McGeorge Law Review

Volume 13
Issue 3 *Symposium: California Insurance Law*

Article 10

1-1-1982

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INTRODUCTION

The following is an update of a 1973 article that was prepared for the Defense Research Institute, Inc. on the subject of excess liability.[1] The current law of excess liability was in its infancy at that time, so it seemed altogether fitting to enhance the earlier discussion in order to chart a proper course for insurance defense counsel.

To almost no defense counsel's surprise, the rapid evolution in the law of excess liability has mandated significant changes in claims settlement procedures. Although in days past the insurance industry could in some instances utilize shrewd tactics to escape liability, continued adherence to this overly protective practice today will prove penny-wise and pound-foolish. As one writer has noted, these dilatory tactics provided the raw material for the development of the law of excess

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1. Costanzo, *Current Thinking on Excess Liability—An Attorney's View, in* DEFENSE RESEARCH INSTITUTE, EXCESS LIABILITY 13 (1973).

liability.[2]

Bad faith liability—usually stated as the breach of an implied covenant of good faith and fair dealing—originated not in insurance law, but instead from contract principles in preserving the right of each party to the fruits of his bargain. Insurance law has nevertheless been the primary area of litigation for this type of action from its inception.

California courts first recognized the insured's right of action against the insurer for unreasonable conduct in the settlement of claims against the insured in *Brown v. Guarantee Insurance Co.*[3] and *Communale v. Traders & General Insurance Co.*[4] Both of these decisions arose out of third party claims, which are to be distinguished from what is termed first party claims, in that the former deals with actions based upon the insurer's conduct which risks potential liability of the insured over the policy limits in suits against the insured. Both *Brown* and *Communale* held that insurers are bound by a duty of good faith and fair dealing in the process of settlement negotiation.

Further, these cases imposed a reciprocal duty upon the parties to refrain from doing anything to injure the right of the other to receive the benefits of the contract.[5] While the *Brown* court based its decision upon contract theory, *Communale* held this duty to be founded in tort principles as well, allowing plaintiff his choice of action. Nearly a decade later, the Supreme Court reaffirmed *Communale* in *Crisci v. Security Insurance Co.*,[6] holding that the insurer must give as much consideration to the financial interest of its insured, which turned upon whether a prudent insurer would have accepted the settlement offer if it alone were to be liable for the entire judgment.

In dictum, the *Crisci* court went even further to propose the imposition of strict liability upon insurers, stating:

> The proposed rule is a simple one to apply and avoids the burdens of a determination whether a settlement offer within the policy limits was reasonable. The proposed rule would also eliminate the danger that an insurer, faced with a settlement offer at or near the policy limits, will reject it and gamble with the insured's money to further its own interests. Moreover, it is not entirely clear that the proposed rule would place a burden on insurers substantially greater than that which is present under existing law.[7]

In 1974, the Supreme Court adopted the *Crisci* suggestions and re-

2. Turner, *Excess Liability, in* GENERAL REINSURANCE MONOGRAPH 13 (1974).
3. 155 Cal. App. 2d 679, 319 P.2d 69 (1957).
4. 50 Cal. 2d 654, 328 P.2d 198 (1958).
5. *Id.* at 658, 328 P.2d at 200.
6. 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).
7. *Id.* at 431, 426 P.2d at 177, 58 Cal. Rptr. at 17.

versed the Appellate Court's decision in *Johansen v. California State Automobile Association Inter-Insurance Bureau*.[8] In *Johansen*, plaintiff Muriel Johansen and her husband brought suit against Gary Dearing, minor son of the insured, for negligent operation of a motor vehicle. The insurer disputed liability, but assumed the defense of the insured under reservation of rights. Prior to trial against the insured, plaintiffs offered to settle for the policy limits. Although in the subsequent trial against the insurer, the insurer conceded the certainty of an excess judgment, it refused to settle, maintaining it would only proffer the policy limits after judicial determination that coverage existed.

