana,* Lorman Insurance Law In Indiana Seminar (February 12, 2003).

[2] Lee R. Russ and Thomas F. Segalla, 14 Couch on Insurance 3d § 200:20 (1997 & Supp. 2004); *See* Cincinnati Ins. Co. v. Mallon, 409 N.E.2d 1100 (Ind. Ct. App. 2d Dist. 1980); *see also* Transamerica Ins. Serv. v. Kopko, 570 N.E.2d 1283, 1285 (Ind. 1991).

[3] *See* American States Ins. Co. v. Kiger, 662 N.E.2d 945, 947 (Ind. 1996) (stating coverage presented substantial question of law); *see also* Meridian Mut. Ins. Co. v. Richie, 540 N.E.2d 27, 28 (Ind. 1989) ("[T]he interpretation of an insurance policy is primarily a question of law for the court. . . ."), *vacated on other grounds*, 544 N.E.2d 488 (Ind. 1989).

[4] Kopko, 570 N.E.2d at 1285.

insured—that is, the specific facts and whether they result in a judgment for the plaintiff—the duty to defend depends merely on the nature of the claim.[5] Thus, the fundamental question as to the duty to defend is not whether the claim against the insured has merit, but whether—assuming the claim to be true—it falls within the coverages of the policy. It is well settled that ambiguities in policy language are construed in favor of coverage as a matter of law in order to further the policy's basic purpose of indemnity.[6]

The Seventh Circuit has explained, "The duty to defend is not just a duty to defend against good claims."[7] On the other hand, the Seventh Circuit has held that it is the factual allegations instead of the legal theories alleged which determine the existence of a duty to defend. [8] Therefore, the prudent insured will seek to raise factual allegations which fall within policy language. The advised insurer, however, will seek to identify and disprove those claims or facts that trigger coverage. Insurers are often confronted with complaints that allege in the same pleading some claims that fall within coverage and other claims that are excluded from coverage. The Indiana Supreme Court in *Kopko* held that if just one of the insured's claims falls within the coverages of the policy, the insurer has a duty to defend the entire suit.[9] *Kopko* stands

---

[5] *Id.*; Mallon, 409 N.E.2d at 1105.

[6] *See* PSI Energy, Inc. v. Home Ins. Co., 801 N.E.2d 705, 723 (Ind. Ct. App. 2004), *trans. denied*; Hoosier Ins. Co. v. Audiology Found. of America, 745 N.E.2d 300, 309 (Ind. Ct. App. 2001), *trans. denied*; *see also* Federal Ins. Co. v. Stroh Brewing Co., 127 F.3d 563, 566 (7th Cir. 1997) ("Typically, an insurer has a duty to defend its insured against suits alleging facts that might fall within the coverage."); Travelers Indem. Co. v. Summit Corp. of America, 715 N.E.2d 926, 936 (Ind. Ct. App. 1999).

[7] Scottsdale Ins. Co. v. Subscription Plus, Inc. 299 F.3d 618, 620 (7th Cir. 2002).

[8] Hurst-Rosche Engineers, Inc. v. Commercial Union Ins. Co., 51 F.3d a336 (7th Cir. 1995) (question of coverage should not hinge exclusively on draftsmanship skills or whims of plaintiff in underlying action; alleged misconduct determinative).

[9] *See* Kopko, 570 N.E.2d at 1285 ("[T]he insurance company is required to defend even though it may not be responsible for all of the damages assessed. . . .").

for the holding that "[t]he duty to defend is determined *solely* by the nature of the complaint.[10] *Kopko* is not without exceptions, however, and has been described as a "dramatic departure from prior cases" by the Seventh Circuit.[11] In the paragraphs that follow, these materials will examine the Indiana Supreme Court's holding in *Kopko*, and the line of Indiana cases which declined to follow *Kopko* in holding that insurers may go beyond the face of a complaint and refuse to defend based on the factual basis of a claim.[12]

1. Examining Indiana Supreme Court's Decision in Kopko: Duty Based on Complaint Only

In *Kopko*, the Indiana Supreme Court held that in a complaint by a homeowner, where, the insured-developer knew of defective sub-soil conditions on the property prior to sale, settlement of a newly-constructed home was not an accident expected or intended by the insured and therefore not an "occurrence" covered by the policy.[13] The Court also found an exclusion from coverage under the policy's alienation clause due to the developer's sale of the parcel to a builder prior to the start of construction of the home.[14] Finding no coverage under the policy, the Court concluded that there was no duty to defend.[15] The Court stated that where a complaint alleged intentional and fraudulent conduct and the insured's defense was that his conduct was

---

[10] *Id.*

[11] Fidelity and Guaranty Ins. Underwriters, Inc. v. Everett I. Brown Co., L.P., 25 F.3d 484, 489 (7th Cir.1994).

[12] *See* Audiology Found., 745 N.E. 2d at 306; *see* also Monroe Guar. Ins. Co. v. Monroe, 677 N.E.2d 620, 623-24 (Ind. Ct. App. 1997), *trans. dismissed* (citing Trisler v. Indiana Ins. Co., 575 N.E.2d 1021 (Ind. Ct. App. 1991); Indiana Ins. Co. v. North Vermillion Community School Corp., 665 N.E.2d 630 (Ind.Ct.App. 1996), *trans. denied*; Wayne Township Bd. Of School Comm'rs v. Indiana Ins. Co., 650 N.E.2d 1205 (Ind. Ct. App.1995), *trans. denied*; Seymour Mfg Co. v. Commercial Union Ins. Co., 648 N.E.2d 1214 (Ind. Ct. App. 1995); Terre Haute First National Bank v. Pacific Ins. Co., 634 N.E.2d 1336 (Ind. Ct. App. 1993)).

[13] Kopko, 570 N.E.2d at 1284-85.

[14] *Id.* at 1285.

[15] *Id.*

merely negligent, the insurer had no duty to defend because the defense did not change the nature of the action.[16] In holding that the duty to defend is determined solely by the nature of the complaint, the Court in *Kopko* relied upon the Indiana Court of Appeals decision in *Mallon*.[17] In *Mallon*, the Court held that when the nature of the claim is not covered by the policy of insurance, there is no duty to defend.[18]

Kopko stands as good authority for insureds and insurers seeking to establish a duty to defend based solely upon the four corners of the complaint. In particular, the facts of *Kopko* are persuasive where an insurer is seeking to avoid the duty to defend against a claim arising out of allegations that 'sound entirely in intentional tort and fraud', as such intentional conduct is not an "accident" or "occurrence" as the term is used in most insurance policies.[19] However, the Indiana Court of Appeals in several key cases following *Kopko* has declined to follow its narrow holding, citing troubling aspects of the *Kopko* decision and the unclear effect of *Kopko's* holding regarding a complaint where there *is* an underlying factual dispute.[20]

2. Beyond the Complaint: Insurer's Duty to Conduct a Reasonable, Independent Investigation Under Indiana Law

Courts have allowed insurers to consider facts outside the complaint in reliance upon decisions from the Indiana Court of Appeals that distinguish do not follow *Kopko*.[21] According to some Indiana decisions since *Kopko*, if the complaint does not disclose a claim within the

---

[16] *Id.*

[17] *Id.* at 1284.

[18] Mallon, *supra* note 5, at 1100.

[19] Kopko, 570 N.E.2d at 1285; *See* Fidelity and Guaranty Ins. Underwriters, Inc. v. Everett I. Brown Co., L.P., 25 F.3d 484, 488.

