

# NOTES

## *Tank v. State Farm*: Conducting a Reservation of Rights Defense in Washington

### I. INTRODUCTION

The key to properly conducting a reservation of rights defense<sup>1</sup> is understanding the interrelationship between insurer, policyholder, and defense counsel. In *Tank v. State Farm Fire & Casualty Co.*,<sup>2</sup> the Washington Supreme Court addressed the rights and duties of the insurer and defense counsel conducting a reservation of rights defense. This case drew interest from plaintiff and defense bar alike.<sup>3</sup> Expressions of victory came from both sides,<sup>4</sup> even though the opinion of the court did not result in a change in the law. The court simply drew upon existing statutory and case law, as well as the Rules of Professional Conduct, to set out fairly explicit cri-

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1. A reservation of rights defense occurs when a liability insurer elects to defend a claim involving questionable coverage but reserves the right to later deny coverage. See *infra* notes 33-39 and accompanying text.

2. James D. Tank v. State Farm Fire & Casualty Co., 38 Wash. App. 438, 686 P.2d 1127 (1984), *rev'd*, 105 Wash. 2d 381, 715 P.2d 1133 (1986).

This appeal was joined with Johnson v. Public Employees Mutual Ins. Co., 105 Wash. 2d 381, 715 P.2d 1133 (1986), to decide the rights of a third party claimant to sue the liability carrier for bad faith refusal to indemnify. The tort claimant in *Tank* had joined with Tank in his action against State Farm. This third party issue, as well as Tank's claim of a violation of the Consumer Protection Act, will not be considered here.

3. See Brief of Amicus Curiae Washington State Trial Lawyers Association, *Tank*, 105 Wash. 2d 381, 715 P.2d 1133 (1986) (Nos. 50994-8, 50933-6) [hereinafter *Amicus Brief W.S.T.L.A.*]; Amicus Brief of Washington Association of Defense Counsel, *Tank*, 105 Wash. 2d 381, 715 P.2d 1133 (1986) (Nos. 50994-8, 50933-6) [hereinafter *Amicus Brief W.A.D.C.*].

4. Compare Kleist, 22 Trial News #3 p. 16 (November 1986) ("It is interesting to note that Mr. Hickman was on the losing side of Tank v. State Farm. Apparently, Mr. Hickman is not pleased by the supreme court's sensibilities to the fiduciary obligations owed insureds by their insurance companies and attorneys.") with Hickman, *The Tank Case*, 9th Annual W.S.T.L.A. Insurance Law Seminar, January 22, 1987 ("Wrong, Mr. Kleist! On both counts. I was on the winning side of Tank. . . . I was very pleased by the supreme court's vote of confidence. . . .") and Hickman, *Royal Globe, Cumis Doctrines Rejected*, For the Defense, September, 1986, at 8 ("[T]he court gave a resounding vote of confidence to the defense bar.").

teria to be followed by insurer and defense counsel when conducting a reservation of rights defense. This criteria was described as an "enhanced obligation of fairness" on the part of the insurance company.<sup>5</sup>

The court reasoned that the enhanced obligation was necessary because of the potential conflict of interest inherent in a reservation of rights defense. The court's conflict of interest analysis corrected the appellate court's erroneous application of the excess of limits conflict to the reservation of rights situation. The court did not, however, directly address important collateral issues such as the insurer's vicarious liability for the conduct of the insurer-retained defense counsel, the ability of defense counsel to give undivided loyalty to the policyholder, or the right to control the defense when an insurer reserves the right to later contest coverage.

These collateral issues were either avoided outright or addressed only by implication. While the court did not declare, as have other courts, that the insurer-retained defense counsel was incapable of acting independently, the imposition of the enhanced obligation cannot be viewed as an unqualified vote of confidence for insurer and defense counsel.

### A. *The Liability Policy*

The typical liability insurance policy imposes two duties on the insurer when presented with a claim for which coverage applies. First, the insurer has the duty to indemnify by paying all amounts that the insured becomes legally obligated to pay, up to the policy limits.<sup>6</sup> Second, the insurer must defend any such suit brought against the insured even if the suit is ground-

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5. *Tank*, 105 Wash. 2d at 387, 715 P.2d at 1137.

6. The homeowner's policy that State Farm sold to Tank provided:

Coverage L — PERSONAL LIABILITY

If a claim is made or a suit is brought against any insured for damages because of bodily injury or property damage to which this coverage applies, we will:

- a. Pay up to our limit of liability for the damages for which the insured is legally liable; and
- b. Provide a defense at our expense by counsel of our choice. We may make any investigation and settle any claim or suit that we decide is appropriate. Our obligation to defend any claim or suit ends when the amount we pay for damages resulting from the occurrence equals our limit of liability.

Respondent's Brief at 1, *Tank*, 38 Wash. App. 438, 686 P.2d 1127 (1984) (No. 5526-III-4), *rev'd*, 105 Wash. 2d 381, 715 P.2d 1133 [hereinafter Respondent's Brief].

less, false or fraudulent.<sup>7</sup> The duty to defend can be described as broader than the duty to indemnify.<sup>8</sup> This is so because the insurer may be required to defend an insured even if the insurer will never be called upon to indemnify for that particular claim or suit.<sup>9</sup>

When the claim is presented, the liability insurer must determine if it has a duty to defend. The general rule is that the duty is determined from the facts alleged in the complaint.<sup>10</sup> The insurer must defend when any facts alleged, if proved, would fall within the provisions of the insurance contract. This general rule has been the object of several exceptions by the courts. Because of changes in pleading practices, for example, the allegations may be too vague for the insurer to precisely know if the policy provisions provide coverage.<sup>11</sup> Alternative allegations may be pled with one allegation clearly covered and the other not.<sup>12</sup> While the allegations may not fall within the policy provisions, the insurer may be aware of facts that bring the suit within the terms of the policy.<sup>13</sup> On the other hand, the third party claimant may assert allegations that are covered even though the facts are not supportive, just

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7. C. APPELMAN, *INSURANCE LAW AND PRACTICE* (Berdal ed.), § 4682 [hereinafter APPELMAN] ("Accordingly, the insurer is bound to defend the insured against suits alleging facts and circumstances covered by the policy, even though such suits are groundless, false or fraudulent.").

8. *Aetna Casualty & Surety Co. v. Coronet Ins. Co.*, 44 Ill. App. 3d 744, 748, 358 N.E.2d 914, 917 (1976).

9. Suppose, for example, that an insured is sued for allegedly causing an auto accident. Even though investigation reveals that the insured was out of town at the time of the accident, and therefore the insurer will never have to indemnify, a defense must still be provided for the insured by the insurer. See generally, KEETON, *INSURANCE LAW* (1971) § 7.6 [hereinafter KEETON].

10. *Holland Am. Ins. Co. v. National Indem. Co.*, 75 Wash. 2d 909, 911, 454 P.2d 383 (1969) ("the insurer's duty to defend, unlike its duty to pay, arises when the complaint is filed and is to be determined from the allegations of the complaint."); *Western National Assurance Co. v. Hecker*, 43 Wash. App. 816, 820, 719 P.2d 954, 957 (1986). See also *Prudential Property & Casualty Ins. Co. v. Lawrence*, 45 Wash. App. 111, 115, 724 P.2d 418, 420 (1986) (pleadings must be liberally construed if facts alleged would render the insurer liable under the policy).

11. *R. A. Hanson Co. v. Aetna Ins. Co.*, 26 Wash. App. 290, 294, 612 P.2d 456, 459 (1980) ("Thus, modern rules of notice pleading, which do not require the definiteness of former rules, may change the general rules. There is greater duty placed on the insurer to determine if there are any facts which could fall within the pleadings, thus giving rise to an obligation to defend."). See also *Nat'l Steel Constr. Co. v. Nat'l Union Fire Ins.*, 14 Wash. App. 573, 543 P.2d 642 (1975).

12. The obvious example is alleging both intentional acts (not covered by policy) and negligent acts (covered by policy). See APPELMAN at § 4683, 53.

13. *Hanson*, 26 Wash. App. at 294, 612 P.2d at 459 (citing *Ross Island Sand & Gravel Co. v. General Ins. Co. of America*, 472 F.2d 750 (9th Cir. 1973)).

to make sure that the insurer is involved.<sup>14</sup> With these exceptions, the general rule of comparing the suit to the policy does not always guarantee certainty when determining coverage.