During the pendency of the action against the insured, the insurer brought a declaratory relief action against the plaintiff and the insured. The trial court found for the insurer, but this ruling was reversed on appeal. The insurer then paid out the policy limits with interest. The Johansens thereafter instituted a proceeding against the insurer for bad faith, taking an assignment for the unpaid portion of the judgment. The trial court rendered its decision in favor of the insurer, holding that the insurer's bona fide belief that coverage did not exist immunized it, since liability can only exist upon a finding of bad faith. In the underlying action, however, the insured admitted liability under advice of counsel retained by the insurer; the Supreme Court, in the bad faith action against the insurer, considered the overwhelming evidence which indicated the existence of a substantial risk for a higher verdict than that rendered.

The majority in *Johansen* refused to recognize the lower court's attempt to use potential collusion between the insured and the attorney representing the claimant as a basis for denying recovery in bad faith actions. The court applied a "per se rule" of bad faith, holding: "[A]n insurer's 'good faith', though erroneous, belief in non-coverage affords no defense to liability flowing from the insurer's refusal to accept a reasonable settlement offer. [Footnote omitted]".[9]

Royal Globe Claims

The newest assault upon the insurance industry came via the 1972 amendments to the Unfair Practices Act.[10] The Act, adopted in 1959, was designed to thwart potential federal regulation of trade practices by reserving control over insurance commerce to the state Insurance

8. 15 Cal. 3d 9, 538 P.2d 744, 123 Cal. Rptr. 288 (1975).
9. *Id.* at 16, 538 P.2d at 748, 123 Cal. Rptr. at 292.
10. Cal. Ins. Code §§790-790.10.

Commissioner.[11]

In 1972, the legislature added subdivision (h) to section 790.03,[12] which sets forth thirteen proscribed unfair settlement practices. The following are the most relevant illegal practices to this discussion: (1) misrepresenting to claimants pertinent facts or insurance policy provisions relating to any coverage at issue;[13] (2) failing to acknowledge and act reasonably promptly upon communications with respect to claims arising under insurance policies;[14] (3) failing to confirm or deny coverage of claims within a reasonable time after proof of loss requirements have been completed and submitted by the insured;[15] (4) not attempting in good faith to effectuate prompt, fair, and equitable settlements of claims in which liability has become reasonably clear;[16] (5) failing to provide promptly a reasonable explanation of the basis relied on in the insurance policy, in relation to the facts or applicable law, for the denial of a claim or for the offer of a compromise settlement;[17] (6) directly advising a claimant not to obtain the services of an attorney.[18]

The Court first recognized an implied right of action under the Unfair Practices Act in *Greenberg v. Equitable Life Assurance Society*,[19] a suit involving restraint of trade. *Greenberg* arose as a class action seeking damages, even though the sole remedial power of the Insurance Commissioner under the Unfair Practices Act was the issuance of a cease and desist order. The court required the Act to be read in the light of other restraint of trade statutes outside the insurance industry and held that the plaintiffs were not required to exhaust all administrative remedies before the commissioner.[20]

With the door ajar, the Supreme Court again took the opportunity to apply the holding of *Greenberg* to subdivision (h) and third party claims in *Royal Globe Insurance Co. v. Superior Court*.[21] *Royal Globe* involved a slip and fall action against a grocery store, in which plaintiff joined in the suit the market's insurer and its independent adjuster as an agent of the insurer. The plaintiffs claimed that the adjuster refused to settle in good faith even though liability had become reasonably

11. Price, Royal Globe Insurance Co. v. Superior Court: *Right to Direct Suit Against an Insurer by a Third Party Claimant*, 31 HAST. L. J. 1161, 1167-68 (1980).
12. CAL. INS. CODE §790.03.
13. *Id.* §790.03(h)(1).
14. *Id.* §790.03(h)(2).
15. *Id.* §790.03(h)(4).
16. *Id.* §790.03(h)(12).
17. *Id.* §790.03(h)(13).
18. *Id.* §790.03(h)(14).
19. 34 Cal. App. 3d 994, 110 Cal. Rptr. 470 (1973).
20. *Id.* at 1001, 110 Cal. Rptr. at 475.
21. 23 Cal. 3d 880, 592 P.2d 329, 153 Cal. Rptr. 842 (1979).

clear. The court vacated the trial court's ruling denying defendant's demurrer, but held this action to be premature, in that the claim against the insured must be concluded prior to the insured's bringing suit for declaratory relief.[22]

In his dissent, Justice Richardson noted that the majority had abrogated the well settled rule that recovery for excess judgments was limited to the insured unless there was an assignment.[23] Justice Richardson stressed the majority's sidestepping of *Murphy v. Allstate Insurance Co.*[24] by creating a weak, artificial distinction premised upon the Unfair Practices Act. *Murphy*, he points out,[25] expressly held that a third party claimant has no direct cause of action against the insurer.