[20] *See* Monroe Guar. Ins. Co. v. Monroe, *supra* note 12.

[21] *Id.*

coverages of the policy, or one which is clearly excluded under the policy, then the insurer must conduct a reasonable investigation into the facts underlying the complaint before it may refuse to defend.[22]

Even then, however, an insurer refuses to defend at its own peril unless its investigation "reveals a claim is patently outside of the risk covered by the policy. . . ."[23] According to these decisions, the evidence that an insurer gathers through its independent investigation into the facts underlying the claim is critical to the determination of the insurer's duty to defend.[24] The courts' decisions emphasize the insurer's duty to conduct an *independent* investigation that extends beyond merely shifting the burden back to the insured. The insurer's investigation must be reasonably thorough and balanced. The insurer who fails to perform a full and fair independent investigation risks breaching the duty of good faith and fair dealing. Where an insured alleges facts and claims that are covered by the policy, the prudent course of action for the insurer is to defend fully and promptly, subject to a reservation of rights, or to file a declaratory judgment

---

[22] Audiology Found., 745 N.E.2d at 306; Monroe Guar. Ins. Co. v. Monroe, 677 N.E.2d at 623-24; *See* Trisler v. Indiana Ins. Co. 575 N.E.2d at 1021 (Just two and one half months after *Kopko* the Indiana Court of Appeals stated that "[T]he insurer's duty to defend is determined from the allegations of the complaint coupled with those facts known to or ascertained by the insurer after reasonable investigation." The Court, however held it was bound to rely on the decision of the Indiana Supreme Court due to inconsistencies with *Kopko.*); *see also* Gallant Ins. Co. v. Oswalt, 762 N.E.2d 1254,1259 (Ind. Ct. App. 2002) (as a matter of law, insurer has a duty to conduct a reasonable investigation into the facts underlying the complaint before it may refuse to defend the complaint) (citing Monroe Guar. Ins. Co. V. Monroe, 677 N.E.2d at 624)).

[23] Freidline v. Shelby Ins. Co., 774 N.E.2d 37, 42 n.6 (Ind. 2002) (emphasis added).

[24] *See* Freidline, 774 N.E.2d at 42 n.6 ("Where an insurer's independent investigation of the facts underlying a complaint against its insured reveals a claim is patently outside of the risk covered by the policy, the insurer may properly refuse to defend."); Audiology Found., 745 N.E.2d at 306 ("If the pleadings fail to disclose a claim within the coverage limits, or one which is clearly excluded under the policy, and the investigation reveals that the claim is outside the coverage of the policy, no defense is required.") (emphasis added)).

action in a timely manner while it conducts its investigation to avoid breaching its duty to defend.[25]

B. The Insured's Strategy: Practical Tips For Seeking Coverage

1. Notice Early, Often, and Every Potential Insurer

The primary consideration for the insured seeking coverage is to provide the insurer(s) with prompt notice because the insurer's duty to investigate is not triggered until it receives proper notice. Policy language often determines what constitutes timely notice and generally requires an oral and/or written description of the occurrence or potential claim within a specified period of time. The first step to securing a defense and indemnity, therefore, is to identify and gather all policies which may be implicated by the claims against the insured.[26] When the pertinent facts concerning notice are not in dispute, what constitutes reasonable notice is a question of law for the court to decide.[27] If the insurer asserts a notice defense to coverage, the court will evaluate whether there was an "unreasonable delay" by the insured in providing notice.[28]

In seeking coverage, therefore, the policyholder should provide notice *early*, *often* and to *every potential insurer* after review of all its policies in effect at the time of the events giving rise to the potential claim. The insured should maintain continuous contact with the insurer and should make every effort to provide the insurer with updates concerning the matter. Further, the insured should respond promptly in writing to the insurer's requests for information. To have a

---

[25] *See* Employers Ins. of Wasau v. Recticel Foam Corp., 716 N.E.2d 1015, 1028 n.16 (Ind. Ct. App. 1999), *trans. denied.*

[26] Give notice under all commercial general liability policies, directors and officers liability policies, umbrella policies, excess policies, and special liability policies, etc; *see* David L. Leitner; Reagan W. Simpson; and John M. Bjorkman, 2 Law and Prac. Of Ins. Coverage Litig. § 6.4 (Supp. 2002).

[27] Askren Hub States Pest Control Services, Inc. Zurich Ins. Co., 721 N.E.2d 270, 278 (Ind. Ct. App. 1999).

viable non-cooperation defense, an insurer must establish the policyholder breached the clause by intentionally and willfully failing to cooperate, as well as actual prejudice.[29] The insured, therefore, should take care to document in detail all conversations with the insurer and be responsive to the insurer's requests in the event it later becomes necessary to prove its good faith efforts to cooperate.

2. The Proof Is In The Pleading

Since as a general rule an insurer's duty to defend the insured is determined primarily on the pleadings, the practitioner should consider when drafting whether to include not only factual allegations but specific legal theories as well (i.e., allegations that the underlying acts were unintentional or intentional).[30] If it serves the plaintiff's purposes, the prudent drafter will plead legal theories supported by factual allegations that could potentially fall within the policy's coverage. Under some practical circumstances, however, a policyholder may wish to plead intentional acts within the four corners of the complaint for the specific purpose of avoiding coverage by alleging facts that clearly fall outside of coverage.[31] For business purposes, an insured may not want to make a claim against a policy and thus trigger the often onerous duty of cooperation with the insurer. Although finding coverage can confer substantial benefit to the insured in the defense of the underlying action, in some circumstances, the insured may wish to

---

[28] Miller v. Dilts, 463 N.E.2d 257, 265 (Ind.1984).

[29] Smithers v. Mettert, 513 N.E2d 660, 662 (Ind. Ct. App. 1987) *reh'g and trans denied*; Newport v. MFA Ins. Co. 448 N.E.2d 1223, 1227 (Ind. Ct. App. 1983).

[30] *See* Lee R. Russ and Thomas F. Segalla, 14 Couch on Insurance 3d § 200:20 at note 44 (citing Connecticut Indem. Co. v. DER Travel Service, Inc. 328 F.3d 347 (7th Cir. 2003) (Under Illinois law, inasmuch as it was allegations of actual complaint that determined duty to defend, professional liability insurer had no duty to defend car rental agency, under policy that covered only negligent acts, error or omissions, in underlying suit under Consumer Fraud Act alleging that agency had fraudulently and intentionally overcalculated VAT tax on foreign rentals, even though *possibility* existed that the agency could have been liable under Consumer Fraud act for negligently failing to tell customers how it calculated VAT, *where no allegations of negligence appeared in complaint*. (Emphasis added).

[31] *See* Transamerica Ins. Servs. v. Kopko, 570 N.E.2d at 1285.

avoid coverage in the interest of a more expeditious, autonomous resolution of the underlying claim.

C. Insurer's Strategy: Practical Tips for Evaluating Coverage

1. Evaluation of Duty to Defend and Indemnify

When a liability insurer receives a request to extend coverage, it may accept the loss as a covered loss, deny coverage, or defend under a reservation of rights. The primary liability insurer's first step in evaluating its obligations to the insured is to analyze whether there is a duty to defend. This evaluation of the duty to defend involves a comparison of the allegations of the underlying complaint, and under certain circumstances, any other facts available as a result of an independent investigation of the claim, against the coverage afforded by the policy.[32] The insurer should gather and review all applicable policies, insuring agreements, exclusions and endorsements that may expand or limit coverage. The insurer must then evaluate whether the factual allegations of the underlying complaint bring the claim within the coverage of the policies at issue. If some claims are within the policy's coverage and some are or may be excluded, the insurer should generally defend under a reservation of rights. If all of the allegations of the complaint are outside the grant of coverage or clearly within one or more exclusions from coverage, the insurer may proceed to decline the defense and indemnity. Evaluation of potential exclusions to coverage is determined by review of the factual allegations of the complaint rather than the legal theory, cause of action, or claim set forth in the complaint.