This uncertainty of coverage is the reason that an insurance company reserves the right to later dispute coverage. Any analysis concerning the reservation of rights defense must be premised on the fact that coverage is uncertain and that the policyholder may not be insured for the particular claim or suit being presented.<sup>15</sup>

### *B. The Insurer's Options When Coverage is Uncertain*

Liability insurers have four distinct options when presented with a claim involving uncertain coverage. First, the insurer can unconditionally provide coverage. Second, the insurer can, following appropriate investigation, decide that coverage does not apply and deny the claim. Third, the insurer can, in appropriate cases, institute a declaratory action and let the courts decide the coverage question. Finally, the liability insurer has the option of conducting a reservation of rights defense.

#### 1. Unconditional Coverage of the Claim

Even if the liability insurer has doubts about coverage, the insurer can, nevertheless, assume the defense of the claim or suit and be prepared to pay any settlement or judgment on behalf of the insured.<sup>16</sup> The unconditional acceptance of the claim may be advantageous since such acceptance preserves the insurer's rights under the policy.<sup>17</sup> These rights include full control of the defense,<sup>18</sup> the right to select defense coun-

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14. Browne, *The Demise of the Declaratory Judgment Action as a Device for Testing the Insurer's Duty to Defend*, 23 CLEV. ST. L. REV. 423, 424 (1974).

15. This article will only refer to the policyholder as an "insured" when coverage is acknowledged by the insurer. The courts and commentators often use the term "insured" to describe a policyholder that has questionable coverage or no coverage at all for the claim in question. This is misleading because without coverage the policyholder is not insured for that claim.

16. If the insurer decides that its arguments against coverage are too weak, it may just decide that it is better to provide unconditional coverage. See Comment, *Insurance Company's Dilemma: Defending Actions Against the Assured*, 2 STAN. L. REV. 383, 383-85 (1950).

17. 1A R. LONG, *THE LAW OF LIABILITY INSURANCE* 5.17-18 (1986) [hereinafter LONG].

18. APPLEMAN, *supra* note 7, at § 4681.

sel,<sup>19</sup> the privilege to settle when expedient,<sup>20</sup> and the option, within the bounds of good faith, to take the case to trial.<sup>21</sup> These are powerful rights, thus the insurer may well decide that it is preferable to accept a claim involving uncertain coverage in order to preserve them.

## 2. Denial of Coverage

Where the company investigates and concludes that neither the allegations nor the facts of the claim or suit fall within the terms of the policy, the claim can be denied.<sup>22</sup> The policyholder is then left to depend on his own resources for both indemnity and defense. The policyholder is, however, free of the policy provisions and able to take whatever action desired.<sup>23</sup> This includes settling the claim, litigating the matter, or even allowing a default judgment.<sup>24</sup> The policyholder's choice is of no consequence to the insurer so long as no coverage exists.<sup>25</sup>

It has been said, however, that the insurer denies coverage at its peril.<sup>26</sup> If the company wrongfully denies coverage, the consequences can be serious, especially if the insured can later demonstrate bad faith on the part of the insurer.<sup>27</sup> Thus, when coverage is questionable, the insurer may be reluctant to deny coverage outright.

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19. Roos, *The Obligation to Defend and Some Related Problems*, 13 HASTINGS L.J. 206, 206-207 (1961) [hereinafter Roos].

20. This right is secured by the terms of the policy. *See id.*

21. APPELMAN, *supra* note 7, at § 4712. *See also*, Hamilton v. State Farm Mut. Automobile Ins. Co., 9 Wash. App. 180, 189, 511 P.2d 1020, 1025 (1973) (Horowitz, C.J., dissenting).

22. Burnham v. Commercial Casualty Ins. Co., 10 Wash. 2d 624, 631, 117 P.2d 644, 647 (1941) (insurer "owed a duty to . . . investigate the facts and circumstances surrounding the accident . . . and, if that investigation disclosed liability on the part of the assured, it was the duty of the . . . insurer to make a good faith attempt to effect settlement.").

23. Steinlage and Higgins, *Duty to Defend: the Insurer's Perspective*, 3 DEF. RES. INST. 37, 43, 44 (1978) [hereinafter Steinlage and Higgins].

24. Roos, *supra* note 19, at 206-7.

25. Waite v. Aetnas Cas. & Surety Co., 77 Wash. 2d 850, 855, 467 P.2d 847, 851 (1970) ("where the insurer refuses to defend a lawsuit on the ground that the claim alleged is not covered by the policy, and the claim is in fact one not covered, the insurer is not responsible for the insured's expenses in defending the suit.").

26. Roos, *supra* note 19, at 207 ("If the company has guessed wrong, it may ultimately have to pay a judgment considerably larger than it would have had to pay had it defended through its own counsel.").

27. Bad faith on the part of the insurer can expose the company to awards in excess of policy limits. *See* Hamilton v. State Farm, 83 Wash. 2d 787, 791, 523 P.2d 193, 196 (1974).

### 3. The Declaratory Action

An insurer faced with a claim to which coverage is uncertain can petition the courts to resolve the coverage question.<sup>28</sup> Insurers of all types can use this action to resolve such issues as whether a contract was ever created, whether the policyholder has fulfilled the required conditions of the policy, whether the loss occurred while the policy was in effect, or whether other insurance coverage should take precedence.<sup>29</sup>

The declaratory action is uniquely restricted in its application to liability insurance. The insurer generally cannot use such an action to resolve coverage disputes that turn on the very facts to be determined in the underlying tort suit.<sup>30</sup> Thus, where the issue of a policyholder's liability to a third party claimant and the issue of coverage both depend on the same facts, the courts will not preempt the underlying tort action with a declaratory judgment.<sup>31</sup> It is when faced with this type of situation that the liability insurer is likely to utilize the fourth option.

### 4. The Reservation of Rights Defense

The liability insurer, when presented with a claim of questionable coverage, can investigate and defend the claim or suit but reserve the right to later decline to indemnify.<sup>32</sup> This option is the middle ground between outright denial of coverage and the unconditional acceptance of the claim. Uncondi-

28. See Uniform Declaratory Judgments Act, WASH. REV. CODE § 7.24.010 (1987). See also *National Indemnity Co. v. Smith-Gandy Inc.*, 50 Wash. 2d 124, 128, 309 P.2d 742, 744 (1957).

29. See *Trinity Universal Ins. Co. v. Willrich*, 13 Wash. 2d 263, 124 P.2d 950 (1942); *Associated Indem. Corp. v. Wachsmith*, 2 Wash. 2d 679, 99 P.2d 420 (1940).

30. Note, *The Role of Declaratory Relief and Collateral Estoppel in Determining the Insurer's Duty to Defend and Indemnify*, 21 HASTINGS L.J. 191, 196 (1969).

31. This issue has not been resolved in Washington. See *Western National Assurance Co. v. Hecker*, 43 Wash. App. at 821-22 n.1, 719 P.2d at 958 n.1 ("Were the circumstances otherwise, we would question the trial court's resolution of the underlying factual issues. Although this issue has not been addressed directly in Washington, a number of courts in other states have held that if an injured party sues the insured and the insurer seeks a declaratory judgment concerning coverage, the court in the declaratory judgment action cannot determine the ultimate question of the insured's liability or the facts upon which such liability is based. See, e.g., *Thornton v. Paul*, 74 Ill. 2d 132, 384 N.E.2d 335 (1979); *Brohawn v. Transamerica Ins. Co.*, 276 Md. 396, 347 A.2d 842 (1975); *Employers' Fire Ins. Co. v. Beals*, 103 R.I. 623, 240 A.2d 397 (1968)."). The closest case in Washington is *Holland Am. Ins. Co. v. National Indem. Co.*, 75 Wash. 2d at 914, 454 P.2d at 386, where the court was concerned with duplication of litigation.