Royal Globe significantly altered the defense counsel's approach to his obligations *vis-à-vis* the insured and insurer. In the first place, this case requires the attorney to take immediate steps to investigate the claim. More importantly, if the facts of this investigation demonstrate "reasonably clear liability," which means that liability and damages are clear, the attorney is required to initiate settlement negotiations with the plaintiff, thereby tipping his hand. Failure by the carrier to do so, or failure to thereafter effectuate a prompt settlement, forms the prima facie case for further liability under *Royal Globe*. Such omissions may also leave the attorney quite vulnerable to a legal malpractice action for mishandling the claim.

The public policies to be promoted by similar vigorous implementation of the Unfair Practices Act were clearly enunciated in *Avila v. Travelers Insurance Co.*[26] These policies were as follows: (1) to facilitate prompt compensation of the injured person; (2) to encourage settlement; and (3) to discourage litigation.[27] The *Avila* court disregarded the interests of the insured by requiring an expeditious settlement by the insurer, even though such quick compensation to the injured could thereby expose the insured to no coverage. This concern for the injured party was adopted in *Aetna Casualty & Surety Co. v. Superior Court*.[28] The court elevated the rights of the third party claimant over that of the insured, holding that an insurance company is not guilty of bad faith or negligence in paying out the policy limits to a seriously injured person, despite the fact that this practice exposes its insured to no coverage, as,

22. *Id.* at 892, 592 P.2d at 337, 153 Cal. Rptr. at 850.
23. *Id.* at 892-93, 592 P.2d at 337-41, 153 Cal. Rptr. at 850-54 (Richardson, J., dissenting).
24. 17 Cal. 3d 937, 553 P.2d 584, 132 Cal. Rptr. 424 (1976).
25. 23 Cal. 3d at 893, 592 P.2d at 337, 153 Cal. Rptr. at 850.
26. 481 F. Supp. 431 (C.D. Cal. 1979).
27. *Id.* at 437.
28. 114 Cal. App. 3d 49, 170 Cal. Rptr. 527 (1980).

for example, in the case of a potential subsequent wrongful death claim.[29]

Thus, the state of the law of excess liability has undergone a vast transformation from its limited application in *Brown v. Guarantee Insurance Co.*[30] Moreover, as many authorities have commented, there is no indication that this area has reached its apex of development.[31]

DEFENSE COUNSEL'S DUTIES AND PROBLEMS

Taking this background into account, the thrust of this discussion will be to consider the practical problems of defense counsel whose client is exposed to a judgment in excess of his policy limits. Such problems have been the subject of considerable scrutiny since the decision in *Lysick v. Walcolm*.[32] In the *Lysick* case, the claimant who had recovered an excess judgment collected the policy limits, and through an assignment brought suit against both the insurer and defense counsel. The insurer settled, leaving defense counsel the only remaining defendant. The court found for the insured's estate, holding that the attorney had failed to inform the insured's estate of the conflicts of interest between the insurer and insured. In addition, the court determined that the attorney had failed to advise the insured of its right to retain independent counsel.[33]

Since the *Lysick* decision, it has become apparent that the attorney compensated by the carrier to represent its insured must conscientiously assess his position vis-à-vis the insurer-insured relation. As a practical matter, it must be realistically conceded that the insurer's position may be somewhat more favorably considered than that of the insured. After all, it is the insurer who controls the purse with which it may curry favor and promote an atmosphere not unlike an employer-employee relationship. On the other hand, the client-insured's value as a future business asset to the attorney is negligible beyond the pending litigation. *Lysick* was accordingly erected to serve as a warning beacon to the attorney who is tempted to follow this natural inclination. If there was any doubt as to the import of *Lysick*, the court in *Klemm v. Superior Court*[34] dispelled it when it unequivocally set forth the effect of such a wrongful breach of the attorney's duty under Rule 5-102 of the State Bar Rules of Professional Conduct.

