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ARTICLES

When Can an Insurer Pursue a Malpractice Claim Against Defense Counsel Retained for an Insured? (Part One)

How and where an insurer may directly pursue malpractice claims against defense counsel.

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When an insurer accepts an insured's tender and agrees to provide a defense, it is often an afterthought as to whether the insurer can actually recoup those defense costs or indemnity payments from the insured or defense counsel if things go south. But in certain circumstances, insurance carriers can, and sometimes do, seek to recoup defense costs—and occasionally even attempt to pursue defense counsel for malpractice.

Part I of this two-part article addresses how and where an insurer may directly pursue malpractice claims against defense counsel. While the majority of courts to have addressed the issue allow insurers to bring claims against defense counsel, there is a split between jurisdictions over the legal bases for those claims, which can also affect the likelihood of success. The three primary vehicles, discussed below, are (1) the tripartite relationship, (2) as third-party beneficiaries, and (3) contractual or equitable subrogation.

It is not always the ultimate verdict or settlement, however, that the insurer is keen to recover. As litigation costs continue to soar, an insurer's obligation to defend can sometimes be more valuable to the insured—and more costly to the insurer—than the indemnity obligation. A second and separate issue is when and how insurers can seek reimbursement of defense costs from the insured if it is later found that a duty to defend was not owed in the first place for some or all of the claims. This second issue will be discussed in Part II of this two-part article.

Theories of Recovery

When an insurer pays a settlement or verdict it believes it would not have been liable for, in whole or in part, if not for certain acts or omission in the handling of the case, it may seek to recover those costs directly from the defense counsel. Generally, an insured's claim for legal malpractice against defense counsel is not assignable. But many states nevertheless recognize a carrier's direct right of action against defense counsel for malpractice. States vary, however, on the bases for allowing such a claim. Three legal theories support recovery: (1) the tripartite relationship between insurers, insureds, and retained defense counsel; (2) the insurer as a nonparty beneficiary of the relationship between the insured and retained defense counsel; and (3) subrogation.

The First Theory: The Tripartite Relationship

In some circumstances, a tripartite relationship exists between the carrier, the insured, and defense counsel in which both the carrier and insured are clients of defense counsel. [1] For example, under the Alabama Rules of Professional Conduct,

[i]n the normal insurance defense relationship where, for example, there are no coverage issues, *appointed counsel has two clients, the insured and the insurer*. [2]

A leading case under the tripartite theory is *General Security Insurance Co. v. Jordan, Coyne & Savits, LLP*. [3] In that case, the carrier paid a default judgment against the insured caused by defense counsel's malpractice. The federal court, predicting Virginia law, held that policy reasons support the ability of the carrier to pursue a malpractice claim against defense counsel, including the tripartite relationship:

The first question—whether an insurer can bring a legal malpractice claim against the law firm it retains to defend an insured—has never been squarely addressed by the Supreme Court of

Virginia. While the courts of other jurisdictions generally recognize such a cause of action, they differ markedly on the theory of liability under which such a claim may be brought. *In most jurisdictions, the retaining insurer may sue the law firm directly as its client*. Although most of the reported cases involving such suits offer no analysis of the insurer's relationship with the law firm, *the few that do reflect the view that a "tripartite relationship" exists among insurer, insured, and counsel, with both insurer and insured as co-clients of the firm in the absence of a conflict of interest*. . . . [4]

Some states, however, decline to permit insurers to sue defense counsel on the basis of a tripartite attorney-client relationship, concluding that there is no automatic "attorney-client relationship" between an insurer and defense counsel. [5] The rationale is grounded in courts' desire to protect the relationship between defense counsel and insureds and to ensure that defense counsel's loyalty flows exclusively to the insured—not the insurer that is paying insured's bills. [6]

The Second Theory: Beneficiary of the Legal Relationship Between Insured and Defense Counsel