32. *Associated Indem. Corp. v. Wachsmith*, 2 Wash. 2d 679, 99 P.2d 420 (1940).

tional investigation and defense can act as a waiver to the right to dispute coverage<sup>33</sup> or the company can be estopped from later asserting the right by real or presumed prejudice to the policyholder.<sup>34</sup> The insurer, by explicitly reserving this right, is forestalling both the possibility of implied waiver and prejudice as well as putting the policyholder on notice of the coverage issue. At the same time, the insurer is going forward with its investigation and defense of the claim or suit. Thus, the policyholder is receiving the benefit of company sponsored defense despite the uncertain coverage. The reservation of rights defense, as opposed to outright denial, provides a service to the policyholder who otherwise would have to totally bear the burden of defending the claim.<sup>35</sup>

Notice, preferably in writing, must be communicated to the policyholder in a timely fashion and specifically identify the coverage issues that the insurer wishes to preserve.<sup>36</sup> If the company and its policyholder end up in a lawsuit over the coverage issue, the nature and content of the reservation of rights notice may come under substantial judicial scrutiny. Hence, the notice must be sufficient to put the policyholder on notice and avoid an implied waiver.<sup>37</sup>

The problem of the content and the timing of the notice is not nearly as formidable as the problem of the relationship between the parties once the notice has been given. It was this problem that the court addressed in *Tank*.

### C. Tank v. State Farm

In *Tank v. State Farm*,<sup>38</sup> the court analyzed the relationship between insurer, policyholder, and defense counsel and discussed this relationship when a reservation of rights defense

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33. Comment, *Insurance Company's Dilemma: Defending Actions Against the Assured*, 2 STAN. L. REV. 383 (1950).

34. *Bosko v. Pitts & Still, Inc.*, 75 Wash. 2d 856, 454 P.2d 229 (1969) (must have prejudice for estoppel); *Transamerica Ins. Group v. Chubb & Son, Inc.*, 16 Wash. App. 247, 252, 554 P.2d 1080, 1083 (1976) ("The course cannot be rerun, no amount of evidence will prove what might have occurred if a different route had been taken. . . . Of necessity, this establishes prejudice."). See also Comment, *Insurance Policy Defenses and Collateral Estoppel*, 43 N.Y.U. L. REV. 140 (1968).

35. *Tank*, 105 Wash. 2d at 390, 715 P.2d at 1139.

36. See Note, *The Reservation of Rights Notice by Insurers*, 19 S.C.L. REV. 210 (1967); Steinlage and Higgins, *supra* note 23, at 39-40; *Associated Indem. Corp. v. Wachsmith*, 2 Wash. 2d at 692-93, 99 P.2d at 426 (Nothing in statutes or cases requires a particular format to put policyholder on notice).

37. For a sample Reservation of Rights Letter, see LONG, *supra* note 17, App. B.

38. 105 Wash. 2d 381, 715 P.2d 1133 (1986).

is undertaken. The court reasoned that since potential conflicts of interest were inherent in this type of defense, the insurer had an enhanced duty of good faith toward the policyholder.<sup>39</sup> The court's finding of an enhanced duty would appear to be a departure from prior decisions that have held the insurer to the same duty toward a policyholder being defended under a reservation of rights as toward an insured being defended unconditionally.<sup>40</sup>

*Tank* arose from the underlying case of *Walker v. Tank*.<sup>41</sup> The facts in this underlying action provide an excellent example of a liability claim with uncertain coverage that cannot be resolved by a declaratory action. Tank and another man, Walker, had an argument that ended when Tank punched Walker to the ground. Tank then kicked Walker about the head and face, which put Walker into the hospital for two days and permanently impaired his sense of taste and smell.<sup>42</sup>

Walker sued Tank alleging battery and demanding damages. Tank, through his personal attorney, tendered the defense of the suit to his homeowners insurer, State Farm Fire and Casualty Company. State Farm had issued a policy to Tank that, in part, promised to pay all sums for which Tank might become legally obligated to pay for personal injuries that Tank might cause.<sup>43</sup> The policy also promised to provide a defense at company expense by counsel chosen by the insurer.<sup>44</sup>

Presented with a request for coverage from a policyholder, State Farm could have exercised any one of the four options previously discussed.<sup>45</sup> First, State Farm could have unconditionally accepted the claim and defended and indemnified as needed. The homeowner's policy, however, specifically excluded claims arising out of the intentional acts of the policyholder.<sup>46</sup> Since the possibility of intentional injury, as alleged in the complaint, was very real, a coverage question

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39. *Id.* at 387-88, 715 P.2d at 1137.

40. *Van Dyke v. White*, 55 Wash. 2d 601, 349 P.2d 430 (1960); *Weber v. Biddle*, 4 Wash. App. 519, 483 P.2d 155 (1971).

41. *Walker v. Tank*, Asotin County Superior Court, Case No. 15389.

42. *Tank*, 38 Wash. App. at 440, 686 P.2d at 1129.

43. *See supra* note 6.

44. *Id.*

45. The four options were unconditional acceptance, outright denial, the declaratory action, and the reservation of rights defense. *See supra* notes 16-37 and accompanying text.

46. The State Farm policy contained the following exclusion:

existed. Hence, State Farm, in the face of this uncertainty, was reluctant to unconditionally accept the claim.<sup>47</sup>

The second option was for the company to deny the claim. Following the general rule, which is to compare the allegations of the suit to the policy provisions, it becomes instantly apparent that the claim should be denied outright because State Farm would not have to pay a judgment for an intentional tort—the only allegation of the suit. Some jurisdictions, however, have found a duty to defend when self-defense is claimed since, if the case were truly one of self-defense, the injuries were not “intentional” and the allegations became “groundless” and “false.”<sup>48</sup>

The third option was the declaratory action. The company could have petitioned the court to decide if coverage applied to this claim. However, the facts that would decide whether Tank had acted intentionally, and thus was liable to Walker, would also decide if there was coverage for the claim. Hence, this claim was inappropriate for a declaratory action.

State Farm chose the fourth option and agreed to defend the action while reserving the right to later deny coverage should it turn out that Tank had acted intentionally. The company notified Tank and his personal attorney by letter.<sup>49</sup>

State Farm hired an attorney to represent Tank and retained separate counsel to represent the company's interest in the coverage issue.<sup>50</sup> Following the depositions of Tank and Walker, the insurer-provided attorney evaluated the case in a letter addressed to State Farm with a copy sent to Tank.<sup>51</sup> The attorney felt that the self-defense argument was weak and that Walker would likely prevail with his battery allegation. The damage award was estimated to run as high as ten to twelve

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1. Coverage L — Personal Liability and Coverage M — Medical Payments to Others do not apply to:

a. bodily injury or property damage which is expected or intended.

Respondent's Brief, *supra* note 6, at 2.

47. Unconditional acceptance of the claim might act as a waiver of policy defenses. See *supra* note 33 and accompanying text.

48. *Grey v. Zurich Ins. Co.*, 54 Cal. Rptr. 104, 419 P.2d 168 (1966); *Allstate Ins. Co. v. Novak*, 210 Neb. 184, 313 N.W.2d 636 (1981).

49. *Tank*, 38 Wash. App. at 439, 686 P.2d at 1128.

50. *Tank*, 105 Wash. 2d 381, 715 P.2d 1133.

51. A copy of this letter was attached to the Brief of State Farm in Response to Brief of W.A.D.C. Brief of State Farm in Response To Brief of W.A.D.C. at app. A-1, *Tank*, 105 Wash. 2d 381, 715 P.2d 1133 (1986) (No. 5526-III-4) [hereinafter Brief of State Farm in Response to W.A.D.C.].

thousand dollars.<sup>52</sup>

The case was tried before a judge who concluded that Tank had intentionally and without justification battered Walker. The damages awarded were just over \$16,000.<sup>53</sup> State Farm refused to pay, pointing to the policy exclusion. Tank then sued State Farm.<sup>54</sup>

In Tank's suit, the trial court held, as a matter of law, that no coverage could be found in Tank's homeowner policy for battery.<sup>55</sup> Since State Farm was not liable to Tank for intentional acts under the policy, the court granted State Farm's motion to dismiss the action.<sup>56</sup>

The appellate court reversed, holding that State Farm, having undertaken Tank's defense, had a duty to make a good faith attempt to settle the claim once Tank's liability became reasonably apparent.<sup>57</sup> The court pointed to cases that had held insurers to a duty to settle within policy limits when coverage was clear but the insured was faced with a claim potentially in excess of policy limits.<sup>58</sup> Since the court felt that the alleged facts created a breach of duty question, the court reversed the summary judgment as to Tank's allegations of breach of duty.<sup>59</sup> State Farm appealed to the Washington Supreme Court.

The supreme court addressed the issue of the insurer's duty of good faith when defending under a reservation of rights. The court held that the insurer's duty of good faith included an enhanced obligation of fairness toward the policyholder when the company was defending under a reservation of rights.<sup>60</sup> Underlying the enhanced obligation of fairness is the potential conflict of interest inherent in this type of

52. *Id.*

53. *Tank*, 105 Wash. 2d at 384, 715 P.2d at 1135.