2. Defending Under Reservation of Rights and Denying Coverage

---

[32] *See supra*, note 22. The focus of this analysis is on the primary insurers' obligations, including any duty to defend. Depending on the type of insurance involved, the policy may state that there is no duty to defend or that the policy only provides excess or umbrella insurance.

There is consistent authority from the Indiana Court of Appeals that an insurer has a duty to conduct a reasonable investigation into the facts underlying the complaint before it may refuse to defend the complaint.[33] Therefore, based upon these decisions, insurers may fulfill that broad duty while at the same time reserving their right to disavow coverage after investigation in a timely, properly worded reservation of rights letter.[34] An insured's failure to timely and specifically assert its defenses to coverage may result in a waiver of those defenses.[35] Part of the duty to conduct a "reasonable" investigation is the duty to conduct a *prompt* investigation.[36] Therefore, after being notified of the claim, the insurer must complete its investigation and promptly notify its insured of its coverage position.

A reservation of rights letter or letter declining coverage[37] should generally:

- Identify the information upon which the insurer's decision is based;
- Be complete, identify all bases for the insurer's conclusion that all or a portion of the claims are not covered. Failure to timely raise defenses to coverage could result in a waiver of those defenses and the insured may later be estopped from raising the defenses as a bar to coverage;
- Cite to specific policy provisions which support the decision ;
- Contain a general reservation of the insurer's rights; and

---

[33] *See supra*, note 22.

[34] *See* Gallant v. Oswalt, 762 N.E.2d at 1254 (citing Illinois Founders Ins. Co. v. Horace Mann, 738 N.E.2d 705 (Ind. Ct. App. 2000)).

[35] *See, e.g.,* Huff v. Travelers Indemnity Co., 363 N.E.2d 985, 991-92 (Ind. 1977) (Travelers tried to enforce a suit limitation provision and requirement of formal proof of loss many months after dealing with its insured and not raising these issues. The court held that the insurer was not permitted to raise such a matter as a defense after acting towards its insured in such a way as to cause the insured to reasonably believe written notice and formal proofs of loss would not be required.).

[36] Stewart v. Walker, 597 N.E.2d 368, 375 (Ind. Ct. App 1992) ("When notified of a claim it [the insurance company] should investigate with reasonable dispatch. . . .").

[37] *See* David L. Leitner; Reagan W. Simpson; and John M. Bjorkman, 2 Law and Prac. of Ins. Coverage Litig. § 6.3 (Supp. 2002).

- Reserve the right to re-examine the insurer's coverage position if additional information is provided.

Insurers seeking to avoid coverage by citing policy exclusions should be mindful that any doubts as to coverage must be resolved in the insured's favor.[38] The terms of the exclusion(s) are to be construed narrowly, in favor of coverage.[39] The insurer will have the burden of proving the exclusion(s) "clearly and unmistakably" preclude its duty to indemnify as a matter of law.[40] Where the insurer has doubt after evaluating the exclusions in the policy compared to the factual allegations of the underlying claim, the insurer should defend under a reservation of rights or initiate a declaratory judgment action while investigating the claim in timely fashion. By taking these steps, the insurer can minimize its exposure for potential bad faith.

D. Declaratory Judgment Actions: Advantages and Disadvantages

1. Generally Defined

A declaratory judgment action is one in which a party seeks a declaration of its rights, status or legal relationship with or in relation to another party.[41] Both Indiana and the federal government have adopted statutes and rules governing declaratory judgments.[42] Declaratory judgments are remedial rather than substantive, meaning that they provide a remedy rather than a cause of action or a set of substantive rights.[43] The remedy of a declaratory judgment is designed

---

[38] *Audiology Found.*, 745 N.E.2d at 309

[39] Asbury v. Indiana Union Mut. Ins. Co., 441 N.E.2d 232, 236 (Ind. Ct. App. 1982).

[40] *Id.* at 241.

[41] *See* Ind. Code § 34-14-1-1 (2002).

[42] Indiana law governing declaratory judgments includes Ind. R. Tr. P. 57 and the more comprehensive Indiana Uniform Declaratory Judgment Act, Ind. Code § 34-14-1-12 (2002). Federal law governing declaratory judgments includes Fed. R. Civ. P. 57 and the Declaratory Judgment Act, 28 U.S.C. §§ 2201-02 (2002).

[43] *See* Ind. Code § 34-14-1-12; Institute for Studies Abroad Inc. v. International Studies Abroad Inc., No. IP-00-1863-C, 2001 U.S. Dist. LEXIS 10657 at *6 (S.D. Ind. July 23 2001) (citations omitted); Brindley v. Meara, 198 N.E. 301 (Ind. 1935).

to "afford relief from uncertainty and insecurity with respect to rights, status and other legal relations,"[44] such as "rights under contracts, wills, trusts, and insurance policies," and validity of statutes, ordinances and regulations.[45] Its purpose is to "afford a final disposition of the controversy before trial by the determination of the legal rights and obligations of the parties, and to prevent threatened wrongs, but is not to be used to force the parties to an injury action to have a dress rehearsal of an important issue expected to be tried in the injury action."[46]

Generally declaratory judgments are appropriate in two related but distinct fact situations: "(1) The controversy has ripened to a point where one of the parties could invoke a coercive remedy (i.e. a suit for damages or an injunction) but has not done so; and (2) Although the controversy is real and immediate, it has not ripened to such a point, and it would be unfair or inefficient to require the parties to wait for a decision."[47] Although the first type of cases consists of clearly justiciable matters for purposes of declaratory judgment, the second type tends to generate more questions. A classic example of the second type of case is a well-known but superseded United States Supreme Court case in which the Court held that a lessee could not obtain, in a suit to "remove a cloud" from the title of the leased premises, a declaration that tearing down an auditorium to allow construction of an office would not violate the lease.[48]

---

[44] Ind. Code § 34-14-1-12.

[45] Stephen A. Arthur and Jerome L. Withered, Declaratory Judgments, 22 Ind. Prac., Civil Trial Practice § 36.12 (2002).

[46] Lee R. Russ and Thomas F. Segalla, 16 Couch on Insurance 3d § 232:47 (1997 & Supp. 2002).

[47] Tempco, 819 F.2d at 749.

[48] *Id.* at 749 n.5 (7th Cir. 1987) (citing Willing v. Chicago Auditorium Ass'n, 277 U.S. 274 (1928)).

Today, declaratory judgments are appropriate in such cases in order to provide a remedy "when there is still an opportunity for peaceable judicial settlement."[49]

Declaratory judgment actions commonly arise in the context of insurance coverage disputes, in which insurers, policyholders and other interested parties file suit to obtain declarations regarding the scope or existence of coverage or the insurers' duty to provide a defense to the policyholder in the underlying dispute. Courts are clear that declaratory judgment actions are "[t]he appropriate procedure for an insured or an insurer to litigate contractual rights under an insurance policy."[50] Further, Indiana courts have carved out a significant exception to Indiana's direct action rule, allowing declaratory judgment actions by third-party claimants against wrongdoers' insurance carriers to determine coverage.[51] The greatest advantage of the declaratory judgment action is that it provides a means of obtaining early, efficient and speedy adjudication of genuine coverage disputes when the likelihood of a negotiated resolution between the insurer and insured is remote.[52]

Both the state and federal declaratory judgment rules and statutes have received extensive treatment in reported case law, particularly in the context of insurance coverage disputes. One of the primary issues in declaratory judgment actions is which party bears the burden of proof. The general rule is that the party seeking to establish coverage bears the burden of proving that the claim at issue falls within the policy's coverage provisions. The burden then shifts to the insurer

---

[49] Volkswagenwerk, A.G. v. Watson, 390 N.E.2d 1082, 1084-85 (Ind. Ct. App. 1979) (citation omitted).

