

Legal Malpractice Claims by Insurers Against Defense Counsel

Gray T. Culbreath – Gallivan, White & Boyd, P.A.

Although legal malpractice claims have existed for over a century, a growing trend which began in the 1980's is the legal malpractice claim by an insurer (primary or excess) against defense counsel retained to defend its insured. Although such a claim is not universally recognized, whether an insurer is entitled to recover for malpractice committed by defense counsel retained to defend the insured has begun to draw more attention. This paper will examine the basis for these claims, the legal theories they are based upon as well as the types of claims that may exist and emerging issues regarding the same.

As a starting point, it is helpful to consider some of the fact patterns which have given rise to legal malpractice claims against insurance defense counsel. These include:

- (1) Failure to assert affirmative defenses such as comparative fault or the statute of limitations.
- (2) Failing to determine the existence of other insurance.
- (3) Runaway verdict.
- (4) Failure to properly investigate the case.
- (5) Failure to respond to Request to Admit in a timely fashion.
- (6) Failure to accurately assess verdict ranges.
- (7) Failure to retain experts.
- (8) Failure to report a proper value or exposure to the insurer.
- (9) Sanctions for discovery abuse which lead to either the striking of pleadings or an adverse verdict.
- (10) Failing to answer a complaint and allowing a default to occur.
- (11) Failing to join a party with liability.
- (12) Sanctions resulting in the exclusion of a witness.
- (13) Failing to assert counterclaims.
- (14) Failing to transmit a settlement offer.

These scenarios are but a handful of the fact patterns presented by the reported cases. By the author's count, over 50 different insurers have brought legal malpractice actions against defense counsel.

The identity of the Plaintiff ranges from primary to excess carriers, even where there is no direct relationship between the carrier and counsel. In addition the theories of liability and defenses vary widely. See e.g. *Ironshore Europe DAC v. Schiff Hardin, L.L.P.*, No. 18-40101 (5th Cir. January 2, 2019). These other scenarios will be explored in greater detail later in the paper.

The majority of states that have considered the issue allow an insurer to sue defense counsel. See *Sentry Select Insurance Company v. Maybank Law Firm, LLC*, 218 WL2423694 (SC 2018). According to the *Sentry* court, 24 states allow an action by an insurer against defense counsel, which represents a majority of states which have considered the issue. However, while courts

“generally recognize such a cause of action, they differ markedly on the theory of liability under which such a claim may be brought.” *General Sec. Ins. Co. v. Jordan, Coyne & Savits, LLP*, 357 F.Supp. 2d 951, 956 (E.D. Va. 2005). The *Coyne* court and numerous commentators have noted while a cause of action is generally recognized, the theory of liability upon which such a claim may be brought differs among the states. The next section of the paper will examine the theories upon which a legal malpractice claim against defense counsel may be based. These theories differ and continue to emerge.

II. Theories of Liability

Since the early 90s, various theories of liability have arisen to subject defense counsel to legal malpractice by an insurer or affiliated entity.¹ Among the United States, four principle theories have emerged as a basis for liability. These are:

- (1) Tripartite relationship theory
- (2) Equitable subrogation theory
- (3) Third-party beneficiary theory
- (4) Restatement theory.

¹ This paper will also examine later the concept of assignment, which is generally disfavored as a basis upon which to premise a legal malpractice action.

Whether a legal malpractice claim will be allowed and under which of these theories depends largely on the examination of the relationship among the insurer, the insured, and defense counsel and the circumstances under which the attorney was retained. Those states which recognize the cause of action often cite to the lack of a motive by an insured to pursue a claim against counsel because they either suffered no damages or the damages were insufficient to motivate them to file suit.

A. The Tripartite Relationship Theory

Under the Tripartite Relationship Theory, courts recognize that among the insurer, the insured, and defense counsel, the insurer and the insured are co-clients of defense counsel in the absence of a conflict of interest.² Under this theory, an attorney hired by an insurer to defend an action against its insured owes fiduciary duties to both the insurer and the insured. As a result, when an insurer hires defense counsel as part of the insurance agreement with its insured, that defense counsel owes a duty of care to the insurer which will support an independent right of the insurer to bring a legal malpractice action for acts or omissions committed during that representation provided that the insured and the insurer do not have a conflict of interest. This theory of liability was first recognized in Illinois in a series of cases which held that defense counsel owes fiduciary duties to the insured as well as the insurer. See *Maryland Casualty Company v. Peppers*, 64 Ill. 2d 187, 355 N.E. 2d 24, 30-31 (1976); *Mobile Oil Corp. v. Maryland Casualty Company Co.*, 288 Ill. App. 3d 743, 224 Ill. Dec. 237, 246, 681 N.E. 2d 552, 561 (1997); *Cincinnati Co. v. West AM. Ins. Co.*, 287 Ill. App. 3d 505, 223 Ill. Dec. 147, 152 679 N.E. 2d 91, 96 (1997).