The *Klemm* court recants the strict standard set forth in *Anderson v.*

29. *Id.* at 59, 170 Cal. Rptr. at 534.
30. 155 Cal. App. 2d 679, 319 P.2d 69 (1957).
31. Wagenseil, *Royal Globe: Reasonably Unclear Liability for Insurers*, 678 INS. L.J. 382 (July 1979).
32. 258 Cal. App. 2d 136, 65 Cal. Rptr. 406 (1968).
33. *Id.* at 151, 65 Cal. Rptr. at 416.
34. 75 Cal. App. 3d 893, 142 Cal. Rptr. 509 (1977).

Eaton,[35] wherein the court stated:

> [I]t is a violation of that duty for him to assume a position adverse or antagonistic to his client without the latter's free and intelligent consent given after full knowledge of all the facts and circumstances. [Citation omitted]. By virtue of this rule an attorney is precluded from assuming any relation which would prevent him from devoting his entire energies to his client's interest. Nor does it matter that the intention and motives are honest. This rule is designed not alone to prevent the dishonest practitioner from fraudulent conduct, but as well to preclude the honest practitioner from putting himself in a position where he may be required to choose between conflicting duties, or be led to an attempt to reconcile conflicting interests, rather than enforce to their full extent the rights of the interest which he should alone represent. [Citation omitted].

Moreover, a breach of the attorney's fiduciary duty in representing the insured can have far-reaching effects on the attorney's continued professional practice—effects which may not be the subject of errors and omissions coverage. The obligation of the attorney to the insured, even though the attorney has been retained by the insurance carrier, must be considered the same as if the client had personally retained him.

The attorney must presume that whatever he does or fails to do in the representation of the insured client may be subject to the scrutiny of a lay jury, with instructions to that jury based upon fiduciary principles. This poses obvious difficulty since the attorney, in representing the insurance carrier, works with people who are thoroughly attuned to the business of dealing with claims and litigation. On the other hand, in representing an individual client, the attorney is generally dealing with one who is unfamiliar with the problems involved in the litigation process.

Logically, then, it would be incumbent upon the attorney to explain to the insured each and every step of the litigation process, from the time he is retained through the conclusion of the case by judgment or settlement.

The duty of the attorney in this respect has been expressed as follows:

> He must disclose clearly all the facts relating to settlement to the insured. He must apprise the insured of the risks and of the leverage he has against the insurer . . . he must conduct himself as the insured's advocate vis-à-vis the company in their struggle because of the disparity in their knowledge and in their bargaining positions . . . .[36]

35. 211 Cal. 113, 293 P.2d 788 (1930).
36. Gallagher, *Problem of Defense Counsel Negotiating Settlement in Potential Excess Cases,*

However, this may be a practical impossibility, for even if an attorney were capable of explaining all the contingencies, he would still face the insurmountable obstacle of ascertaining just what the client understood. As noted in the 1973 article, the attorney may find himself in a plight similar to that of the physician. When faced with an allegation that the client was not fully informed as to the possible risks of the litigation process, it may be insufficient for him to be able to prove that he performed his professional services impeccably.[37] In attempting to satisfy the demands of the fiduciary duty imposed upon him to render professional advice, the attorney must be aware of the potential need to satisfy a finder of fact that he has met that duty. In some jurisdictions, the mere fact that the individual practitioner conformed to the standard of other practitioners does not preclude use of the informed consent doctrine. Similarly, the individual attorney should not feel secure in conforming to the standard of other practitioners in advising of the risks of litigation. The court, in a recent medical malpractice case, spoke of the standard to be applied in informed consent cases, using language that has relevance for the attorney in his role of advising insured clients:

> The scope of a physician's duty to disclose is measured by the amount of knowledge a patient needs in order to make an informed choice. All information material to a patient's decision should be given .[38] . . . Material information is that which the physician knows or should know would be regarded as significant by a reasonable person in the patient's position when deciding to accept or reject the recommended medical procedure. [Citation omitted]. To be material, a fact must also be one which is not commonly appreciated. [Citation omitted]. If the physician knows or should know of the patient's unique concerns or *lack of familiarity* with medical procedures, this may expand the scope of required disclosure. [Citation omitted].[39]

ADVISING AND PROTECTING THE INSURED-CLIENT

From the above discussion, it should be apparent that the attorney must advise and protect the insured at all stages of the proceedings as if the client were uninsured and possessed substantial assets. Such advice and protection encompasses not only the tangible and intangible rights

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in DEFENSE RESEARCH INSTITUTE, CONFLICTS OF INTEREST IN INSURANCE PRACTICE 44, 46 (1971).