[50] National Mutual Ins. Co. v. Sparks, 647 N.E.2d 375, 377 (Ind. Ct. App. 1995) (citations omitted).

[51] See, e.g., Community Action of Greater Indianapolis, Inc. v. Indiana Farmers Mutual Insurance, 708 N.E.2d 882 (Ind.Ct.App. 1999); Araiza v. Chrysler Insurance Co., 716 (N.E.2d 993 (Ind. Ct. App. 1999); *see also* Brent W. Huber and Angela P. Krahulik, *The Erosion of the Direct Action Rule in Indiana*, 1 Indiana Civil Litigation Review 35, 35-42 (Spring 2004).

[52] *See* David L. Leitner; Reagan W. Simpson; and John M. Bjorkman, 2 Law and Prac. of Ins. Coverage Lit. § 6.3 (Supp. 2002).

to prove that the claim is barred by an exception or exclusion. Although these rules seem straightforward, in practice they are not always easy to apply to cases in which the policy language narrows coverage by use of definitions rather than exclusions, or cases in which the declaratory judgment action is brought by the insurer rather than the party seeking coverage.

2. Courts Have Discretion in Hearing Declaratory Judgments- *Volkswagenwerk*

One leading Indiana case addressing propriety of declaratory relief is *Volkswagenwerk, A.G. v. Watson*.[53] In that case, an automobile manufacturer sought declarations regarding Indiana's application of the crashworthiness doctrine to the facts of an automobile crash lawsuit pending in federal court. The court stated that "[t]he use of a declaratory judgment is discretionary with the court and is usually unnecessary where a full and adequate remedy is already provided by another form of action."[54] The court then stated that in determining the propriety of declaratory relief, "the test to be applied is whether the issuance of a declaratory judgment will effectively solve the problem, whether it will serve a useful purpose, and whether or not another remedy is more effective or efficient."[55] In a case such as this where another suit involving the same controversy is pending in another court, a court may refuse to entertain a declaratory judgment if it will not "result in a just and more expeditious and economical determination of the entire controversy."[56] The court determined that in this case, a favorable declaratory judgment would not terminate the parties' controversy because the question of whether the manufacturer had a viable defense to the underlying tort action would still have to be

---

[53] 390 N.E.2d at 1082.

[54] *Id.* at 1085 (Ind. Ct. App. 1979) (citing Brindley v. Meara, 198 N.E. 301 (Ind. 1935)).

[55] *Id.* (citing Smith v. Vowell, 379 F. Supp. 139 (E.D. Tex. 1974)).

[56] *Id.* (citing Firemen's Ins. Co. v. Riley, 322 F. Supp. 349 (W.D. Ky. 1971)).

determined upon the facts of the case.[57] Accordingly, it affirmed dismissal of the manufacturer's declaratory judgment action in order to further the policies of avoiding piecemeal litigation and preventing the use of declaratory judgment actions by defendants in anticipation of defenses in the underlying dispute.[58]

3. Practical Tips for Insurers and Insureds Seeking Declaratory Judgment

a. Declaratory Judgment as an Effective Tool

The declaratory judgment action is one of the most important tools available in insurance coverage actions to obtain a judicial determination of the insurer's rights and obligations to its insured. There are several practical considerations that may make the institution of a declaratory judgment action advantageous for either the insurer or insured. For example, if there is a legitimate dispute as to coverage, an insurer's institution of a declaratory judgment action demonstrates its good faith in attempting to resolve the matter and may avoid assertion of or liability on a bad faith claim in any action for breach of the insurance contract. [59] Further, several factors may counsel an *insurer* to bring an action for declaratory relief [60]:

- Ability to select the forum. The ability to select the forum may make it easier for the insurer to predict the outcome of a particular issue affecting coverage based upon the conflict and choice of law rules applicable in the forum state. Initiating the declaratory judgment action allows the "plaintiff" to frame the issues first.

- Efficiency. The ability to obtain early and complete relief on the issue of duty to defend by dispositive motion that may be combined on the indemnity issue may resolve all matters relating to coverage without the need for discovery or a trial. This is particularly advantageous if the court is persuaded to follow the Indiana Supreme Court's decision in *Kopko* and look solely at the allegations of the underlying complaint.

---

[57] *Id.* at 1086.

[58] *Id.* at 1084.

[59] *See* David L. Leitner; Reagan W. Simpson; and John M. Bjorkman, 2 Law and Prac. Of Ins. Coverage Lit. § 6.3 (Supp. 2002).

[60] *Id.*

- Binding determination. An insurer who obtains a favorable coverage determination may not be subject to further litigation by the claimant.

Likewise, an *insured* may want to seek declaratory relief for similar advantageous reasons, especially the choice of the forum or a prompt resolution of the insurer's duty to defend after receipt of a denial letter.[61] Early determination of the insurer's duty to defend could confer upon the insured substantial benefits, such as defense costs and the investigative resources of the insurer. The defense issue can often be resolved by filing a motion for judgment on the pleadings or partial summary judgment early in the proceedings. The motion should include a claim for any counsel fees and costs incurred in the underlying action.

However, the insured should give further consideration to whether a declaratory judgment action is appropriate. It may not be necessary or advisable for the insured to initiate a declaratory judgment action if the insurer is defending under a reservation of rights. Further, an insured could prejudice its defense of the underlying claim by initiating a declaratory judgment action, particularly as to duty to indemnify. If the insurer prematurely races to the courthouse to seek such a binding determination of its duties to the insured, the insured may wish to file a motion to stay or dismiss the proceedings pending the outcome of the underlying litigation so as to avoid prejudicing the merits of its defense against the underlying claim.

b. Summary

Declaratory judgments are often sought by parties to disputes over insurance coverage. Declaratory judgment actions are governed by both state and federal statutes and trial rules that impose basic principles of appropriateness, justiciability and standing. Because declaratory judgment laws are remedial in nature, federal courts apply the federal declaratory judgment laws

[61] Id. at § 6.4

even when exercising diversity jurisdiction where state substantive law would apply. In practice, however, state and federal declaratory judgment laws are similar.

E. Hot Button Issues that Arise When the Insurer's Reservation of Rights Creates a Conflict of Interest.

Another practical issue that can arise in cases in which coverage is disputed under a liability policy is whether the policyholder has a right to counsel of its choice when the insurer's reservation of rights creates a "conflict of interest." A related question is the potential waiver of privileges when counsel, insurers and insureds share privileged information or when an insurer requires that legal bills be turned over to an outside auditor. Both issues have received widely inconsistent treatment in jurisdictions throughout the United States.