² Most courts hold that the existence of a conflict of interest is sufficient to negate the insurer's ability to pursue a legal malpractice action.

It should be noted that there are various approaches and/or models of the tripartite relationship. Courts and scholars have recognized a number of versions of the ethical and fiduciary relationships among, insurer, insured and defense counsel: the one-client model, the two-client model, the modified two-client model, and the contractual approach set forth in the Restatement (Third) of the Law Governing Lawyers. If faced with the defense of such a legal malpractice claim, it is important to know which approach, if any, your state has adopted.

Courts have used differing approaches to determine whether the Tripartite Relationship exists. Compare *Marten Transport, Ltd. v. Hartford Specialty Co.*, 533 N.W. 2d 452 (Wi. 1995) with *Pine Island Farmers Co-Op v. Erstad & Riemer, PA*, 649 N.W. 2d 444 (Minn. 2002). Hence, the importance of determining the rule in your state.

B. The Equitable Subrogation Approach

Under the equitable subrogation approach, an insurer may assert its insured's claims for malpractice against counsel retained to defend the insured. Equitable subrogation is not a theory but instead a limited exception to the privity of contract requirement. The doctrine of equitable subrogation provides that an insurer who pays a loss is thereby placed by operation of law in the position of its insured such that the insurer may recover from a third party tortfeasor whose negligence or wrongful act caused the loss. An insurer's right to equitable subrogation is based on two principles:

- (1) The third party tortfeasor should reimburse the insurer for payments the insurer makes to cover the loss; and
- (2) The insured should not be allowed to recover twice for the same loss, that is, to recover from the tortfeasor after recovering from the tortfeasor.

These cases often occur where no legal remedy is allowed or applied or where the facts of a case suggest allowing direct or third-party beneficiary liability would create a conflict ridden

setting, but an insurance carrier may nonetheless proceed on a claim based on equitable subrogation. The subrogation is based on the equitable doctrine that one who has indemnified another in pursuit of the indemnitor's obligation to do so is entitled to redress held by the party indemnified against the person causing the loss. See *National Union Insurance Company v. Dowd & Dowd, PC*, 2 F.Supp. 2d 1013 (N.D. Ill. 1998). The policy underlying equitable subrogation is based on the premise that injustice should be prevented and the economic burden associated with the malpractice should be shifted to the party responsible for the loss. Courts which permit a legal malpractice action against defense counsel under equitable subrogation hold that it would be inequitable to place the burden of legal malpractice on the insurer "allowing a negligent attorney to escape the consequences of his misconduct, merely because the insured lacks the economic incentive to sue." *Id.* at 1024. See also *Ace Am. Ins. Co. v. Sandberg*, 900 F. Supp. 2d 887 (S.D. Ill. 2012).

In *Atlanta Int'l. Ins. Co. v. Bell*, 438 Mich. 512, 521-522, 475 N.W. 2d 294, 303-304 (1991), the Michigan Supreme Court held:

Equitable subrogation has been described as a "legal fiction" that permits one party to stand in the shoes of another. The doctrine is eminently applicable under the facts of this case. A rule of law expanding the parameters of the attorney-client relationship in the defense counsel – insurer context might well detract from the attorney's duty of loyalty to the client in a potentially conflict ridden setting. Yet to completely absolve a negligent defense counsel for malpractice liability would not rationally advance the attorney-client relationship. Moreover, defense counsel's immunity from suit by the insurer would place the loss for the attorney's misconduct on the insurer. The only winner produced by an analysis precluding

liability would be the malpracticing attorney. Equity cries out for application under such circumstances.

The conditions required for equitable subrogation to apply are:

- (1) a special relationship must exist between the client and the third party in which the potential for conflicts of interest is eliminated because the interests of the two merge with regard to the particular issue where legal malpractice is alleged,
- (2) the third party must lack any other available remedy, and
- (3) the third party must not be a “mere volunteer,” i.e., the damage must have been incurred as a consequence of the third party’s fulfillment of a legal or equitable duty the third party owed the client. *Id.* at 519-520.