37. Costanzo, *supra* note 1, at 15.

38. Truman v. Thomas, 27 Cal. 3d 285, 291, 611 P.2d 883, 902, 165 Cal. Rptr. 289, 308 (1980) *citing* Cobbs v. Grant, 8 Cal. 3d 229, 502 P.2d 1, 104 Cal. Rptr. 505 (1972).

39. 27 Cal. 3d at 291, 611 P.2d at 905-06, 165 Cal. Rptr. at 311-12 (emphasis added).

of the insured, but also a recognition of the inextricable interrelationship between those assets and the insurance policy. Indeed, the policy must be treated as an enhancement of the property rights of the insured, as well as an independent protectable asset. This approach requires a consideration of the insurance policy as protection afforded the insured as to his other assets, both existing and future. If, therefore, in the litigation process, a potential threat—no matter how remote—is posed to the assets of the insured over and above the protection afforded by the insurance company limits, the attorney must advise the insured to retain independent counsel in order to protect his individual assets.

There are situations in which the insured himself may have a definite monetary interest in not making a demand that the insurance company settle within his policy limits. For example, the settlement in some cases may result in higher premiums for future or existing coverages. Moreover, the insured's professional standing may be a paramount factor (e.g., a doctor accused of malpractice or a manufacturer accused of product design defects). However, counsel is more often dealing with an individual who is not confronted with such collateral concerns.

Considered Opinion Needed

In order to fully protect the individual client, the attorney should take immediate steps—whether or not a demand letter has been received—to ascertain the facts necessary to give a considered opinion as to: (1) the liability of the insured; and (2) the nature and extent of the damages sustained by the claimant. Such procedure is both earnestly desired by the carrier and essential to the individual client. In light of *Royal Globe*, this recommended procedure may well be imposed by law. The attorney must develop his plan accordingly, including conferring with opposing counsel as necessary, to obtain the necessary information.

If the investigation is thorough and well documented, the evaluation will be reasonable and not susceptible to "bad judgment."[40] As another observer has noted:

> The obligation is to defend a case, not a policy limit . . . . In short, in all things related to investigation and defense the insurer should behave as if its policy were unlimited. Any attempt to gear the investigation or defense to the policy limit rather than to the needs of the case as a whole will risk failure to develop essential defensive evidence thereby exposing the insurer to excess liability . . . . It may

40. Kennedy, *Current Thinking on Excess Liability—An Insurer's View, in* Defense Research Institute, Excess Liability 7 (1973).

> also lay the insurer open to the charge that by reason of its inadequate investigation it was unable to make a good faith appraisal of settlement value.[41]

If, upon receipt of the complaint or during discovery, a demand in excess of policy limits is made, defense counsel should inform the carrier and insured of the rights and obligations of each party. Most importantly, the insured should be advised of his right to independent counsel if a conflict exists (i.e., when the insured's interest is not congruent with that of the insurer). Also, the insured should be apprised of his right to contribute toward settlement, and the insurer's pledge of cooperation between its counsel and the insured should he choose to retain independent counsel.

As soon as counsel receives information indicating "reasonably clear" liability, a potential *Royal Globe* action makes it certain he should take even greater care to avoid such settlement practices as refusing to negotiate, waiting for plaintiff to forget the claim, or other dilatory tactics. Defense counsel should also be alert to advise the claims adjuster to avoid careless remarks in the claims file, as they are more than likely discoverable in this type of action.

Even where no demand has been made, prudent counsel should closely monitor the investigation and should prepare to initiate settlement negotiations when and if the facts indicate reasonably clear liability. This approach is equally sound when the demand is below or at the policy limits. Here again the attorney must promptly inform the insured and the carrier of the demand and the potential risks to each party in the event it should be rejected.

