

ALERT

No Basis to Allocate Defense Fees in Partially Covered Suit; Coverage Granted for Nominal Fees Incurred in Uncovered Suit That Were "Reasonably Related" to Covered Claim

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Applying Washington law, the United States District Court for the Western District of Washington has ruled that an insurer did not breach its duty to defend where it agreed to defend the covered claim in one lawsuit and correctly determined that there was no potentially covered claim in a second, related lawsuit. *Weinstein & Riley, P.S. v. Westport Insurance Corp.*, 2011 WL 887552 (W.D. Wash. Mar. 14, 2011). Although it concluded that only one of four claims in the first lawsuit was potentially covered under the policy, the court ruled that the insurer was obligated to pay all defense fees incurred in that suit because there was no basis to allocate the fees between covered and uncovered claims. The court also determined that there was coverage for some of the fees incurred in the second lawsuit because they were "reasonably related" to the covered claim in the first lawsuit, but held that the insurer did not act in bad faith in denying coverage for those fees. In addition, the court ruled that the insurer's reservation of rights did not create an actual conflict of interest with the insureds and that the insurer did not act in bad faith by appointing defense counsel. The court further held that the insurer had no duty to indemnify because the insureds received several million dollars in the global settlement of the two lawsuits and therefore did not incur a "Loss."

The insured law firm and its principal owner were involved in a lawsuit in Oregon with the buyer of a company the law firm had formed to provide support services to the firm. The firm also had provided legal services to the company. As part of the transfer of

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control, the company terminated the service agreements with the law firm. The company indicated that it would file the forms necessary to withdraw the law firm as its representative in bankruptcy proceedings, although it believed that it was the law firm's legal responsibility to file those forms.

The company subsequently filed a separate lawsuit in Washington against the law firm and its owner for legal malpractice. Among other things, the company alleged that the insureds committed malpractice by failing to withdraw as its counsel of record in bankruptcy cases after the attorney-client relationship had been terminated. The Washington lawsuit was stayed at the insureds' request pending resolution of the Oregon lawsuit.

The insureds sought to have the Oregon court resolve the malpractice and breach of fiduciary duty claims asserted against them in the Washington lawsuit and eventually filed a third-party complaint against the now-separated company seeking a declaration that those claims were without merit. The company responded with a counterclaim alleging malpractice, but did not reference the insureds' failure to withdraw as counsel as a basis for these claims. In March 2009, the parties entered into a global settlement of the Oregon and Washington lawsuits in which the insureds received \$4.7 million in cash and rights valued around \$1 million.

The insureds tendered the Washington lawsuit for coverage under their professional liability policy shortly after that suit was filed. The insurer issued a reservation of rights letter in which it explained that only the claim based on the insureds' alleged failure to withdraw as the company's counsel in the bankruptcy cases potentially triggered coverage under the policy. The insurer agreed to provide a defense but reserved the right to allocate defense costs between the potentially covered claim and the uncovered claims.

The insureds declined representation by the attorney appointed by the insurer and asserted that the insurer's reservation of rights created a conflict of interest that entitled them to independent counsel. The insureds also demanded that the insurer pay defense costs incurred in the Oregon lawsuit because those costs were "reasonably related" to the insureds' defense of the Washington lawsuit. After reviewing documents provided by the insureds concerning the Oregon lawsuit, the insurer advised that the Oregon lawsuit did not appear to involve any potentially covered claims based on the information provided.

About four months later, the insureds demanded payment of approximately \$500,000 in attorneys' fees incurred in the Oregon and Washington lawsuits. The insurer agreed to pay about \$150,000, which was the total incurred in the Washington lawsuit, and advised that it still did not believe that there was any coverage for fees incurred in the Oregon lawsuit. After an unsuccessful mediation concerning coverage for the Oregon fees, the insureds filed the instant lawsuit to determine coverage and alleging bad faith.

The court first ruled that the insurer had not breached its duty to defend because it agreed to defend the covered claim in the Washington lawsuit and correctly determined that there was no potentially covered claim in the Oregon lawsuit. In this regard, the court concluded that the malpractice claims that were eventually filed against the insureds in the Oregon lawsuit—which were the only Oregon claims at issue in the coverage dispute—were not covered due to certain exclusions in the policy.

The court also ruled that the insurer did not breach the policy, act in bad faith or violate Washington insurance regulations by selecting defense counsel. The court noted that Washington law does not recognize a right to independent counsel due to conflicts of interest, but instead imposes on insurer-selected counsel an enhanced obligation of fairness to the insured. The court also ruled that there was no right to independent counsel under the terms of the policy because the insurer's reservation of rights did not create an actual conflict of interest. In addition, the court found that the insureds had not been harmed in any case. It reasoned that the insureds had rejected insurer-selected counsel, who never entered an appearance on their behalf, and the insurer had agreed to pay the reasonable fees incurred by the insureds' own counsel in defending the covered claim.

Next, the court ruled that the insureds were entitled to a small portion of the fees incurred in the Oregon lawsuit and to all of the fees incurred in the Washington lawsuit. Based on its review of the defense invoices, the court determined that certain work performed in the Oregon lawsuit was "reasonably related" to the defense of the covered claim in the Washington lawsuit. However, it found that the insureds did not meet their burden of establishing the amount of attorney's fees incurred in the Oregon lawsuit that was "reasonably related" to the covered claim. The court additionally determined that the \$1.8 million in fees the insureds sought was "excessively disproportionate" to their risk of liability on the covered claim. The court therefore ruled that the insureds were entitled to a nominal amount of fees with respect to the Oregon lawsuit. Although it ruled that some of the fees incurred in the Oregon lawsuit were "reasonably related" to the covered claim, the court determined that the insurer's position was not unfounded or unreasonable. The court therefore held that the insurer did not act in bad faith or violate the Washington Insurance Fair Conduct Act by declining to pay those fees.

The court found that the work on preliminary motions by defense counsel in the Washington lawsuit before it was stayed addressed the case as a whole and that there was no basis to allocate the fees between the covered claim and the uncovered claims. Accordingly, the court concluded that the insureds were entitled to recover all of the fees incurred in that action. Because it found no basis for an allocation, the court rejected the insurer's counterclaim to recover 80% of the fees it had paid for the Washington lawsuit. In doing so, the court declined to apply *Waite v. Aetna Casualty & Surety Co.*, 467 P.2d 847 (Wash. 1970), which held that an insurer's duty to defend is limited to covered claims when a complaint includes both covered and uncovered claims.

In addition, the court held that the insurer did not breach its duty to indemnify the insureds because the insureds had not incurred a Loss, which was defined in the policy to mean the "monetary and compensatory portion" of a settlement or judgment. The court noted that the insureds were not obligated to pay anything in the global settlement of the Oregon and Washington lawsuits, but instead received several million dollars. The court also found that the insureds had not established that they incurred any Loss attributable to the covered claim.