Notwithstanding the many jurisdictions which have analyzed equitable subrogation, some courts refuse to recognize this theory. The seminal case rejecting the equitable subrogation theory is *Goodley v. Wank & Wank, Inc.*, 62 Cal. App. 3d 389, 133 Cal. Rptr. 83 (2d. Dist. 1976); see also 50 A.L.R. 6th 63, “Right of Insurer to Assert Equitable Subrogation Claim Against Attorney for Insured on Grounds of Professional Malpractice”

C. The Third-Party Beneficiary Theory

Some courts have allowed a legal malpractice claim against defense counsel on the theory that an insurer has a right of action against defense counsel based upon the conclusion that the insurer was an intended third-party beneficiary of the relationship between the insured and the attorney. See *Grinnell Mut. Reinsurance Co. v. Franks, Gerkin and McKenna*, 2000 U.S. Dist. LEXIS 12636 (N.D. Ill. 2000). A third-party beneficiary contract typically arises when two parties enter into an agreement with the intent to confer a direct benefit on a third party, allowing the third party to sue on the contract despite a lack of privity. This theory is often asserted by a primary insurer for legal malpractice against a lawyer that it did not retain, i.e., defense counsel retained by the insured and not the insurer.

D. The Restatement Theory

Another theory of liability upon which courts have found defense counsel liable for legal malpractice is found in the Restatement (Third) of the Law Governing Lawyers. Section 51, “Duty of Care to Certain Non-Clients” provides in relevant part:

For the purposes of liability under § 48, a lawyer owes a duty of care within the meaning of § 52 in each of the following circumstances:

- (3) to a non-client when and to the extent that:
 - (a) the lawyer knows that a client intends as one of the primary objectives of the representation that the lawyer’s services benefit the non-client;
 - (b) such a duty would not significantly impair the lawyer’s performance of obligations to the client; and
 - (c) the absence of such a duty would make enforcement of those obligations to the client unlikely.

Jurisdictions which follow the logic of the Restatement have held that a lawyer retained 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 the insured are not in conflict whether or not the insured is a co-client of the lawyer. While the Restatement theory closely resembles the third-party beneficiary theory, comment g to Section 51 fleshes out in greater detail the basis for this approach:

g. A liability insurer’s claim for professional negligence. Under Subsection (3), 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 the insured are not in conflict, whether or not the insurer is held to be a co-client of the lawyer (see § 134, comment f). For example, if the lawyer negligently fails to oppose a motion for summary judgment against the insured and the insurer must pay the resulting adverse judgment, the insurer has a claim against the lawyer for any proximately caused loss. In such circumstances, the insured and the insurer, under the insurance contract, both have a reasonable expectation that the lawyer’s services will benefit both insured and insurer. Recognizing that the lawyer owes a duty to the insurer promotes enforcement of the lawyer’s obligations to the insured. However, such a duty does not arise when it would significantly impair, in the circumstances of the representation, the lawyer’s performance of obligations to the

insured. For example, if the lawyer recommends acceptance of a settlement offer just below the policy limits and the insurer accepts the offer, the insurer may not later seek to recover from the lawyer on a claim that a competent lawyer in the circumstances would have advised that the offer be rejected. Allowing recovery in such circumstances would give the lawyer an interest in recommending rejection of a settlement offer beneficial to the insured in order to escape possible liability to the insurer.

The annotations to comment g set forth a host of cases which deal with the issues found in the Restatement view. These cases reflect the logic of the Restatement that find that insurers, although not clients, are owed a duty of care, which allows them to bring suit for legal malpractice. See e.g. *State and County Mut. Fire Ins. Co. v. Young*, 490 F.Supp. 2d 741 (N.D. W. Va., 2007); *Paradigm Ins. Co. v. Langerman Law Offices, P.A.*, 200 Ariz. 146, 24 P. 3d 593 (2001); *Home Indem. Co. v. Lane Powell Moss Miller*, 43 F 3d 1322 (9th Cir. 1995); *Unigard Ins. Group v. O’Flaherty Belgum*, 38 Cal. App. 4th 1229, 45 Cal. Rptr. 2d 565 (1995) and *Atlanta Int’l. Ins. Co. v. Bell*, supra. These cases illustrate the application of the Restatement theory to a legal malpractice suit brought by a non-client insurer against the attorney it hired to represent its insureds. Simply stated, regardless of its attorney-client status, “an insurer should be accorded standing to assert a claim for appropriate relief from the lawyer for financial loss proximately caused by “the attorney’s professional negligence...because and to the extent that the insurers directly concerned in the matter financially.” *Paradigm*, 24 p. 3d at 599-600 (quoting restatement).

III. Defenses to Legal Malpractice Claim

A review of the precedent from across the country has identified at least two theories upon which courts have rejected the adoption of a legal malpractice claim against defense counsel. While other defenses may exist, these two are the most recognized.