In some situations, a demand for the policy limits is made before a considered opinion can be given on either liability or damages. Where a demand contains a limited time for its acceptance, it would appear that both a practical and ethical solution is possible. A basis for considering the demand should be established in light of information which counsel making the demand should be responsible for supplying. The attorney should write a letter to plaintiff's counsel requesting all information in his possession upon which his demand is based. Failure to respond by the plaintiff's attorney would indicate that his demand was not made in good faith.

Treating the demand and the litigation process as though the policy had no limits may also afford a realistic approach in those jurisdictions that impose what is tantamount to absolute liability for failure to settle.

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41. Turner, *Avoiding Excess Liability, in* DEFENSE RESEARCH INSTITUTE, AVOIDING EXCESS LIABILITY II (1967), *reprinted in* DEFENSE RESEARCH INSTITUTE, EXCESS LIABILITY 69 (1973).

It may also have distinct advantages in those jurisdictions where the question is one of bad faith, provided the insurer is cognizant of the underwriting problems imposed in writing a policy which has limits that may, in exceptional situations, be waived by the insurer.

Essentially, the same advice would apply in those situations where the insured has no assets and probably never will. It would apply, for example, where an estate has been established, the only item remaining in the estate is the policy limits protection afforded the client, and there is no possibility of a collectible excess judgment. The tendency of the decisions has been to impose the same liability upon both the insurer (and probably the attorney) as if the estate were a healthy entity with substantial assets.[42] However, it should be noted that there may be instances where no liability for bad faith action will arise. The court in *Shapero v. Allstate*[43] held no cause of action will arise where there is no possibility of damage to the insured. This case, however, may be limited to its peculiar facts (i.e., the plaintiff's attorney was also the employer of the defendant—decedent's administrator).

CONCLUSION

For the law of excess liability as it exists to date, the following is a set of rules that should govern the conduct of defense counsel in advising and protecting his clients in insurance cases. Counsel should:

(1) Always begin the investigation within a reasonable time and stress to all parties the importance of avoiding unnecessary delays;

(2) Immediately write to the insured, informing him/her as to all relevant facts already discovered and all applicable policy provisions. Be sure the carrier notifies the insured of any reservation of rights language the insurer intends to use should it be found later that no coverage exists.

(3) Immediately write to the insurer to inform it of the steps which are being taken or should be taken. It is vitally important that the adjuster be alerted to potential discovery of the claims file.

(4) Upon formulation of an opinion that a verdict would most likely be in excess of the policy limits or upon demand for such, counsel must promptly advise the insured of: (a) his/her right to independent counsel; (b) his/her right to contribute; and (c) the insured's right that his/her representative receive the fullest cooperation from the insurer's counsel.

(5) As soon as facts are received indicating "reasonably clear liability," the carrier must be informed immediately that settlement negotiations must promptly be initiated and the insured should be kept

42. Lysick v. Walcolm, 258 Cal. App. 2d 136, 65 Cal. Rptr. 406 (1968).
43. 14 Cal. App. 3d 433, 92 Cal. Rptr. 244 (1971).

advised. Thereafter, counsel should take the necessary steps to effectuate this settlement.

(6) When faced with certain liability, counsel should advise the insurer to make advancements to the injured party. Also, counsel should stress that the insurer not use the precarious financial condition of either the injured person or the insured to coerce settlement.

(7) Keep the insured and insurer frequently advised of any and all progress in the defense of the claim. These reports should note the risks to each party presently known and the suggested tactics to be used in future discovery or settlement proceedings.

(8) Advise the carriers to continually educate their adjusters as to those illegal practices set forth in the Unfair Practices Act. Counsel should also avail himself of the adjusters for the purpose of answering questions relating to the application of the Act or advise the insurer to use its house counsel so as to clear up any doubt as to its effect upon the carriers' procedures.

Perhaps, the best approach to the dilemma facing any defense lawyer would include a closer personal relationship with the defendant-insured, as well as a spirit of cooperation by the client-carrier. They must build a unified defense effort, based on a recognition by all parties of the respective rights and obligations of the insured-insurer clients vis-à-vis the defense attorney.