54. *Tank* "sued State Farm for breach of duty of good faith. His complaint alleged that State Farm failed to make reasonable efforts to settle the Walker claim and that State Farm subordinated Tank's interests to its own interests by structuring a defense which would absolve State Farm of liability under Tank's insurance policy." 105 Wash. 2d at 385, 715 P.2d at 1135.

55. *Tank*, 105 Wash. 2d at 385, 715 P.2d at 1135.

56. *Id.*

57. *Tank*, 38 Wash. App. at 446, 686 P.2d at 1132.

58. *Id.* at 442, 686 P.2d at 1130 (citing *Hamilton v. State Farm*, 83 Wash. 2d 787, 523 P.2d 193 (1974); *Burnham v. Commercial Casualty Ins. Co.*, 10 Wash. 2d 624, 117 P.2d 644 (1941); *Tyler v. Grange Ins. Ass'n.*, 3 Wash. App. 167, 473 P.2d 193 (1970)). All three of these cases involved excess of limits situations.

59. *Tank*, 38 Wash. App. at 443, 686 P.2d at 1132.

60. *Tank*, 105 Wash. 2d at 383, 715 P.2d at 1135.

defense. Before analyzing this enhanced obligation, it is important to make an analysis of conflicts of interest in the insurance defense setting.

#### D. Conflicts of Interest

When an insurer defends the insured, the interests of the two are usually the same.<sup>61</sup> Both seek to avoid liability or, if necessary, to settle the claim. In the usual case, only the insurer's funds are at stake, thus the insurer makes the decisions regarding the handling of the claim or suit.<sup>62</sup> Once coverage is acknowledged and the legal liability of the insured becomes reasonably clear, the company is bound by its duty to the insured to attempt to settle with the third party.<sup>63</sup> If liability is questionable, or if the demands by the third party are unreasonable, the insurer can, within the bounds of good faith, elect to go to trial.<sup>64</sup> So long as the interests of insurer and insured are the same, the relationship problems are minimal.

The identity of interests can diverge, however, and, at some point, conflict. A typical example of a conflict of interest is the excess of limits situation.<sup>65</sup> The excess of limits conflict arises when it is probable that the insured has caused damage to a third party in excess of his policy limits but the third party claimant is willing to settle for those limits. Assuming that settlement is only possible at or near policy limits, the insurer has little to lose by taking the case to trial.<sup>66</sup> If the insured is found not liable or liable for less than the policy limits, the insurer will have saved money. If the judgment is in excess of

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61. Knepper, *Conflict of Interest in Defending Insurance Cases*, 19 DEF. L.J. 515 (1970).

62. Maines, *Legal and Contractual Relationship in Insurance Liability Defense Cases*, 37 INS. COUNSEL J. 5 (Oct. 1970).

63. *Burnham*, 10 Wash. 2d 624, 117 P.2d 644; *Evan v. Continental Casualty Co.*, 40 Wash. 2d 614, 245 P.2d 470 (1952); *Hamilton v. State Farm Ins. Co.*, 83 Wash. 2d at 791, 523 P.2d at 196.

64. *Tyler v. Grange Ins. Ass'n*, 3 Wash. App. 167, 172, 473 P.2d 193, 197 (1970) ("The typical liability insurance policy contains no express provision requiring the insurer to settle and gives the company control over the defense of the claim and control over the decision concerning opportunities of settlement within policy coverage. The existence of this control of defense and settlement is a necessity of insurance practice, but, with this power given the insurer, the courts have stated there is a duty sounding in tort requiring the insurer to give consideration to the interests of the insured, when negotiating a settlement.").

65. Annotation, *Duty of Liability Insurer to Settle or Compromise*, 40 A.L.R. 2d 168 (1955).

66. See excess of limits cases cited at *supra* note 58. See also KEETON, *supra* note 9, at § 7.8 (a).

the policy limits, the company can simply pay the limits and leave the excess for the insured to pay.<sup>67</sup> Obviously, this strategy risks the financial well-being of the insured, which is the very well-being that the insured was attempting to preserve by purchasing the policy. As a result of this type of conflict, the courts have imposed on the insurer first both a duty to refrain from placing its interest above that of the insured,<sup>68</sup> and a duty to effect settlement when liability becomes reasonably clear,<sup>69</sup> as well as a penalty for bad faith claim handling, which makes the insurer responsible for the entire judgment, even in excess of the policy limits.<sup>70</sup>

The supreme court in *Tank* observed that a potential conflict of interest is inherent in every reservation of rights defense.<sup>71</sup> The appellate court also considered the potential conflict but applied the case law that had been formulated for the excess of limits conflict.<sup>72</sup> The appellate court felt that the excess limits rationale was "equally applicable" to the conflict potential in a reservation of rights defense.<sup>73</sup> This application of the excess of limits conflict to the reservation of rights defense ignores the distinction between the two types of conflicts. In one situation, the conflict arises because the insurance purchased by the insured may be inadequate to pay the entire judgment; in the other situation, the conflict arises because the insurance purchased may be inapplicable to the claim.

The excess of limits conflict is not directly applicable to the reservation of rights conflict because a policyholder might not be covered under the terms of the policy and, therefore, not an insured.<sup>74</sup> The conflict arises because the insurer is reluctant to provide coverage in an uncertain coverage situation, while the policyholder desires unconditional commitment to defend and indemnify. Since the company, defending under a reservation of rights, still controls the defense, there is concern that the insurer might tailor the defense in such a way as

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67. KEETON, *supra* note 9, at 509.

68. *Tyler*, 3 Wash. App. at 174, 473 P.2d at 199.

69. *Burnham*, 10 Wash. 2d at 631, 117 P.2d at 647.

70. *Hamilton*, 83 Wash. 2d at 791, 523 P.2d at 196.

71. *Tank*, 105 Wash. 2d at 387-88, 715 P.2d at 1137.

72. *See supra* note 58.

73. *Tank*, 38 Wash. App. at 443, 686 P.2d at 1130.

74. *See* Brief of State Farm in Response to W.A.D.C. *supra* note 51, at 6-9 (where there is no coverage, there is no duty to settle).

to avoid coverage.<sup>75</sup>

The appellate court's imposition of a duty to settle when liability of the insured is reasonably clear, makes good sense when applied to acknowledged coverage situations, yet makes little sense when applied to questionable coverage situations. The duty to settle is not appropriate where coverage is uncertain because such a duty would render the reservation of rights useless and leave the insurer in the position of unconditional acceptance.<sup>76</sup> The policyholder could demand that the insurer settle a claim, with company money, once liability of the policyholder became reasonably clear even though coverage was still uncertain.

All will agree that Mr. Tank did not purchase his homeowner's policy so that State Farm would be available to pay for damages resulting from battery.<sup>77</sup> Since a declaratory action was unavailable, imposing a duty to settle, even in the face of uncertain coverage, would have left State Farm with two unpalatable options at the outset. State Farm could have, at its peril, denied coverage and hoped that the court would find an intentional tort.<sup>78</sup> Alternatively, the company could have assumed the unconditional defense of Mr. Tank and been prepared to attempt settlement when Tank's liability became reasonably clear. The first option leaves the policyholder without a company-sponsored defense that he may deserve. The second option forces the insurer to pay for claims that may not be covered.

The duty to settle in a known coverage case must be distinguished from the duty of an insurer in a reservation of rights case. The supreme court recognized this distinction by pointing out that "[i]n a reservation of rights defense, it is the insured who might have to pay any judgment or settlement. Therefore, it is the insured who must make the ultimate choice regarding settlement."<sup>79</sup> This language rejects the appellate court's application of the duty to settle in an excess of limits

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75. Maryland Casualty Co. v. Peppers, 64 Ill.2d 187, 355 N.E.2d 24 (1976).

76. See Brief of State Farm In Response To Brief of W.S.T.L.A. at 12-14, *Tank*, 105 Wash. 2d 381, 715 P.2d 1133 (Nos. 50933-6, 50994-8) [hereinafter Brief of State Farm in Response To W.S.T.L.A.].

77. Public policy will not allow insuring such events.

78. See Roos, *supra* note 19, at 206-07 ("An insurance company which refuses to defend a claim made against its insured upon the grounds that the claim does not fall within its coverage, acts at its peril. If it makes an incorrect decision, the consequences are serious.")