1. Insured's Right to Counsel of Its Choice When Reservation of Rights Creates a Conflict of Interest.

In cases in which insurance coverage is disputed, insurers will often agree to "provide a defense" subject to a "reservation of rights" to deny the insurer's duty to indemnify. This commonly occurs when a third party has multiple claims against the policyholder, some of which fall outside the scope of coverage of the insurance policy but some of which arguably are covered.[62] The insurer contends that the entire action is outside the policy, while the policyholder demands that the insurer provide a defense and asserts there is coverage. The insurer then provides a defense subject to a reservation of its rights to deny coverage, claiming that there was no "occurrence" or making some other argument that creates a situation in which the interests of the carrier and the policyholder are adverse. If the insurer selects and hires the defense counsel, there is still a conflict of interest between the insurer and the policyholder, and the counsel hired by the insurer is prevented by ethical considerations from counseling the

[62] *See, e.g.*, Transamerica Ins. Serv. v. Kopko, 559 N.E.2d 322, 326 n.2 (Ind. Ct. App. 1990), *vacated on other grounds*, 570 N.E.2d 1283.

policyholder on coverage issues. The defense counsel hired by the insurer might have an incentive to provide a less vigorous defense on the issues that would benefit the insurer, especially if that counsel regularly receives work from the insurer.[63] Courts have attempted to solve this conflict by requiring the insurer to pay the costs of an attorney chosen by the insured, thereby removing the insurer's right to control the defense.[64]

The counsel selected by the insured in these situations is sometimes called "*Cumis* counsel," a term which comes from the leading decision in *San Diego Navy Credit Union v. Cumis Insurance Society.*[65] As described above, in the well-known *Cumis* case, the California Court of Appeals allowed the insured to retain independent counsel to represent the insured's interest at the expense of the insurer. The right to hire so-called *Cumis* counsel has been granted by statute in California, as well as in a few other states. The California Insurance Code § 2860 provides that:

> When independent counsel has been selected by the insured, it shall be the duty of such counsel and the insured to disclose to the insurer all information concerning the action *except privileged materials relevant to coverage disputes*, and timely inform and consult with the insurer on all matters relating to the action... (emphasis added)[66]

Consequently, the appointment of *Cumis* counsel has great practical significance to both insurers and attorneys defending an insured pursuant to a reservation of rights. Despite the fact

---

[63] Lee R. Russ and Thomas F. Segalla, 14 Couch on Insurance 3d § 202:23 (1997 & Supp. 2002).

[64] *See* Kopko, 559 N.E.2d at 326 n.2 (quoting Keeton and Widiss, Insurance Law §§ 7.6(d)(6) and 9.3(1)), *vacated on other grounds*, 570 N.E.2d 1283; *see also* All-Star Ins. Corp. v. Steel Bar, Inc., 324 F. Supp. 160, 165 (N.D. Ind. 1971); *see also* David L. Leitner; Reagan W. Simpson; and John M. Bjorkman, 2 Law and Prac. Of Ins. Coverage Litig. § 8.5 (Supp. 2002).

[65] 162 Cal. App. 3d 358, 208 Cal. Rptr. 494 (Cal. Dist. Ct. App. 1984); *See also* 22 ERIC MILLS HOLMES, HOLMES' APPLEMAN ON INSURANCE 2D § 136.9 at p. 69 (2d ed. 2004) ("Conflicts of Interest").

[66] Cal. Ins. Code § 2860(d); *See also* Peter J. Kalis, Thomas M. Reiter and James R. Segerdahl, Policyholder's Guide to the Law of Insurance Coverage § 25.05 at p. 25-39 (1997 & Supp. 2000).

that the insurer pays the legal bills, it does not have the right to control the defense of the underlying lawsuit like it does when it provides a defense for an insured in the absence of a reservation of rights.[67]

The comments to Indiana Rule of Professional Conduct 1.7 specifically address an attorney's duty of loyalty in this situation. They state that a third party may pay for a client's defense so long as the arrangement "does not comprise the lawyer's duty of loyalty to the client. For example, when an insurer and its insured have conflicting interests in a matter arising from a liability insurance agreement, and the insurer is required to provide special counsel for the insured, the arrangement should assure the special counsel's independence."[68] Under Rule 1.7, then, the fact that third parties are paying for a client's defense does not entitle them to the loyalty of the insured's counsel. Quite the opposite; the insured's counsel is under a duty to avoid letting the third party compromise its independence.

Not every perceived or potential conflict of interest, however gives rise to a duty on the part of the insurer to pay for independent counsel. As one leading commentator explained:

> the most widely employed criterion appears to be whether the nature of the divergent interests is such that under the facts of the dispute between insurer and insured, contrasted with the dispute between the insured and the third-party claimant, the insured's attorney would have an incentive to steer the facts of the [underlying] litigation to a conclusion which would benefit the insurer by avoiding or minimizing coverage, while prejudicing the insured in some manner, usually by rendering it necessary for the insured to pay a judgment which the insurer might otherwise have been required to pay.[69]

---

[67] It is important to note, however, that although it is permissible for an attorney to enter into a contract that gives the carrier the right to control the defense of the insured, that contract may not permit the carrier to direct or regulate the lawyer's professional judgment in rendering legal services. *See* Indiana State Bar Association Legal Ethics Committee, Op. No. 3 of 1998.

[68] IND. R. PROF. CONDUCT 1.7 cmts. ("Interest of Person Paying for a Lawyer's Service").

[69] Lee R. Russ and Thomas F. Segalla, 14 Couch on Insurance 3d § 202:23 (1997 & Supp. 2002).

This conflict can take at least three forms: the insurer might offer only a token defense because it later intends to deny coverage, the insurer might steer liability toward a theory that is outside the policy's coverage, or the attorney defending the insured might learn information that would be damaging to the insured in the subsequent litigation to determine coverage of the insured's liability in the underlying suit.[70] When such a conflict exists, most jurisdictions hold that the policyholder is entitled to independent counsel at the insurer's expense.[71]

Even when it is clear that the policyholder is entitled to independent counsel, the courts do not agree how that independent counsel must be selected. Some jurisdictions allow the insurer to appoint the independent counsel, while others permit the policyholder to make the selection.[72] The Indiana courts have not spoken definitively on the issue, but a few decisions indicate that Indiana allows the policyholder to select the independent counsel subject to the practical limitation that the insurer has the power to "approve" the selection, "thereby transforming the duty to defend 'into an obligation to reimburse the insured for . . . defense costs related to the claims that are within . . . the coverage.'"[73] Though no Indiana court has spoken on whether the insurer may not unreasonably withhold approval of the policyholder's choice of

---

[70] *Id.* at § 202:27 (citing CHI of Alaska, Inc. v. Employers Reinsurance Corp., 844 P.2d 1113 (Alaska 1993)).

[71] *See, e.g.*, Cincinnati Ins. Co. v. Wills, 717 N.E.2d 151, 162-63 (Ind. 1999) (If a conflict arises "based on coverage disputes, the risk of a claim in excess of policy limits, the acquisition of information from the insured that bears on coverage, or a variety of other items . . . retention of new counsel to represent the policyholder may be either preferred or necessary."); Village Management, Inc. v. Hartford Accident & Indemnity Co., 662 F. Supp. 1366, 1372-73 (N.D.Ill. 1987); All-Star Ins. Corp. v. Steel Bar, Inc., 324 F. Supp. at 165.

[72] *See* Todd R. Smyth, Annotation, Duty of Insurer to Pay for Independent Counsel When Conflict of Interest Exists Between Insured and Insurer, 50 ALR 4th 932 (1986).