The next rationale for recognizing a cause of action in favor of the carrier and against defense counsel is that the carrier is a nonparty beneficiary of the law firm's legal services, as "[s]ome courts and the Restatement recognize an additional or substitute cause of action by the insurer as a non-client beneficiary of the firm's legal services." [7] Significantly, the *Restatement (Third) of the Law Governing Lawyers* permits insurers to sue defense counsel—but not on the premise that the insurer is a "client" of defense counsel. Instead, the *Restatement* provides that a lawyer owes an actionable duty of care to a non-client in the following circumstances:

1. the lawyer knows that a client intends as one of the primary objectives of the representation that the lawyer's services benefit the nonclient;

2. such. . . duty would not significantly impair the lawyer's performance of obligations to the client; and

3. the absence of such a duty would make enforcement of those obligations to the client unlikely. . . . [8]

A comment to this provision explains its applicability in the insurance-defense context: "a lawyer designated by an insurer to defend an insured owes a duty of care to the insurer with respect to matters as to which the interests of the insurer and insured are not in conflict, whether or not the insurer is held to be a co-client of the lawyer. . . ." (9) Several courts have followed the *Restatement*'s rationale for permitting claims by insurers against defense counsel. (10)

The Impact of Conflicts of Interest on the Tripartite Relationship and Beneficiary Theories

Both the tripartite relationship and the beneficiary theories depend on the existence of a duty of care running from defense counsel to the carrier. This duty may be disrupted when a conflict of interest threatens the firm's ability to represent the insured, for example, when a coverage issue exists. (11)

Conflicts may arise from reservation of rights as to coverage defenses, and from exposure excess of limits, among other instances. For example, Alabama generally applies the tripartite relationship rule, but in reservation of rights cases, the defense counsel's *sole* client is the insured, *and* both the carrier and defense counsel owe enhanced duties to the insured. (12) In that instance, neither the tripartite relationship nor the beneficiary doctrines would create a duty to the carrier. That would leave subrogation as the only vehicle for a malpractice action.

The Third Theory of Liability: Subrogation

The third rationale for permitting a carrier to pursue a claim against defense counsel is subrogation. Subrogation arises when the carrier pays an obligation of the insured caused by third parties; here, the defense counsel. A key requirement is that the insurer pay the claim on behalf of the insured. (13) However, some courts have allowed subrogation suits to proceed as a "contingent claim" when, for example, the carrier has not yet paid the judgment but an appeal is pending and allowing the claim would further judicial economy. (14)

Courts have cited numerous policy grounds for permitting subrogation claims against defense counsel:

- Permitting an insurer to sue the firm it retains can "promote[ ] enforcement of [the firm's] obligations to the insured." (15)

- "[B]oth insurer and insured often share a common interest in developing and presenting a strong defense to a claim that they believe to be unfounded as to liability, damages, or both." [16]
- The insurer, rather than the insured, is typically required to satisfy a judgment resulting from the firm's negligence; therefore, the insured rarely has any incentive to bring a claim for malpractice against the retained firm. [17]
- Permitting subrogation "to a party with an interest in the claim who has 'the time, energy and resources to bring the suit' [such as an insurer] may be the most efficient way, in some instances, to realize the value of such a claim." [18]
- The failure to recognize a cause of action by the insurer, therefore, serves the interests of no one except the entity that committed the malpractice. [19]
- "The lawyer's services are ordinarily intended to benefit both the insurer and the insured when their interests coincide." [20]

Accordingly, despite the fact that "the tripartite relationship between insured, insurer, and defense counsel contains rife possibility of conflict," [21] "nearly all courts have concluded that the harms-benefits calculus weighs in favor of recognizing an insurer's [subrogation] legal malpractice claim against the lawyer or law firm it retains to represent an insured." [22] Indeed, courts have recognized that a subrogation theory raises fewer legal and policy questions than a direct cause of action, as it respects the attorney-client relationship between the insured and defense counsel and maintains the focus on the counsel's duties to the insured. [23] As the Supreme Court of Michigan observed,