79. *Tank*, 105 Wash. 2d at 389, 715 P.2d at 1138.

situation to the reservation of rights defense. If the company has a duty to settle, the policyholder cannot make the ultimate choice regarding settlement; the choice remains with the insurer. Since the insurer is not likely to settle until both liability and coverage become reasonably clear, the policyholder is at risk because the coverage issue may be decided against him. The policyholder must be allowed to minimize this personal exposure by settling the case if he so decides.<sup>80</sup> The insurer, still uncertain whether coverage applies, is allowed to take the case to trial for a determination of the facts that will decide both the liability issue and the coverage question. The right to dispute coverage, following this determination, will have been preserved by the reservation of rights notice.

Of course, the insurer cannot, in good faith, conduct the reservation of rights defense in such a manner as to be prejudicial to the policyholder.<sup>81</sup> According to the supreme court, the potential conflict of interest "inherent in this type of defense mandate[s] an even higher standard: an insurance company must fulfill an enhanced obligation to its insured as part of its duty of good faith."<sup>82</sup>

### *E. The Enhanced Obligation*

The supreme court in *Tank* addressed the issue of the insurer's duty of good faith when defending under a reservation of rights. The court focused first on the evolution of the

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80. The insured can always settle the claim and then sue the insurer for coverage. This tactic worked well in *Hering v. St. Paul-Mercury Indem. Co.*, 50 Wash. 2d 321, 311 P.2d 674 (1957). The insured was sued for assault and battery but claimed self-defense. The insurer refused to defend so the insured settled and then sued to prove self-defense. The court accepted the self-defense argument and held that the insurer had breached its duty to defend and must pay the reasonable settlement.

81. *Tank*, 105 Wash. 2d at 387, 715 P.2d at 1137 (quoting *Weber v. Biddle*, 4 Wash. App. 519, 524, 483 P.2d 155 (1971) ("A reservation of rights agreement is not a license for an insurer to conduct the defense of an action in a manner other than it would normally be required to defend. The basic obligation of the insurer to the insured remains in effect.")).

82. *Tank*, 105 Wash. 2d at 387, 715 P.2d at 1137. It is fundamental that the insurer is the fiduciary of the policyholder. The insurer must exercise good faith in all dealings with the policyholder. The concept of an enhanced obligation raises the question of how the insurer, already a fiduciary charged with a standard of good faith and fair dealing, can be any *more* fair toward, or careful with, the interests of the policyholder. The courts will be called upon to gauge the fairness of the insurer in a reservation of rights situation. Conceivably, the insurer could be found to have been fair to the policyholder but not fair enough to avoid a breach of duty. The courts will have to decide among shades of fairness as opposed to simply fairness or the absence of fairness.

duty of good faith imposed on insurers in Washington. Next, the court considered this duty in a reservation of rights context and finally, the court applied the good faith duty under the reservation of rights to the facts of the case.

The duty of an insurer to act in good faith has been formulated by judicial decisions,<sup>83</sup> legislative enactment,<sup>84</sup> and administrative regulation.<sup>85</sup> The duty of good faith and the liability for bad faith "usually refer[s] to the same obligation"<sup>86</sup> and is used interchangeably by Washington courts.<sup>87</sup> The court explained the source of this duty:

However, regardless of whether a good faith duty in the realm of insurance is cast in the affirmative or the negative, the source of the duty is the same. That source is the fiduciary relationship existing between the insurer and insured. Such a relationship exists not only as a result of the contract between the insurer and insured, but because of the high stakes involved for both parties to an insurance contract and the elevated level of trust underlying insureds' dependence on their insurers.<sup>88</sup>

The court then considered this good faith duty in the context of a reservation of rights defense. It was noted in *Tank* that two cases in Washington dealt with this issue and both held that the same duty of good faith, regardless of the type of defense, was applicable.<sup>89</sup> The supreme court in *Tank* departed from this standard by ruling that, given the potential conflicts of interest inherent in the reservation of rights defense, the insurer must fulfill an "enhanced obligation" to the policyholder.<sup>90</sup> The court described "specific criteria" that an insurer must follow while conducting the defense, in order to fulfill its enhanced obligation.

First, the company must thoroughly investigate the cause of the insured's accident and the nature and severity of the plaintiff's injuries. Second, it must retain competent defense counsel for the insured. Both retained defense coun-

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83. See *Tank*, 105 Wash. 2d at 386, 715 P.2d at 1136, and the cases cited therein.

84. WASH. REV. CODE § 48.01.010 (1987).

85. WASH. ADMIN. CODE § 284-30-300 (1986).

86. *Tyler*, 3 Wash. App. at 173, 473 P.2d at 197.

87. *Murray v. Mossman*, 56 Wash. 2d 909, 355 P.2d 985 (1960).

88. *Tank*, 105 Wash. 2d at 385, 715 P.2d at 1136.

89. *Van Dyke*, 55 Wash. 2d 601, 349 P.2d 430; *Weber*, 4 Wash. App. 519, 483 P.2d 155.

90. *Tank*, 105 Wash. 2d at 387-88, 715 P.2d at 1137.

sel and the insurer must understand that only the *insured* is the client. Third, the company has the responsibility for fully informing the insured not only of the reservation of rights defense itself, but of all developments relevant to his policy coverage and the progress of his lawsuit. Information regarding progress of the lawsuit includes disclosure of all settlement offers made by the company. Finally, an insurance company must refrain from engaging in any action which would demonstrate a greater concern for the insurer's monetary interest than for the insured's financial risk.<sup>91</sup>

When the criteria are compared to the then existing law in Washington, it becomes apparent that the court's decision did not result in a real change in the rights and duties of the insurer, policyholder, or defense counsel. Since State Farm complied with its duty of good faith to Tank as it existed at the time and since the enhanced obligation resulted in no substantial change in the duty, the trial court's summary judgment in favor of State Farm was upheld. This is seen when the criteria are compared to the facts of *Tank*.

The first criterion is that of a thorough investigation.<sup>92</sup> Any time a liability insurer is presented with a claim, it must investigate.<sup>93</sup> The decisions regarding defense, settlement, and indemnification must be made with sufficient knowledge in order to safeguard company and policyholder alike. Failure to properly investigate will lead to the granting of coverage where not deserved and denial of coverage where deserved. Given the fiduciary relationship of insurer to insured the courts are ready, and rightfully so, to penalize insurers who, for lack of proper investigation, wrongfully deny coverage,<sup>94</sup> fail to settle,<sup>95</sup> or conduct an inadequate or improper defense.<sup>96</sup> The case law prior to *Tank* was clear: an insurer had to investigate.

In *Tank*, no claim was asserted that State Farm or defense counsel failed to adequately investigate. The insurer-retained defense counsel gathered sufficient information to correctly

91. *Tank*, 105 Wash. 2d at 388, 715 P.2d at 1137.

92. *Id.*

93. *Tyler*, 3 Wash. App. at 179, 473 P.2d at 200-01 ("The insured has the duty to thoroughly investigate to determine the facts upon which a good faith judgment as to the settlement can be formulated and its failure to do so properly may evidence a lack of good faith.").

94. *Hering*, 50 Wash. 2d 321, 311 P.2d 674.

95. *Hamilton*, 83 Wash. 2d 787, 523 P.2d 193.

96. KEETON, *supra* note 9, at § 7.6 (b).

predict that the court would find that Tank had committed battery.<sup>97</sup> The estimate on the damages likely to be awarded was lower than the outcome<sup>98</sup> even though the estimate assumed that Walker had an impaired sense of taste and smell.<sup>99</sup> Failure to accurately estimate a court award does not amount to improper investigation, though poor investigation can certainly result in inaccurate estimates.<sup>100</sup>

The second criterion is that the insurer, in a reservation of rights defense, must hire competent defense counsel with the understanding that only the policyholder is the client.<sup>101</sup> This requirement existed in Washington long before *Tank*.<sup>102</sup> Indeed, State Farm had retained an attorney to defend Tank while retaining separate counsel to represent the company regarding the coverage question. It was alleged, however, that the attorney considered both Tank and State Farm as his clients.<sup>103</sup> In the usual no-conflict situation, a single attorney often protects the interests of both insurer and insured.<sup>104</sup> Since, however, potential conflict of these interests is inherent in a reservation of rights defense, separate attorneys must be retained and each attorney must know which interests he is to

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97. The evaluation letter by Tank's insurer provided attorney predicted that the court would find liability. See *Tank*, 105 Wash. 2d at 384, 715 P.2d at 1135.