[73] Transamerica Ins. v. Kopko, 559 N.E.2d 322, 326 n.2 (Ind. Ct. App. 1990), *vacated on other grounds*, 570 N.E.2d 1283; All Star Ins. v. Steel Bar, Inc., 324 F. Supp. 160, 161-62 (N.D. Ind. 1971).

counsel, this duty may follow from the insurer's power to approve the policyholder's choice of independent counsel.[74]

Accordingly, when an insurer's reservation of rights creates a conflict of interest between it and the policyholder, most jurisdictions require that the insurer pay for independent counsel to represent the insurer in the underlying lawsuit. Indiana law seems to provide that in these circumstances the policyholder has the right to choose its own counsel subject to the insurer's approval. However, practitioners are cautioned that this issue receives different treatment in other jurisdictions.

2. Privilege Issues

A growing trend in insurance defense litigation is the practice of auditing an attorney's legal bills, either by using an insurer's internal auditing department or an outside auditor. The insurer's interest in utilizing this practice to reduce its costs can clash with the policyholder's interest in protecting its attorney-client and work product privileges. The insurer may request legal bills and other documents and information by raising the "cooperation clause" argument that insureds have a duty to cooperate with the insurer in the defense of underlying actions and, accordingly, have contractually waived their right to withhold documents relating to the underlying litigation.[75]

In *Remington Arms Company v. Liberty Mutual Insurance Company*, the insurer, Liberty Mutual, moved to compel production of documents insured, Remington withheld from production based upon assertion of privilege. Liberty Mutual argued that (1) Remington had waived its attorney-client privilege in the underlying actions by putting its knowledge and

---

[74] Lee R. Russ and Thomas F. Segalla, 14 Couch on Insurance 3d § 202:35 (1997 & Supp. 2002).

[75] *See*, e.g., Remington Arms Co. v. Liberty Mut. Ins. Co., 142 F.R.D. 408, 410 (D. Del. 1992).

conduct "at issue" by seeking insurance coverage; (2) Remington was contractually obligated to cooperate with Liberty Mutual with respect to the underlying claims; and (3) Remington and Liberty Mutual shared a common interest in the defense of underlying claims.[76] The court held that Remington did not forfeit protection of the privileged documents by claiming that its attorney's fees in the underlying action were reasonable, "provided that it does not rely on the exact nature of the legal advice made at the time or introduce its contents to proves these assertions as part of its legal case".[77] The Court further examined the "cooperation clause" argument advanced by Liberty Mutual and held that "[t]he Court cannot justify finding waiver of privileged information merely to provide the opposing party information helpful to cross-examination or because information is relevant."[78]

A demand for *Cumis* counsel may provide a means to insulate insureds from many of these complicated privilege issues. The Standing Committee on Ethics and Professional Responsibility of the American Bar Association ("ABA"), issued an opinion concluding that even where the policy authorizes the insurer to control the defense, the insured must be given the "opportunity to reject the defense offered by the insurer and to assume responsibility for his own defense at his own expense."[79] The ABA has thus buttressed the insured's right to its own counsel, with whom it would be able to engage in privileged communications.[80]

---

[76] *Id.*

[77] *Id.* at 414.

[78] *Id.* at 415.

[79] ABA Formal Opinion 96-403 at 1 (August 2, 1996).

[80] Peter J. Kalis, Thomas M. Reiter and James R. Segerdahl, Policyholder's Guide to the Law of Insurance Coverage § 25.05 at p. 25-39 (1997 & Supp. 2000).

When an insurer provides a defense to a policyholder subject to a reservation of rights, it is not entirely clear whether or in what circumstances the defense lawyers' disclosure of privileged matter to the insurer or its auditors may constitute a waiver of the attorney-client or work product privilege. Although this is a relatively common issue in insurance defense cases, there is little consensus among jurisdictions on the issue of waiver in cases in which there is *Cumis* counsel. The Southern District Court of Indiana has issued an opinion in *Hartford v. Guide* indicating that an agreement between a policyholder in a *Cumis* situation and its insurers to limit waivers resulting from inadvertent (or deliberate disclosures) "cannot limit waivers as to third parties."[81] Thus, even a protective order between the insured and insurer regarding the disclosure of privileged materials may not be binding on third parties and could result in dire consequences to the insured in the underlying case.[82] Therefore, under such circumstances where the risk of disclosure to the insured is particularly serious, factors weigh against an insured's voluntary disclosure of privileged information that may result in a waiver of its privileges in the underlying case.

The Indiana courts, however, have not spoken on many aspects of the various issues that can arise in *Cumis* counsel situations, thus leaving many unresolved issues.

a. Background

It is common practice for an insurer to require defense lawyers to submit detailed billing information to the insurer or an independent auditor in order to determine whether the legal bills conform to the insurer's general litigation management guidelines or other restrictions.[83] Sometimes these billing records and supporting documentation may reveal the motive of the

---

[81] *See* Hartford Fire Ins. Co. v. Guide Corp., 206 F.R.D. 249, 250-51 (S.D. Ind. 2001).

[82] *See generally* IND. R. PROF. CONDUCT 1.6 ("Confidentiality of Information").

client in seeking representation, litigation strategy, or the specific nature of the services provided to the insured, all of which may be protected by either the work product or attorney-client privileges.[84] In cases in which the insurer and the insured are in agreement about the nature and extent of the insurer's obligation to provide a defense and coverage for any judgments, the insurer and insured may be regarded as co-clients of the lawyer and therefore disclosure of the legal bills to the insurer may not constitute a waiver of the privilege or a breach of the lawyers' ethical obligation to the insured.[85]

However, in cases in which the insurer requires the attorney to turn the legal bills over to an outside auditor, such disclosure could constitute a waiver of the work product or attorney-client privileges because the auditor is not a party to the joint representation.[86] Similarly, if the insurer and insured are engaged in a conflict over the extent of the insurer's obligation to cover the costs of the defense or any judgments stemming from the underlying lawsuit, disclosure of the legal bills to the insurer could conceivably constitute a breach of confidentiality and a waiver of the work product or attorney-client privilege.[87] A waiver in either of those circumstances could have profound effects on the outcomes of the underlying litigation and/or the coverage dispute between the insurer and insured.

---

[83] *See* ABA Formal Op. 01-421 (2001).

[84] *Id.*

[85] *See id.*

[86] *See id.*; Katherine E. Giddings and J. Stephen Zielezienski, Insurance Defense in the Twenty-First Century: The Florida Bar's Proposed Statement of Insured Client's rights—A Unique Approach to the Tripartite Relationship, 28 Fla. St. U. L. Rev. 855 (Summer 2001).

[87] *See* ABA Formal Op. 01-421 (2001); Giddings and Zielezienski, *supra* note 195, at 855.

b. Nature of the Attorney-Client and Work Product Privileges

The attorney-client privilege protects communications between an attorney and client relating to the legal representation of the client.[88] Its purpose is to "encourage full and frank communication between attorneys and their clients and thereby promote broader public interest in the observance of law and the administration of justice."[89] The United States Supreme Court observed that this privilege is based upon the principle that "sound legal advice or advocacy serves public ends and that such advice or advocacy depends upon the lawyers being fully informed by the client."[90] However, because the privilege is contrary to the rule allowing liberal discovery of facts, it must be narrowly construed and can be waived by disclosure of otherwise privileged matters to parties outside of the attorney-client relationship.[91] Regardless of whether an action is pending in state or federal court, the scope of the attorney-client privilege will be determined by state law if the rule of decision of the underlying matter is provided by state law, such as when a federal court sits in diversity.[92] Thus the scope of the privilege in most insurance coverage cases will be governed by state law. In Indiana, the attorney-client privilege is codified in Indiana Code Section 34-46-3-1.[93]

Though similar in concept to the attorney-client privilege, the work product doctrine is broader than the attorney-client privilege and provides protection from discovery of materials

---

[88] Upjohn Co. v. United States, 449 U.S. 383 (1981).