> [t]o hold that an attorney-client relationship exists between insurer and defense counsel could indeed work mischief, yet to hold that a mere commercial relationship exists would work obfuscation and injustice. The gap is best bridged by resort to the doctrine of equitable subrogation to allow recovery by the insurer. Equitable subrogation best vindicates the attorney-client relationship and the interests of the insured, properly imposing the social costs of malpractice where they belong. Allowing the insurer to stand in the shoes of the insured under the doctrine of subrogation best serves the public policy underlying the attorney-client relationship. [24]

A recent example of a court permitting an insurer to pursue a claim against defense counsel on a subrogation theory is found in the Florida Supreme Court's decision in *Arch Insurance Co. v. Kubicki Draper, LLP*. [25] Prior to this decision, the high court had not spoken on the issue, leaving other courts to "guess" as to how it might address it. [26] In that case, Arch Insurance retained the Kubicki Draper firm to defend its insured, Spear Safer, in litigation brought by a court-appointed receiver for one of Spear Safer's former clients. [27] Prior to trial, the receiver's claims against Spear Safer were settled within the Arch policy limits for $3.5 million. [28] Arch then sued the Kubicki firm, claiming Kubicki failed to timely raise a statute of limitations defense on behalf of Spear Safer and that this failure substantially increased the settlement cost. [29]

Arch pursued a wide range of claims against Kubicki, alleging legal malpractice, breach of fiduciary duty, subrogation, assignment, third-party beneficiary, and breach of contract. [30] Kubicki filed a motion for summary judgment, alleging Arch lacked standing to sue it because it lacked privity of contract with Kubicki and was not in an attorney-client relationship with it. [31] Arch, however, responded that it was in privity with Kubicki and that it also was a third-party beneficiary of the attorney-client relationship between Kubicki and Spear Safer. [32] Arch also contended that it was entitled to pursue Spear Safer's claims against Kubicki by virtue of the subrogation rights afforded it by Arch's insurance policy. [33] The trial court granted Kubicki's motion for summary judgment, finding that Arch was not in privity with Kubicki. [34] The Fourth District Court of Appeals affirmed, and Arch appealed to the Florida Supreme Court. [35]

The Florida Supreme Court reversed. While the court agreed that Kubicki was not in privity with Arch, Arch nevertheless had standing to pursue a malpractice claim against Kubicki by virtue of its subrogation rights. [36] The court cited the contractual subrogation language in Arch's policy:

> To the extent of any payment under this Policy, we [Arch] shall be subrogated to all your [Spear Safer] rights of recovery therefor against any person, organization, or entity and you shall execute and deliver instruments and papers and do whatever else is necessary to secure such rights. You shall do nothing after any loss to prejudice such rights. [37]

In the court's view, this language was sufficient to provide Arch with Spear Safer's rights against Kubicki, thus enabling Arch to pursue a direct claim against Kubicki. "Where an insurer has a duty to defend and counsel breaches the duty owed to the client insured, contractual subrogation

permits the insurer, who—on behalf of the insured—pays the damage, to step into the shoes of its insured and pursue the same claim the insured could have pursued." (38)

The court reached this conclusion even in light of the fact that it had previously prohibited, on the basis of public policy, the assignment of malpractice claims. But, citing prior precedent, the court noted that "there are exceptions when public policy is not applicable." (39) The public policy behind prohibiting assignment is "mainly concerned about creating a market for legal malpractice claims." (40) No such concern is presented by recognizing an insurer's subrogation rights, particularly given the insurer is "not a 'stranger' to the attorney" and "[t]o the contrary, the insurer is trying to recover money it paid to its insured from the lawyer it hired." (41) The court noted that the lawyer was on notice of the subrogation rights in the insurance policy and, moreover, "Florida public policy does not support shielding the law firm from accountability for its professional malpractice." (42) The court also recognized Florida's public policy interest in keeping insurance rates low, noting that "subrogation exists to hold premium rates down by allowing the insurers to recover indemnification payments from the tortfeasor who caused the injury." (43)

While *Arch Insurance* is consistent with the majority of jurisdictions, which allow insurer suits against defense counsel for malpractice under varying theories, it is emblematic of courts' distaste for reaching any conclusion that would create duties running from the defense counsel to the insurer. Again, by recognizing that Arch's only recourse was to exercise its subrogation rights, the Florida Supreme Court advanced the public policy goal of vitiating attorney malpractice and keeping insurance rates down, while ensuring that defense counsel do not have to look over their shoulders to fulfill additional duties to insurers while defending insureds.