98. Tank's attorney estimated the high range would be \$10,000.00 to \$12,000.00. The judgment was just over \$16,000.00. *Tank*, 38 Wash. App. at 441, 686 P.2d at 1129.

99. Tank's attorney had assumed that Walker would be able to prove a loss of the sense of taste and smell when he made his award estimates. *Id.* at 440, 686 P.2d at 1129. This writer has attempted also to put a monetary figure on such a loss. Not only is the nature of the loss especially intangible, but, since the loss is purely subjective, the cooperation of the claimant is needed in order to even document that the loss has occurred.

100. A good example is found in *Tyler*, 3 Wash. App. 167, 473 P.2d 193, where the insurer failed to examine the claimant's medical records or secure independent medical examination. An excess verdict resulted and the insurer was held liable for the entire judgment.

101. See *supra* note 91 and accompanying text.

102. See, e.g., *Van Dyke*, 55 Wash. 2d 601, 349 P.2d 430; *Weber*, 4 Wash. App. at 524, 483 P.2d at 159 ("A reservation of rights agreement is not a license for an insurer to conduct the defense of an action in a manner other than it would be normally required to defend. The basic obligations of the insurer to the insured remain in effect.").

103. *Tank*, 38 Wash. App. at 440, 686 P.2d at 1129.

104. MALLEN & LEVIT, *LEGAL MALPRACTICE* 620 (2nd ed. 1981) [hereinafter MALLEN & LEVIT] ("Insurance defense counsel routinely and necessarily represent two clients: insurer and insured."); Williams and Jernberg, *Conflicts of Interest in Insurance Defense Litigation: Common Sense for Changing Times*, F.I.C. QUARTERLY at 111 (Winter 1981) ("The job of defense counsel is to represent both the insurer and the insured.").

protect. While not changing the law, this criterion does help define the role of the insurer-retained defense counsel.

The third criterion is that the insurer must keep the policyholder fully informed of the reservation of rights defense, of all developments relevant to his policy coverage, and of the progress of the lawsuit.<sup>105</sup> This, too, is not a unique requirement.<sup>106</sup> As the fiduciary of the policyholder, the insurer is duty-bound to keep the policyholder fully informed, whether a conflict of interest exists or not. In a conflict situation, it is not so much the insurer's duty to provide information that increases as it is the policyholder's need for this information. When coverage is uncertain or inadequate, the policyholder must take an active role to protect his interests. The need for information is increased since the policyholder will have to make informed decisions along the way.<sup>107</sup> Depending on the nature of the conflict, these decisions may be to retain personal counsel, to demand that the company settle or to settle the claim with his own funds. The participation of the policyholder might vary but the increased need for information exists whenever a conflict of interest threatens.

Tank alleged in his suit against State Farm that a settlement opportunity was lost for lack of communication.<sup>108</sup> State Farm, probably to avoid the cost of trial, was willing to contribute up to \$5,000.00 to settle the claim.<sup>109</sup> While State Farm mentioned the possible contribution to Tank's insurer-retained attorney, it appears that the attorney did not tell Tank.<sup>110</sup> Tank alleged that State Farm's failure to tell him of the contribution was a breach of duty. Tank also asserted that this breach was the cause of the failure to settle because he was willing to contribute and that the claimant Walker had, in an affidavit, stated that he might have settled for \$10,000.00.<sup>111</sup>

105. See *supra* note 91 and accompanying text.

106. *Hamilton*, 83 Wash. 2d 787, 523 P.2d 193.

107. *Tank*, 105 Wash. 2d at 389, 715 P.2d at 1138 ("In a reservation of rights defense, it is the insured who may pay any judgment or settlement. Therefore, it is the insured who must make the ultimate choice regarding settlement. In order to make an informed decision in this regard, the insured must be fully appraised of all activity involving settlement, whether the settlement offers or rejections come from the injured party or the insurance company.").

108. Response Brief of Tank and Walker To Brief of Amicus Curiae and State Farm Fire & Casualty Company, *Tank*, 105 Wash. 2d 381, 715 P.2d 1133 (Nos. 50994-8, 50933-6).

109. *Tank*, 105 Wash. 2d at 396, 715 P.2d at 1142.

110. *Tank*, 38 Wash. App. at 441, 686 P.2d at 1130.

111. *Id.* This affidavit was provided to oppose the motion for summary judgment.

The majority opinion dealt with this argument by saying that "State Farm fully informed Tank of all developments regarding policy coverage and the progress of the insured's lawsuit."<sup>112</sup> The dissent felt that several questions of fact existed on this issue and stated that "[f]ailure to disclose the offer of \$5,000.00 as a contribution toward settlement prevented the insured from potentially avoiding the \$16,000.00 judgment."<sup>113</sup> Regardless of the correctness of the decision on the issue, the court held the insurer to a duty of fully informing the policyholder.

It is not clear whether the insurer's duty is independent of the defense counsel's duty of full and on-going disclosure to the policyholder.<sup>114</sup> The problem with this criterion is that, if strictly applied, the insurer might have to independently strive to keep the policyholder fully informed and not be able to rely on the defense attorney to perform this function.<sup>115</sup> It is significant that the court imposes on both insurer and defense counsel this duty to fully inform the policyholder. The insurer, State Farm, told the attorney retained for Tank of the possibility of contribution and may have assumed that the attorney would inform Tank. Such an assumption may no longer be a valid one for an insurer to make.<sup>116</sup>

The final criterion is that the insurance company "must refrain from engaging in any action which would demonstrate a greater concern for the insurer's monetary interest than for the insured's financial risk."<sup>117</sup> The court did not elaborate nor

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At this point, Walker had intervened with Tank against State Farm. The only documented demand by Walker, prior to trial, was for \$25,000.00.

112. *Tank*, 105 Wash. 2d at 389, 715 P.2d at 1138.

113. *Id.* at 396, 715 P.2d at 1142.

114. See *infra* note 131 and accompanying text.

115. This could prove to be a duty that the insurer is not fully capable of performing. Indeed, the attorney of the policyholder is in a much better position to fulfill this duty since the attorney will, presumably, be in closer communication with his client the policyholder than the insurer, especially in a conflict situation. The duty of keeping the policyholder informed of the progress of the lawsuit should naturally fall to the defense counsel, but the court has doubled up on this responsibility.

116. As will be seen, the court did not address the issue of the insurer's vicarious liability for the acts of the insurer-retained defense counsel. Had it done so, the court would have had to decide if the defense attorney's alleged failure to inform Tank of State Farm's willingness to contribute to settlement was negligence, and, if so, whether the negligence should be attributed to the company. The imposition of a duty to keep the policyholder independently informed sidesteps the vicarious liability issue in this narrow sense. If defense counsel failed to adequately inform Tank and State Farm failed as well, State Farm would be negligent in its own right, not vicariously.

117. *Tank*, 105 Wash. 2d at 389, 715 P.2d at 1137.

did it give any examples of what behavior would constitute such a demonstration. The court simply stated that it did not find that State Farm had exhibited such behavior.<sup>118</sup>

The language of this criterion is similar to language used by courts in excess of limits situations.<sup>119</sup> In excess cases, the insurer is not allowed to demonstrate greater concern for its own monetary interests by risking the insured's finances in the hopes of paying less than policy limits.<sup>120</sup> In the case of uncertain coverage, however, the insurer is not, by reserving the right to later contest coverage, putting its interests ahead of an insured. Indeed, the insurer is, at its own expense, providing a defense to a policyholder that may not be insured for that particular claim. The concern of the insurer is to avoid paying claims that are not covered by the policy.

The language of this final criterion fails to maintain the necessary distinction between the excess of limits cases and the uncertain coverage cases.<sup>121</sup> The use of such language will create doubt whether the appellate court's application of the excess of limits analysis to this uncertain coverage case was fully rejected by the supreme court. The distinction must be maintained or use of the reservation of rights defense will be discouraged.

Perhaps this criterion should simply be viewed as a "catch-all" to deal with unforeseeable misconduct. Certainly, the courts will not tolerate the insurer structuring the defense so as to keep any judgment outside the scope of the policy.<sup>122</sup> Likewise, the insurer is not allowed to benefit from the ethical improprieties of the insurer-retained defense counsel.<sup>123</sup> This criterion could prove troublesome because it is not clear how the court meant it to be applied.