[89] *Id.* at 389.

[90] *Id.*

[91] *See id.*

[92] Fed. R. Evid. 501; *see also* Michael Keeley, The Attorney-Client Privilege and Work Product Doctrines: the Boundaries of Protected Communications between Insureds and Insurers, 33 Tort & Ins. L. J. 1169 (Summer 1998).

[93] Ind. Code § 34-46-3-1 (2002).

prepared by counsel in anticipation of litigation.[94] The United States Supreme Court first announced the work product rule in the landmark case of *Hickman v. Taylor*, in which it recognized a "general policy against invading the privacy of an attorney's course of preparation" that is "so essential to an orderly working of our system of legal procedure" that "[n]ot even the most liberal of discovery theories can justify unwarranted inquiries into the files and the mental impressions of an attorney."[95] The work product doctrine was later codified in Federal Rule of Civil Procedure 26(b)(3) and the state counterpart, Indiana Rule of Trial Procedure 26(b)(3). Because the work product doctrine is codified in a rule of procedure, state courts will apply the work product doctrine as defined by state law, and federal courts will apply the work product doctrine as defined by federal law.

Both the attorney-client privilege and the work product privilege can be waived by disclosure of the communications or materials to someone outside the scope of protection, thus causing the formerly privileged communications or trial preparation materials to become fully discoverable.[96] This can occur in insurance cases in which the insurer's and the insured's interests become adverse or in which the lawyer's legal bills are audited by an outside firm. In such instances, it is not clear whether the sharing of information or the disclosure of legal bills may constitute a waiver of any applicable privileges.

---

[94] Bartlett v. State Farm Mut. Auto. Ins. Co., 206 F.R.D. 623, 628 (S.D. Ind. 2002); Fed. R. Civ. P. 26(b)(3); Ind. R. Tr. P. 26(b)(3).

[95] 329 U.S. 495, 510, 512 (1947).

[96] *See, e.g.*, Bartlett, 206 F.R.D. at 626 (stating that the attorney-client privilege can be waived by when confidentiality of communications is not safeguarded); Christa L. Klopfenstein, Note: Discoverability of Opinion Work Product Materials Provided to Testifying Experts, 32 Ind. L. Rev. 481 (1999) (discussing whether disclosure of attorneys' opinion work product materials to testifying experts should cause them to become discoverable pursuant to Fed. R. Civ. P. 26(b)(3)).

c. Does Sharing of Privileged Information Among Lawyer, Insurer and Insured Constitute a Waiver?

In cases in which insurance coverage of an underlying claim is not disputed, an attorney's representation of an insured pursuant to an insurance contract that requires the insurer to provide a defense generally gives rise to a "tripartite" relationship among the attorney, the insurer and the insured against whom a claim was filed that is covered under the policy.[97] This tripartite relationship arises as a result of two separate contracts: the contract of insurance between the insurer and the insured, and the retainer agreement between the insurer and the defense attorney.[98] Some jurisdictions hold that the tripartite relationship creates a situation of "joint representation" of both the insurer and the insured in relation to the underlying lawsuit.[99] In the context of a joint representation, the lawyer has a duty both to the insured to protect its interests and to the insurer to control the costs of the litigation.[100] Unless there is a joint defense agreement or a viable "common interest" privilege asserted, however, the insured may risk a waiver of a privilege by providing privileged information.

Because of the community of interest between the insurer and the insured and their status as co-clients, the lawyer defending the insured may share privileged information with the insurer without causing a waiver of the attorney-client or work product privileges.[101] This is sometimes called the "common interest" exception to waiver.[102] However, when conflicts about coverage

---

[97] *See generally* Giddings and Zielezienski, *supra* note 195, at 859.

[98] *Id.*

[99] ABA Formal Op. 01-421 (2001); Cincinnati Ins. Co. v. Wills, 717 N.E.2d 151, 161 (Ind. 1999) (stating that although joint representation of insurers and insureds may become problematic in some situations, "that is no basis for prohibiting the arrangement in all cases.").

[100] *See* Giddings and Zielezienski, *supra* note 195, at 866.

[101] *See* Richey v. Chappell, 594 N.E.2d 443 (Ind. 1992); ABA Formal Op. 01-421.

[102] *See, e.g.*, Bituminous Cas. Corp. v. Tonka Corp., 40 F.R.D. 381, 387 (D. Minn. 1992).

for the underlying lawsuit arise between the insurer and the insured, the "community of interest" in the underlying defense that justifies the categorization of insurer and insured as co-clients no longer exists.[103] "[O]nce an actual conflict arises, the insurer may be required to provide special counsel and be considered a third-party payor of legal services."[104] In such a case, any sharing of confidential information with the insurer may result in a waiver of the formerly applicable privilege.[105]

There is little agreement among jurisdictions on this issue, and the Indiana courts have not examined the issue. "While some courts hold that a reservation of rights or denial of coverage cannot negate the carrier's right to obtain information with the policyholder, other courts hold that where the carrier has denied coverage or issued a reservation of rights, there can be no common interest in the underlying defense."[106] Although the Indiana Supreme Court has expressly held that "statements from the insured to his insurer are protected from discovery by a third party" in cases in which there is no coverage dispute,[107] it is unclear whether the Indiana courts would also hold that other documents and communications between insurer and insured remain privileged under the common interest doctrine after a dispute has arisen that creates a conflict of interest between the insurer and insured. Therefore, the safe approach from the

---

[103] *See, e.g.,* Elaynne B. Cothran, *Can Carriers Legitimately Evaluate Independent Counsel Fees Without Impeding Counsel's Independent Legal Judgment?*, 29-SPG BRIEF 38 (American Bar Ass'n Spring 2000).

[104] Giddings and Zielezienski, *supra* note 195, at 866 (citations omitted).

[105] Moreover, an insured may not limit waivers as to third parties by producing documents to an insurer pursuant to an agreement that there is no waiver. *See*, Hartford v. Guide Corp., 206 F.R.D. at 250-51.

[106] Cothran, *supra* note 212, at 40 (citing Eugene R. Anderson and James J. Fournier, *The Ethics of Policyholders' Defense Counsel: Who Is the Client: Who Is the Boss*, COVERAGE, 20 (July/Aug. 1998); other citations omitted).

[107] Richey v. Chappell, 594 N.E.2d 443, 445 (Ind. 1992).

insured's perspective is to cooperate with the insurer while protecting privileged documents from disclosure.[108]

d. Does Disclosure of Legal Bills to an Outside Auditor Result in a Waiver?

Insurance companies increasingly require outside auditing firms to conduct "legal bill audits" of services provided by attorneys hired to defend insureds. Such audits frequently go beyond simply examining attorneys' legal bills, sometimes encompassing "a range of services, from an examination of the face of the legal bill for improper charges or errors to a detailed analysis of original time records, attorney work product, expenses and hourly rate benchmarks, and more."[109] Both the American Bar Association and the Indiana State Bar Association have issued opinions recently declaring that "[t]he submission of statements containing confidential information to an independent auditor, without the express consent of the insured after consultation, is a breach of the attorney's ethical obligation to maintain confidentiality of information."[110] In addition to constituting a breach of a lawyer's ethical duties, disclosure of confidential information to outside auditors may also result in a waiver of the attorney-client and work product privileges.[111]

---

[108] See Remington Arms, 142 F.R.D. at 412. ("Because a plaintiff puts a question 'at issue' which would normally be, as in this case, creating a divergence of claims between the parties who would normally be on the same side, does not in itself mean the plaintiff has to give up, blanket-wise, all of the privileges that have been bestowed upon attorneys by our law.").