Contractual (Legal) versus Equitable Subrogation

A subrogation claim originates from the insurance contract, not the attorney-client relationship. (44) Many courts allow subrogation based on subrogation clauses in the policies: "[A]fter an insurance company has paid a loss on behalf of its insured under a policy containing a subrogation of rights clause, it is entitled to subrogation by express contract rights." (45)

Equitable subrogation, on the other hand, arises by operation of law from paying the obligation owed by an insured. (46) Some courts are less likely to permit an insurer to pursue claims against defense counsel through equitable subrogation alone.

Arguably, equitable subrogation poses a greater threat to the duty of confidentiality because it arises out of equitable principles and not specific contractual language to which the insured has already agreed. An insured may thus be caught blind-sided by the operation of an equitable doctrine that permits its attorney to breach confidences. (47)

The concern is that equitable subrogation invades the professional confidential relationship or may introduce conflicts into the relationship:

This court need search neither long nor wide to identify *significant potential conflicts of interest inherent in the relationship* between an insured and its excess carrier that would intrude on the special duty an insured's counsel owes to the client alone. It is not difficult to envision a situation where the interests of the insured and excess insurer could diverge in a medical malpractice action, though the two would not traditionally be adversaries in the litigation. A crossroads may arrive during the course of a suit where either the insured or excess carrier wishes to settle, yet the other party desires continued pursuit of a vigorous defense. In such an antagonistic situation, an attorney with a contractual obligation to the insured and a judicially-imposed obligation to the coverage carrier may face an *irreconcilable conflict of interest*. Not only would the attorney's loyalty to the insured be dissipated, but counsel might be open to a malpractice action by his client in fact. (48)

This concern is not universal. For comprehensive arguments supporting equitable subrogation, see *TIG v. Chicago Insurance Co.* (49)

The final word may be summed up by the court in *General Security Insurance Co. v. Jordan, Coyne & Savits, LLP*: "Accordingly, despite sharp doctrinal differences regarding the relationship between the insurer and the firm it retains, nearly all jurisdictions in the United States permit some form of legal malpractice action by an insurer against the firm it retains to defend an insured." (50)

Practical Considerations

Irrespective of whether they *can* pursue a malpractice claim or the theory used to pursue claims against defense counsel, carriers should bear in mind some key considerations in determining whether to pursue such claims in the first place. First, a carrier must be willing to "burn the house down." Often defense counsel are on insurers' panels and thus handle many claims for the insurer. A suit will likely permanently rupture what may have been a long and successful relationship, not

only with the particular attorney or attorneys who handled the claim but also with the firm. If defense counsel are handling other claims for the carrier, a claim against defense counsel could chill or otherwise impair communication in connection with the other pending claims and may require those claims be moved to new defense counsel, which could be expensive, time-consuming, and strategically disadvantageous. Before pursuing such a claim, carriers should carefully evaluate the law in the jurisdiction where suit is to be brought. If, for example, the jurisdiction permits only claims against defense counsel under a subrogation theory and there is no clear contractual subrogation clause, an equitable subrogation theory could be insufficient to give the insurer standing. If a carrier is considering pursuing a claim against defense counsel, it also should promptly undertake efforts to assert its rights to ensure that those rights are not impaired by its insured. Finally, a carrier should exercise caution, as legal malpractice claims are disfavored and a carrier will not be given any favors by courts (or even juries) in pursuing such claims.

Stay tuned for Part II of this two-part article, which will address the related question of whether and how an insurer can recoup defense costs from its insured. Part II will be published in the next issue of *Coverage*.

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This article is jointly authored through a collaborative process by attorneys representing policyholders and insurance carriers. The opinions expressed herein do not necessarily reflect the opinions of each of the authors, their firms, or their clients.

Endnotes

ENTITY:

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