A. No Attorney-Client Relationship Exists Between Defense Counsel or Insurer

Under this defense, an attorney-client relationship in the third-party insurance context only exists between the insured and defense counsel and generally refuses to apply the tripartite relationship theory and/or the third-party beneficiary theory. Courts typically refuse to recognize an attorney client relationship between insurer and defense counsel involving fact patterns which include: (1) the exposure exceeds the coverage limit, (2) the insurer is issued a reservation of rights or (3) the insurer does not have an obligation to indemnify the insured because of policy language. See e.g. *In re: Ugrin, Alexander, Zadick & Higgins, P.C.*, 2 P. 3d 806, 813 (Mont. 2000).

B. Legal Malpractice Claims Are Not Subject to Assignment

As noted previously in this paper, one of the earliest theories for legal malpractice claims against defense counsel came from the concept of assignment. However, most jurisdictions hold a claim for legal malpractice is not assignable. Those jurisdictions applying a blanket prohibitional and assigned legal malpractice claims are: Arizona, *Botma v. Huser*, 39 P.3d 538 (Ariz. Ct. App. 2002); Colorado, *Roberts v. Holland & Hart*, 857 P.2d 492 (Colo. Ct. App. 1993); Florida, *Law Office of David Stern v. Sec. Nat'l. Servicing Corp.*, 968 So.2d 962 (Fla. 2007); Indiana, *Picadilly, Inc. v. Raikos*, 582 N.E.2d 338 (Ind. 1991); Kansas, *Bank IV Wichita, National Association v. Arn, Mullins, Unruh, Kuhn & Wilson*, 827 P.2d 758 (Kan. 1992); Kentucky, *Davis v. Scott*, 320 S.W.3d 87 (Ky. 2010); Louisiana, *Taylor v. Babin*, 13 So.3d 633 (La. Ct. App. 2009); Michigan, *Joos v. Drillock*, 338 N.W.2d 736 (Mich. Ct. App. 1983); Minnesota, *Wagener v. McDonald*, 509 N.W.2d 188 (Min. Ct. App. 1993); Missouri, *VinStickers, LLC v. Stinson Morrison Hecker*, 369 S.W.3d 764 (Mo. Ct. App. 2012); Nebraska, *Earth Science Laboratories, Inc. v. Adkins & Wondra, PC*, 523 N.W.2d 254 (Neb. 1994); Nevada, *Chaffee v. Smith*, 645 P.2d 966 (Nev. 1982); New Jersey, *Alcman Servs Corp. v. Samuel H. Bullock, PC*, 925 F.Supp. 252 (D.N.J. 1996) Aff'd. 124 F.3d 185

(3d Cir. 1987); North Carolina, *Revolutionary Concepts, Inc. v. Clements Walker, PLLC*, 774 S.E.2d 130 (N.C. Ct. App. 2013); Tennessee, *Can Do, Inc. Pension and Profit Sharing Plan v. Manier, Herod, Hollabaugh & Smith*, 922 S.W.2d 865 (Ten. 1996); Virginia, *MNC Credit Corp. v. Sickels*, 497 S.E.2d 331 (Va. 1998); and West Virginia, *Delaware CWC Liquidation Corp. v. Martin*, 584 S.E.2d 473 (W. Va. 2003). See also *Gen. Sec. Ins. Co. v. Jordan Coyne & Savits, LLP*, 357 F.Supp. 2d 951, 958 Fn. 19 (which collects cases from other jurisdictions holding legal malpractice claims unassignable). See also *Skipper v. Ace Property and Casualty Co.*, 413 SC 33, 775 S.E. 2d 54 (2015) (holding that a legal malpractice claim is not assignable to plaintiff's counsel in settlement of a claim). This prohibition of the assignment of legal malpractice claims is based on public policy grounds, such as the risk of jeopardizing the confidential fiduciary relationship between attorney and client which is implicit in many of the other theories upon which a legal malpractice claim is allowed. In cases in which assignment has been rejected, these courts usually reject the insurer's standing as an equitable subrogee as well.

In addition to those jurisdictions that apply blanket prohibition to the assignment of legal malpractice claims, five other jurisdictions also recognize that assignment of legal malpractice claims, in and of themselves, violate public policy. However, these jurisdictions allow legal malpractice claims to be transferred as part of a larger commercial transaction, such as a stock or asset purchase. These jurisdictions include: California, *White Mountain Reinsurance Company of America v. Borton Petrini, LLP*, 163 Cal. Rptr. 3d 912 (Cal. Ct. App. 2013); District of Columbia, *Richter v. Analex Corp.*, 940 F.Supp 353 (D.D.C. 1996); Idaho, *Saint Lukes Magic Valley Regional Medical Center v. Luciani*, 154 Idaho 37, 293 P.3d 661 (Idaho 2013); Illinois, *Learning Curve International v. Seyfarth Shaw, LLP*, 912 N.E.2d 1073 (Ill. Ct. App. 2009); and Rhode Island, *Cerberus Partners, LP v. Gadsby & Hannah*, 728 A.2d 1057 (R.I. 1999).

