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Ethical Issues When Insurers Won't Fund the Defense

Hamel's application of *Gandy*'s "fully adversarial trial" rule

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I. The Duty to Defend exists to protect the insured

State and federal courts applying Texas law repeatedly reference the duty to defend as a benefit to the insured.[1] Even when the plaintiff's allegations are false, insurers must provide a defense so long as the claims are potentially within the scope of coverage. Benefit of the doubt inures to the insured, not the insurer.[2]

When insurers defend their insureds, the system generally works. The insurer assigns a lawyer to the insured, the lawyer exercises his fiduciary duty to the insured, and the case proceeds along towards trial or settlement. Sure, there are hiccups along the way in some cases; but in general, the insurers' exercise of its duty to defend correlates with standard litigation practices.

Ethical dilemmas rise when insurers wrongfully refuse to defend their insureds. Faced with cases where the defendants lack the financial stability to fund their own defense, lawyers have created numerous creative solutions. At least three approaches have been stricken by the Texas Supreme Court—(1) Mary Carter Agreements;[3] (2) assignments;[4] and (3) pre-trial agreements.[5] In deciding each case, the Texas Supreme Court focused on the perceived perversion of justice in order to allow insurers to challenge or avoid underlying judgments against their insureds. The latest *Hamel* ruling seeks to avoid overinflated judgments created through sham trials. Its new requirement of fully adversarial trials, even in cases where the insurer wrongfully refused to defend the case, however, also invalidates routine settlements that courts previously found binding on insurers as a consequence of their wrongful denial.[6]

This paper addresses these cases and provides guidance to counsel as they continue to come up with creative solutions to help their clients, without crossing any ethical lines.[7]

II. Invalidated approach: Mary Carter Agreements / *Elbaor*

Mary Carter agreements are (were) creative solutions for defendants who lacked resources to fund a settlement for their full share of damages.[8] A Mary Carter agreement exists when a settling defendant remains a party at the trial of the case with the potential to offset some or all of its settlement.[9] In *Elbaor*, three of the defendants settled with the plaintiff for the total sum of $425,010. Under the terms of their settlement, they were required to participate at trial and were entitled to a pay-back of their settlement money out of the plaintiff's recovery from the non-settling defendant. The jury found plaintiff's damages totaled $2,253,237 and placed 88% liability on the non-settling defendant.[10]

The Texas Supreme Court used this case as a means to invalidate Mary Carter agreements. The opinion calls such agreements "inimical to the adversary system" and makes "litigation inevitable" instead of promoting settlements.[11] Although prior opinions expressed methods to moderate the impact of such agreements during trial of the underlying case, the *Elbaor* court flatly

rejected this approach. Remedial measures, such as disclosing the true alignment of the parties and revealing the agreement to the jury "cannot overcome collusion between the plaintiff and settlement defendants who retain a financial interest in the plaintiff's success."[12]

In declaring Mary Carter agreements as violative of sound public policy, the *Elbaor* court specifically called out the agreements as skewing the trial process, misleading the jury and promoting unethical collusion among nominal adversaries.[13] The Texas Supreme Court so disliked this type of agreement that they took the unusual step of cautioning lawyers that such methods may force attorneys into questionable ethical solutions under Rule 3.05 of the Texas Disciplinary Rules of Professional Conduct, entitled "Maintaining the Impartiality of the Tribunal."[14]

> **Rule 3.05 (a):**
>
> **A lawyer shall not …seek to influence a tribunal concerning a pending matter by means prohibited by law or applicable rules of practice or procedure;**
>
> **Comment 2:**
>
> **In recent years, however, there has been an increase in alternative methods of dispute resolution, such as arbitration, for which the standards governing a lawyer's conduct are not as well developed. In such situations, as in more traditional settings, a lawyer should avoid any conduct that is or could reasonably be construed as being intended to corrupt or to unfairly influence the decision-maker.**

III. Invalidated approach: *Gandy* arrangements

The practice of plaintiffs and defendants agreeing to judgments enforceable only against defendants' insurers fell out of favor with the *Gandy* opinion. Distilling the *Gandy* case into its most basic components: plaintiff filed a lawsuit against defendant for past abuse. The defendant turned the claim over to his insurer, who agreed to defend the case. Without notice to the insurer, the defendant agreed to a judgment against him for over $6 million and assigned any claims he had against his insurer over to the plaintiff. In turn, the plaintiff agreed to collect the judgment only against the insurer.[15]

A. Benefits of the *Gandy* arrangement

Through this arrangement, the parties avoided a long trial filled with very personal accusations of abuse. Twelve people were not pulled from their jobs to serve as jurors to listen to witnesses in an effort to answer questions on long legal-ese filled verdict forms. Defendant, by agreeing to a judgment, brought the litigation against him to a close. Plaintiff secured a judgment that then could be enforced against the only viable asset, the defendant's insurance policy. The

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