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Keep Your Balance on the Three-Legged Stool: Challenges Facing the Tripartite Relationship

I. **The Liability Insurance Policy -** Liability insurance is purchased to protect against two related but distinct risks of loss: the risk of paying to defend a lawsuit and the risk of having to pay damages to a plaintiff. Most policies cover both, obligating the insurance company to pay the costs of defense and to indemnify the insured for judgments and settlements up to a specified limit. Similarly, most policies give the insurance company the right to defend the case while requiring the insured to cooperate with the defense. Typically, this type of arrangement will allow the insurance company to select counsel and to supervise litigation and settlement strategy. When coverage questions arise, the interest of the insurance company and the insured are no longer completely aligned creating the opportunity for conflict and confusion as to the respective roles of the parties.

A. **The Duty to Defend** – Not all policies have a duty to defend. Some solely require a duty to indemnify. The duty to defend is triggered when a claim is made against one or more covered insureds involving alleged acts or omissions that fall within the coverage parameters of the applicable insurance policy. It does not matter if the allegations being made are false and/or frivolous. The mere possibility that a claim covered under the policy is being pursued is sufficient to impose the duty to defend. The duty to defend is very broad and arises even if the claim is eventually dismissed. If a duty to defend is triggered, both the primary and excess insurer may have a duty to defend depending on the policy language and the amount in question.

B. **The Duty to Indemnify** - The duty to indemnify is much narrower in scope and only comes into play if the claimant's allegations are proven at trial. In the absence of any bad faith claims, an insurer only has a duty to indemnify for settlement or judgment amounts up to the limit of liability set for in the insured's policy.

II. **Defining the Tripartite Relationship and Establishing the Swim Lanes-** Only the company and the insured are parties to the liability contract. Consequently, the liability contract *directly* governs only the relationship between the company and the

insured. It does not *directly* bind defense counsel or affect defense counsel's professional obligations. Defense counsel's relationships with the company and the insured (the tripartite relationship) comes into existence when the attorney agrees to handle a representation at the company's request. Thus, the tripartite relationship stems from the insurer's duty to defend the insured against claims asserted by third parties. While not *directly* governed by the liability policy, the relationship is governed by a complex system of case law, statutory law, contracts, and ethical rules. Coverage Counsel are not traditionally considered part of the "tripartite relationship." Nonetheless, coverage counsel (or in some situations monitoring settlement counsel) will interact with and in many instances step into negotiations on behalf of the insurance company for settlement purposes. These relationships, as they exist in most jurisdictions can be depicted as follows:

<table>
<tr><td colspan="2" rowspan="2">WHO IS THE CLIENT?
(Majority View)</td><td colspan="2">INSURED</td></tr>
<tr><td>NON-CLIENT</td><td>CLIENT</td></tr>
<tr><td rowspan="2">INSURANCE COMPANY</td><td>NON-CLIENT</td><td>NO COUNSEL</td><td>C
Independent Counsel or Cumis Counsel</td></tr>
<tr><td>CLIENT</td><td>B
Coverage Counsel or Settlement Counsel</td><td>A
Insurer Appointed Defense Counsel</td></tr>
</table>

A. Insurer Appointed Defense Counsel – As depicted in the table above, most jurisdictions hold that an insurer-appointed defense counsel has two clients, the insured and the insurer, and owes the full spectrum of attorney-client duties to them both. A minority of jurisdictions, consider the insured as the only client, or the primary client, and at least one jurisdiction considers the insured the client and the insurance company "sometimes" the client depending on circumstances:

- **Insured is Only Client:** In Texas, Montana, Michigan, Connecticut, and Tennessee the law is clear that the policyholder is the only client.

See Safeway Managing General Agency, Inc. v. Clark & Gamble, 985 S.W.2d 166, 168 (Tex.App.-San Antonio 1998) (no attorney-client relationship exists between an insurance carrier and the attorney it hired to defend one of the carrier's insureds); *Bradt v. West*, 892 S.W.2d 56, 77 (Tex.App.-Houston [1st Dist.] 1998); *State Farm Mut'l Auto Ins. Co. v. Traver*, 980 S.W.2d 625-27 (Tex.1998) (the attorney owes unqualified loyalty to the insured). See also e.g. *In Re Rules of Professional Conduct and insurer Imposed Billing Rules and Procedures*, 2 P.3d 806 (Mont.2000); *Atlanta Int'l Ins. Co v. Bell*, 475 N.W.2d 294 (Mich.1991); *Metropolitan Life Ins. Co. v. Aetna Cas. & Sur. Cor*., 730 A.2d 51 (Conn.1999). *Givens v. Mullikin ex rel. Estate of McElwaney*, 75 S.W.3d 383 (Tenn. 2002) *superseded by statute on other grounds* in *Willeford v. Klepper* 597 S.W. 3d 454 (Tenn. 2020).