[109] ABA Formal Op. 01-421 (2001) (citing John Toothman, Surviving a Legal Bill Audit, 15 Complete Lawyer 45 (Winter 1998)).

[110] Indiana State Bar Ass'n Legal Ethics Comm., Op. No. 4 of 1998; ABA Formal Op. 01-421.

[111] *See id.*; United States v. Massachusetts Institute of Technology, 129 F.3d 681 (1st Cir. 1997). It is important to note that the term "outside auditors" may include not just auditing firms separate from the insurer, but also auditing teams internal to the insurer's organization that perform functions unrelated to claims fraud.

See United States v. South Chicago Bank, No. 97 CR 849 - 1, 2, 1998 U.S. Dist. LEXIS 17445 at *8 (N.D. Ill. Oct. 16, 1998) (holding that a "banks' year-end audit team -- as opposed to the fraud audit team -- was outside

In an opinion that has received approval in many jurisdictions, the First Circuit held that auditors generally are not part of the circle of persons with whom confidential information may be shared without destroying the attorney-client or work product privilege.[112] In that case, the Internal Revenue Service ("IRS") sought to discover bills for legal services provided to the Massachusetts Institute of Technology ("MIT").[113] Although MIT objected to the discovery on the grounds of the attorney-client and work product privileges, MIT had already provided the same documents to the Defense Contract Audit Agency pursuant to a contract between MIT and the Department of Defense that allowed for routine audits to ensure that the Department of Defense was not being overcharged for services.[114] The First Circuit held that MIT had waived any privileges that may have otherwise attached to these documents by submitting the legal bills to the auditing firm.[115]

Although neither the Indiana courts nor the Seventh Circuit have spoken on this issue, the United States District Court for the Northern District of Illinois followed the First Circuit in holding that "auditors are not generally part of the circle of persons, including secretaries and interpreters, for example, with whom confidential information may be shared without destroying the privilege."[116] Given that insurers are increasingly requiring defense counsel to submit to

---

the circle of persons with whom confidential information could be shared because they were performing work in the ordinary course of business, not for the sake of legal advice").

[112] Massachusetts Institute of Technology, 129 F.3d at 684.

[113] *Id.* at 683.

[114] *Id.*

[115] *Id.* at 683, 686.

[116] South Chicago Bank, 1998 U.S. Dist. LEXIS 17445 at *7 (citing Massachusetts Institute of Technology, 129 F.3d at 684; United States v. Arthur Young & Co., 465 U.S. 805, 819 (1984)). In many cases, the legal bills may not contain privileged communication. At least one court has held that a legal bill is not intended to constitute or convey legal advice and thus ordinarily is not something that would be protected by the attorney-client privilege. Schachar v. American Academy of Ophthalmology, 106 F.R.D. 187, 191-92 (N.D. Ill. 1985).

legal bill audits, practitioners should be wary of inadvertently waiving any privileges by authorizing the disclosure of privileged legal bills and supporting documentation to auditors.

e. Privileges and the Insured's Duty of Cooperation

The vast majority of courts have held that the cooperation clause in a liability policy does not obligate the policyholder to waive its attorney-client or work product privileges, especially where the insurer denies coverage or reserves its rights to deny coverage.[117] These cases all recognize the obvious risk—that the insurer is not seeking the documents in order to "cooperate" on the underlying litigation—but rather to find a basis for denying coverage and succeeding in a coverage dispute.[118] The insurer may argue that the insured's failure to provide the requested documents violates the "cooperation" clause, and is cause to void the policy's coverage. If the insurer insists on receipt of the requested information, and all other options have been exhausted, the insured's counsel should explicitly state in its written response that any information being provided is so as not to breach the "cooperation" clause of the policy and that the provision of the information does not constitute a waiver of any privilege.[119] However, this option is still problematic because including this non-waiver language may not bind adverse third parties, such as the claimant in the underlying case, and thus may not protect the privilege.[120]

---

[117] *See, e.g.*, Eastern Air Lines, Inc. v. United States Aviation Underwriters, Inc., 716 So. 2d 340, 343 (Fla. Ct. App. 1998); Rhone-Poulenec Rorer, Inc. v. Home Indemnity Co., 32 F.3d 851, 864 (3rd Cir. 1994); First Pacific Networks, Inc. v. Atlantic Mutual Ins. Co., 163 F.R.D. 574, 579-80 (N.D. Cal. 1995); Rockwell Int'l Corp. v. Superior Court, 32 Cal. Rptr. 2d 153, 158-59 (Cal. Ct. App. 1994), review denied; Bituminous Cas. Corp., 140 F.R.D. at 386; Remington Arms, 142 F.R.D. at 416-17.

[118] Remington Arms, 142 F.R.D. at 417.

[119] *See* David L. Leitner; Reagan W. Simpson; and John M. Bjorkman, 2 Law and Prac. Of Ins. Coverage Lit. § 8.5 (Supp. 2002).

[120] See Hartford v. Guide Corp., 206 F.R.D. at 250-51.

To avoid liability due to the insured's alleged non-compliance, the insurer must show actual prejudice from an insured's non-compliance with the policy's cooperation clause.[121] The alleged non-compliance must be material.[122] Cooperation requirements, like notice, may also be waived by the insurer.[123] To have a viable non-cooperation defense, the insurer must establish the policyholder breached the clause by intentionally and willfully failing to cooperate, as well as actual prejudice.[124] To prove actual prejudice, the insurer must prove that the outcome of the underlying case would have been different had the insured cooperated.[125] The insurer must also establish its good faith efforts and diligence in obtaining the insured's cooperation.[126] In a conflict of interest or *"Cumis"* counsel situation, it likely will be impossible for the insurer to prove prejudice for a lack of cooperation because the insured is doing the "defending," and the insurer does not have the right to control the defense of the underlying case unless it drops its reservation of rights.

Conclusion

Cases involving business torts can raise a variety of interesting issues, including questions about insurance coverage . These insurance coverage issues are evolving and can be complex, and will continue to challenge even the most experienced practitioners. Insurers and

---

[121] *See* Miller v. Dilts, 463 N.E. 2d at 265; Motorists Mutual Ins. Co. v. Johnson, 218 N.E.2d 712, 715-16 (Ind. Ct. App. 1966).

[122] Johnson, 218 N.E.2d at 715.

[123] Johnson, 218 N.E.2d at 718; Huff V. Travelers Indemnity, 363 N.E.2d 985, 991-92 (Ind. 1997).

[124] Smithers v. Mettert, 513 N.E.2d 660, 662 (Ind. Ct. App. 1987), *reh'g and trans denied*; Newport v. MFA Ins. Co, 448 N.E.2d 1223, 1227 (Ind. Ct. App. 1983).

[125] Cincinnati Ins. Co. v. Irvin, 19 F. Supp. 2d 906, 916 (S.D. Ind. 1998).

[126] Smithers, 513 N.E.2d at 662; Newport, 448 N.E.2d at 1227; State Farm. S. Mutual Automobile Ins. Co. v. Walker, 382 F.2d 548, 551 (7th Cir. 1967), cert. denied, 389 U.S. 1065 (1968).

policyholders alike would be well advised to seek the advice of experienced counsel in these matters.