In the event of an assignment claim in your case, carefully evaluate whether or not your state has rejected such a claim or whether public policy reasons would cause your state to reject it.

IV. Legal Malpractice Scenarios versus Defense Counsel

The majority of the cases discussed thus far deal with a situation in which the primary insurer which retained defense counsel has brought a legal malpractice action. However, the types of claims and the insurer which brings them vary widely.

A. Claims by the Excess Carrier

Excess insurers have sued defense counsel on both direct duty and equitable subrogation theories. In addition, a subissue not fully discussed in this presentation are circumstances noted in the case law in which suit by the primary carrier against defense counsel is a condition placed upon it by the excess carrier to participate in the settlement. An excellent discussion of this issue is found in *4 New Appleman on Insurance* § 24.08.

An example of a claim brought by an excess carrier is *National Fire Insurance Co. v. Dowd & Dowd*, supra. There, the verdict exceeded the primary limit and the excess carrier brought suit for malpractice. Despite a motion to dismiss, the lawsuit was allowed to go forward. This should be compared with *Continental Casualty Co. v. Pullman, Comley, Bradley & Reeves*, 929 F 2d 103 (2d Cir 1991) in which the court declined to allow an excess insurer to sue on an equitable subrogation theory.

The law regarding excess carriers' rights against defense counsel is still developing. As a result, counsel should be prepared to analyze any of the theories set forth previously in this paper.

B. Other Scenarios

Other types of claims that arise in the excess context include a claim by the excess carrier versus the primary carrier for bad faith associated with defense counsel's actions and the primary

carrier third parties and defense counsel. A similar claim is where the excess carrier sues both the primary carrier and defense counsel. Finally, the last potential claim is that by a primary or an excess carrier against defense counsel retained by the insured directly.

V. The Restatement of the Law of Liability Insurance

The controversial Restatement of the Law of Liability Insurance contained from the outset a provision dealing with insurer's liability for the malpractice of its defense counsel. As originally drafted, the proposed Section 12 of the Restatement set forth two alternative conditions under which a liability insurer exercising the right to defend a claim is subject to liability for a breach of professional obligation by defense counsel. The first condition involves circumstances in which defense counsel was an employee of the insured (i.e. staff counsel) and the second condition was that the insured negligently selected or supervised defense counsel. This included a provision which addressed defense counsel with inadequate malpractice insurance. The initial versions of Section 12 introduced vicarious liability as a basis to find an insurer liable.

As the Restatement evolved to its final draft, there was considerable pushback over the vicarious liability provisions found in the initial drafts. However, as late as December of 2017 the drafts of Section 12 contain specific reference to vicarious liability notwithstanding the pushback from numerous groups regarding the same. Ultimately the vicarious liability provisions were removed.

The proposed final draft No. 2 of the controversial Restatement of the Law of Liability Insurance was approved by the American Law Institute at its May 2018 meeting. Included in the drafting was a revised Section 12, which imposes liability on insurers for the malpractice of defense counsel. The current Section 12 found in final draft 2, "Liability of Insurer for Conduct of Defense" provides:

An insurer exercising the right to defend a legal action is subject to liability for the negligence or other breach of professional obligation of defense counsel and related service providers in relation to the action if:

- (1) Defense counsel is an employee of the insurer acting within the scope of employment; or
- (2) The insurer negligently selects or supervises defense counsel, including by retaining counsel with inadequate liability insurance.

This provision has evolved significantly since it was first introduced in 2015 and the comments and reporter's notes discuss the issues associated with vicarious liability. Assuming this to be the final version, with the accompanying comments and reporter's notes, the Restatement may provide yet another basis for liability. Under such a scenario, defense counsel might be subject to a third party claim by the insurer.

CONCLUSION

Legal Malpractice claims by insurers against defense counsel are now commonplace, although not uniformly recognized in all 50 states. If faced with such a claim, a law firm and its defense counsel needs to understand the law of their state as it relates to the tripartite relationship, the attorney client relationship, equitable subrogation and third party beneficiaries. Counsel should also be aware of the Restatements that potentially create a cause of action and whether or not it is recognized in your jurisdiction.