#### F. *Duty of the Insurer-Provided Defense Counsel*

The court in *Tank* not only formulated specific criteria for

118. *Tank*, 105 Wash. 2d at 398, 715 P.2d at 1138.

119. *See, e.g.*, *State Farm v. White*, 248 Md. 324, 332, 236 A.2d 269, 273 (1967) ("actions which demonstrate greater concern for the insurer's monetary interest than the financial risks attendant to the insured's predicament."); *Tyler*, 3 Wash. App. at 172, 473 P.2d at 197 ("the insurer to give consideration to the interests of the insured . . .").

120. *See Tyler*, 3 Wash. App. 167, 473 P.2d 193.

121. *See supra* notes 74-82 and accompanying text.

122. *See Weber*, 4 Wash. App. at 524, 483 P.2d at 159.

123. *See Van Dyke*, 55 Wash. 2d 601, 349 P.2d 430.

the insurer but also for the defense counsel retained by the insurer. "First, it is evident that such attorneys owe a duty of loyalty to their clients. . . . Second, defense counsel owes a duty of full and ongoing disclosure to the insured."<sup>124</sup>

The attorney owes his loyalty to his client, the policyholder. On appeal, Tank argued that "the attorney retained by the insurance company is subjected to the pressure of continued employment by the insurance carrier to protect its interest, in opposition to that of the insured."<sup>125</sup> Tank quoted the Canons of Professional Responsibility to describe the economic pressure that would be exerted by the "person or organization that pays or furnishes lawyers to represent others. . . ."<sup>126</sup> Tank alleged that the insurer-provided attorney conducted the defense of Tank in such a way that the insurer would not be called upon to pay any judgment.<sup>127</sup> The trial court granted summary judgment for State Farm<sup>128</sup> and the supreme court affirmed, pointing out that the insurer had retained an attorney for Tank and a separate attorney to protect its interests.<sup>129</sup> In addition, the court held that the evidence before it did not support any allegations of attorney misconduct.<sup>130</sup>

In addition to loyalty, the defense counsel has a duty of "full and ongoing disclosure" to the policyholder.<sup>131</sup> This duty of disclosure has three aspects.

First, potential conflicts of interest must be fully disclosed and resolved in favor of the insured. The dictates of

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124. *Tank*, 105 Wash. 2d at 388, 715 P.2d at 1137.

125. Brief of Appellant at 14-15, *Tank*, 38 Wash. App. 438, 686 P.2d 1127 (No. 5526-III-4) [hereinafter Brief of Appellant].

126. *Id.* at 15 (quoting MODEL CODE OF PROFESSIONAL RESPONSIBILITY EC 5-23 (1981)).

127. This allegation ignores the fact that, given the pleadings by Walker in the suit against Tank, State Farm could never have been held to indemnify Tank. Absent an allegation of negligence, Tank would either be found to have acted in self-defense and, therefore, not liable, or else to have acted intentionally and, therefore, excluded from policy coverage. No tailoring of the defense was necessary in this case since the insurer would never have to indemnify.

128. *Tank*, 105 Wash. 2d at 385, 715 P.2d at 1135.

129. *Id.* at 389, 715 P.2d at 1138.

130. The supreme court rejected the use of the deposition of Tank's insurer provided attorney, as it was not before the trial court at the time of the summary judgment. *Id.* at 390, 715 P.2d at 1138. The attorney's deposition helped convince the appellate court to reverse the summary judgment. Apparently, the attorney stated that he considered both State Farm and Tank as his clients. Other admissions regarding the conduct of the defense may have been made as well but the transcript of the deposition was not before the trial court so the supreme court disallowed it.

131. *Tank*, 105 Wash. 2d at 388-89, 715 P.2d at 1137-38.

RPC 1.7, which address conflicts of interest such as this, must be strictly followed. Second, all information relevant to the insured's defense, including a realistic and periodic assessment of the insured's chances to win or lose the pending lawsuit, must be communicated to the insured. Finally, *all* offers of settlement must be disclosed to the insured as those offers are presented.<sup>132</sup>

The duty of disclosing and resolving conflicts of interest in favor of the client was thoroughly analyzed more than 25 years ago by the supreme court.<sup>133</sup> In *Van Dyke v. White*, the court quoted from the Canon of Professional Ethics 6,<sup>134</sup> as well as from cases outside of Washington<sup>135</sup> to describe the "undeviating fidelity of the lawyer to his client"<sup>136</sup> in a conflict of interest situation. "The lawyer employed by the insurance company to represent White owed him undivided loyalty, but he acted for the [insurer] instead of for White. Such a situation is contrary to public policy."<sup>137</sup> In *Tank*, the court also calls upon the Rules of Professional Conduct.<sup>138</sup> Hence, this duty is not unique or original.

The duty of providing all relevant information and of disclosing all offers of settlement is not unique but exists as part

132. *Id.*

133. *Van Dyke*, 55 Wash. 2d 601, 349 P.2d 430.

134. Canon of Professional Ethics 6 states:

It is the duty of a lawyer at the time of retainer to disclose to the client all the circumstances of his relations to the parties, and any interest in or connection with the controversy, which might influence the client in the selection of counsel.

It is unprofessional to represent conflicting interests, except by express consent of all concerned given after a full disclosure of the facts. Within the meaning of this canon, a lawyer represents conflicting interests when, in behalf of one client, it is his duty to contend for that which duty to another client requires him to oppose.

The obligation to represent the client with undivided fidelity and not to divulge his secrets or confidences forbids also the subsequent acceptance of retainers or employment from others in matters adversely affecting any interest of the client with respect to which confidence has been reposed.

*Quoted in Van Dyke*, 55 Wash. 2d at 612, 349 P.2d at 437.

135. "Where an insurer's attorney has reason to believe that the discharge of his duties to his client, the insured, will conflict with his duties to his employer, the insurer, it becomes incumbent upon him to terminate his relationship with the client." *Van Dyke*, 55 Wash. 2d at 612, 349 P.2d at 437 (quoting *Allstate Ins. Co. v. Keller*, 17 Ill. App. 2d 44, 149 N.E.2d 482 (1958)). *See also* *Hammett v. McIntyre*, 114 Cal. App. 2d 148, 249 P.2d 885 (1952).

136. *Van Dyke*, 55 Wash. 2d at 613, 349 P.2d at 437.

137. *Id.* at 612, 349 P.2d at 437.

138. *Tank*, 105 Wash. 2d at 388, 715 P.2d at 1137.

of every attorney's fiduciary duty.<sup>139</sup> However, this duty becomes even more important in a reservation of rights defense since the policyholder may be ultimately responsible for paying any judgment or settlement.<sup>140</sup> Only by knowing his chances of prevailing on the liability and coverage issues, as well as being fully informed of the settlement negotiations, can the policyholder exploit every opportunity to favorably resolve the matter.

The criteria described in *Tank* does not represent a radical departure from the obligation of the insurer and defense counsel toward the policyholder. However, the description of the enhanced duty may result in insurer and defense counsel better understanding their roles and duty in the reservation of rights defense. The analysis of the *Tank* decision and of the relationship between insurer, defense counsel, and policyholder is not complete until three collateral issues are addressed.

### G. The Collateral Issues

The *Tank* decision does not address three collateral issues that are fundamental to the interrelationship between insurer, policyholder and defense counsel. These issues are (1) the ability of the insurer-retained and paid defense counsel to be completely loyal to the policyholder; (2) the insurer's vicarious liability for the acts of defense counsel; and (3) the issue of who controls the defense of the policyholder.

#### 1. The Loyalty of Defense Counsel

Tank asserted that his insurer-retained attorney's first loyalty was to State Farm.<sup>141</sup> This argument raises the question of whether the attorney selected and paid by the insurer can truly be loyal only to the policyholder in a conflict of interest situation. Some courts have adopted the view that the insurer-retained defense counsel is too close to the company to be loyal to the policyholder against the interests of the company.<sup>142</sup>

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139. See *Hamilton*, 9 Wash. App. at 183, 511 P.2d at 1022.

140. Since the attorney is a fiduciary for the policyholder-client, the duty exists to keep the client fully informed whether a conflict of interest exists or not. The attorney must disclose everything relevant to the client, in all situations.

141. See Brief of Appellant, *supra* note 125, at 14-15.

142. *Purdy v. Pacific Automobile Insurance Co.*, 157 Cal. App. 3d 59, 203 Cal. Rptr. 524 (1984); *San Diego Navy Federal Credit Union v. Cumis Insurance Society*, 162 Cal. App. 3d 358, 208 Cal. Rptr. 494 (1984); *USF&G v. Louis Roser Co.*, 585 F.2d 932 (8th

These courts deal with this perceived loyalty problem by allowing the policyholder to select his defense attorney and requiring the insurer to pay reasonable legal expenses.<sup>143</sup> One court noted that insurers hire relatively few attorneys and a lawyer not looking out for the company's best interest might find himself without work.<sup>144</sup> Allowing the policyholder to select "independent" counsel is meant to minimize this problem.

Other courts have rejected this analysis because of their belief that the defense bar has been able to comply with its ethical obligation.<sup>145</sup> Thus, the insurer is allowed to select defense counsel even in the face of conflicting interests.<sup>146</sup>

The court in *Tank* did not directly address the issue of defense counsel's loyalty. The court left the choice of defense counsel with the insurer since the only way to fulfill the duty of hiring competent defense counsel is to be able to choose. However, the court took pains to point out that "both retained defense counsel and insurer must understand that only the *insured* is the client."<sup>147</sup> The court appears to be saying that the insurer-retained and paid defense counsel can be loyal to the policyholder once the policyholder has been identified as the attorney's only client.

## 2. The Insurer's Vicarious Liability

The second collateral issue is the insurer's vicarious liability for the acts of the defense counsel. This issue was briefed by the amicus curiae<sup>148</sup> but the court disregarded the actions of Tank's insurer-retained attorney as not having been properly before the court.<sup>149</sup> Hence, the court was "unable to enter into any discussion of an insurer's vicarious and direct liability and/or defense counsel's liability as an independent contractor for breach of defense counsel's duties as an attorney."<sup>150</sup>

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Cir. 1978); *State Farm v. Pildner*, 40 Ohio St. 2d 101, 321 N.E.2d 600 (1979) (O'Neal, C.J., concurring).

143. See Mallen, *A New Definition of Insurance Defense Counsel*, INSURANCE COUNSEL J. 109 (Jan. 1986) and cases cited therein.

144. *San Diego Navy Federal Credit Union*, 162 Cal. App. 3d at 364, 308 Cal. Rptr. at 498.

145. *Siebert Oxidermo Inc. v. Shields*, 430 N.E.2d 401 (1982).

146. *Id.*

147. *Tank*, 105 Wash. 2d at 388, 715 P.2d at 1137.

148. See *supra* note 3.

149. See *supra* note 130.

150. *Tank*, 105 Wash. 2d at 390, 715 P.2d at 1138.

Advocates of such vicarious liability declare the insurer-retained defense counsel to be the agent of the insurer and, therefore, any negligence of defense counsel should be imputed to the insurer.<sup>151</sup> Opponents describe defense counsel as an independent contractor solely responsible for his own acts and omissions.<sup>152</sup> If, as the court states, the attorney is to consider only the policyholder as client in a reservation of rights situation, the agency analysis is weakened. The client, as principal, should turn to his attorney, as agent, for relief if the attorney acts improperly, since the attorney is supposed to be independent of the insurer's influence and must act as though the policyholder is paying the bills.

For reasons unknown, Tank did not sue his insurer-retained attorney. Had the attorney also been a defendant, the trial court may have had to look closer at Tank's allegation that the defense was conducted against Tank's best interest.<sup>153</sup> In any event, the supreme court was able to avoid the issue of vicarious liability.

### 3. Control of the Defense

The *Tank* decision fails to address the issue of who controls the defense. When defending unconditionally, the insurer has complete control of the defense. The company selects counsel, decides strategy and runs the investigation.<sup>154</sup> On the other hand, when the claim is denied outright, the policyholder

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151. It is reasoned that since under the terms of the policy the insurer must provide a defense, if the quality of the defense is impaired by the acts or omissions of the attorney the insurer should be responsible. See *Amicus Brief W.S.T.L.A.*, *supra* note 3, at 26-27. See also *Smoot v. State Farm Mutual Automobile Ins. Co.*, 299 F.2d 525, 530 (5th Cir. 1962) ("Those whom the Insurer selects to execute its promises, whether attorneys, physicians, no less than company-employed adjusters, are its agents for whom it has the customary legal liability." footnote omitted)).

152. This would appear to be the law in Washington. See *Evans v. Steinburg*, 40 Wash. App. 585, 588, 699 P.2d 797, 798-99 (1985) ("Even if the defense counsel provided inadequate representation, Continental would not be vicariously liable for the acts of the defense attorneys who were acting as independent contractors."). But see *Hamilton*, 9 Wash. App. at 190, 511 P.2d at 1026 (Horowitz, C.J., dissenting) ("The appointed attorney, both as attorney for the insured and as the insurer's agent, must adequately advise the insured on settlement offers received.").

153. A finding of no insurance coverage by the court should not sustain a summary judgment in favor of an insurer retained defense attorney that allegedly committed legal malpractice. Once retained, the attorney must act in the best interest of the policyholder. The attorney cannot be relieved of his obligation to the client simply because the insurer is later found not to have had a duty to defend.

154. See *supra* note 19 and accompanying text.

is left on his own and is free to control the litigation.<sup>155</sup> Since a reservation of rights defense is neither unconditional acceptance of the claim nor outright denial, the question of who controls the defense is raised.

By imposing the duty on the insurer to hire competent defense counsel, the *Tank* decision allows the insurer, even in a reservation of rights defense, to choose the defense counsel for the policyholder.<sup>156</sup> The attorney, once retained, must begin to make decisions regarding the defense of the policyholder. Normally, the insurer runs the investigation and decides to what extent discovery should be pursued. Now, the insurer-retained attorney for the policyholder will want to make these decisions solely in the interest of his client. Clearly, the right to control the defense can have a tremendous impact on the coverage question.<sup>157</sup> If the policyholder's insurer-retained attorney is really to act only for the policyholder, then the attorney has the duty to acquire and maintain full control of the defense and structure the defense in the best interest of his client.<sup>158</sup>

Given the explicit language of the *Van Dyke* opinion, the duty of the insurer-retained defense counsel toward the policyholder has not undergone a real change under the *Tank* criteria.<sup>159</sup> The insurer and defense counsel must realize that the policyholder is the client of the attorney and that the attorney is duty-bound to work for his client's best interest.<sup>160</sup> The insurer has investigators and attorneys available to protect its interests at all times. Since the insurer has undertaken to provide the policyholder with a defense, that defense should be

155. See *supra* notes 23-24 and accompanying text.

156. See *supra* note 101 and accompanying text.

157. For examples of structuring the defense in favor of the insurer, see KEETON, *supra* note 9, at § 7.7(c) and cases cited therein.

158. Only with complete control of the defense can the policyholder's attorney fulfill his ethical obligation to the client. Interference by any third party is intolerable.

159. See *supra* notes 133-38 and accompanying text.

160. In a reservation of rights defense, since the interests of the policyholder will conflict with the interests of the insurer, the attorney retained by the insurer will be acting against the insurer's interests. Thus, the insurer should not be surprised if, for example, the attorney demands that the insurer settle the claim. This, after all, is in the best interest of the policyholder.

In *American Employer's Ins. Co. v. Crawford*, 87 N.M. 375, 533 P.2d 1203 (1975), the court pointed out that the attorney had demanded on behalf of the policyholder that the company settle. The court indicated that this was to be expected from the policyholder's attorney and ruled that the company was free to ignore the letter since it had no duty to indemnify.

conducted on behalf of the policyholder with the highest degree of advocacy.<sup>161</sup>

## II. CONCLUSION

Though no single criterion is new or unique, the *Tank* criteria as a whole do provide insurer and defense counsel with a good description of the interrelationship of the parties to a reservation of rights defense. The court left a key part of the reservation of rights defense, that of choosing defense counsel, with the insurer. Apparently the court was unwilling to further the proposition that insurer-retained defense counsel could not act independently of the company. This and the avoidance of the vicarious liability issue might suggest a victory to some. Yet the fact remains that the court found it necessary to impose an enhanced obligation of fairness on the insurer and to backstop the attorney's duty to keep the policyholder fully informed with an independent duty on the part of the insurer. This decision does not warrant the term "victory."

*Matthew L. Sweeney*

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161. Such advocacy should not be viewed by the company with disfavor. Any disfavor would lend weight to the argument that the company can and will exert pressure on the insurer chosen and insurer paid defense counsel.