- **Insured is Primary Client:** Florida, Pennsylvania, South Dakota, and West Virginia, describe the relationship to defend as being primary to the insured. *See, FL BAR Rule* 4-1.7(e) (Upon undertaking the representation of an insured client at the expense of the insurer, a lawyer has a duty to ascertain whether the lawyer will be representing both the insurer and the insured as clients, or only the insured, and to inform both the insured and the insurer regarding the scope of the representation). *See also, CAMICO Mut. Ins. Co. v. Heffler, Radetich & Saitta, LLP*, 2013 WL 315716 (E.D. Pa. 2013) (Where an insurance company funds a defense, the insurance company "may be but is not always" a co-client of the insured). *See, also, St. Paul Fire & Marine Ins. Co. v. Engelmann*, 639 N.W.2d 192, 200 (S.D. 2000); *Barefield v. DPIC Cos., Inc.*, 600 S.E.2d 256 (W. Va. 2004).

B. Coverage Counsel are hired by the carrier and advocating on behalf of the carrier. When coverage is wholly or partially in dispute, coverage counsel and the coverage adjuster may be in an adversarial position with the insured, who is being guided by the liability counsel paid by carrier. Coverage Counsel must protect the carrier from potential bad faith and should, if possible, attempt to globally resolve the coverage and liability claims in a manner which protects the insured and the insurance company's interests.

C. Independent Counsel v. Cumis Counsel – Independent Counsel are hired directly by the insured, and ***do not receive payment*** from the insurance company but are typically paid by the insured. An insurer should give the insured notice of his/her right to hire independent counsel to protect the insured's own interest especially in situations where policy limits may be exceeded. Cumis Counsel are independent counsel ***paid by*** the insurance company. The concept arose from the California decision in *San Diego Federal Credit Union v. Cumis Ins. Soc'y,* (1984) 162 Cal.App.3d 358 and was codified and limited in scope by California Civil Code §2860. Under the code,

a conflict of interest arises "when an insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim..." However, not every reservation of rights creates a conflict of interest (i.e., non-coverage of punitive damages). Rather, it depends on the nature of the coverage issue and whether it would impact defense counsel's ability to avoid affecting a coverage outcome.

D. The Coverage Adjuster and the Liability Adjuster

- **Splitting the File** – There is no legally established duty to split a file between a coverage adjuster and a liability adjuster. *See,* Plitt & Gross, *Splitting Claim Files: Managing the Concern for Conflicts of Interest through use of Insurance Company Conflict Screens*, 32 No. 6 Ins. Litig. Rep. 151 (Apr. 26, 2010) However, to protect attorney-client privileged information and to avoid future allegations of bad faith, it is strongly advised to segregate liability and coverage activities. *See, e.g., Employers Ins. Of Wausau v. Albert D. Seeno Constr. Co*., 945 F.2d 284, 286-88 (9th Cir. 1991); *Armstrong Cleaners, Inc. v. Erie Ins. Exchange*, 364 F.Supp.2d 797, 814 (S.D. Ind. 2005); *CHI of Alaska, Inc. v. Employers Reinsurance Corp*., 844 P.2d 1113 (Alaska 1993); *Nandorf, Inc. v. CNA Ins. Co*., 134 Ill. App.3d 134 (1st Dist. 1985); *United Servs. Auto Ass'n v. Bult*, 183 S.W.3d 181, 187-188 (Ky. Ct. App. 2003); *Travelers Indem. Co. v. Page & Assocs. Constr. Co*., 2002 WL 1371065, (Tex. App. Ct. June 25, 2002; *Givens v. Mullikin ex rel. Estate of McElwaney*, 75 S.W.3d 383 (Tenn. 2002) (*superseded by statute on other grounds, Willeford v. Klepper,* 597 S.W. 3d 454 (Tenn. 2020).

    1. **Splitting the File Does Not Obviate Need for Cumis Counsel Where Required -** The duty to provide Cumis counsel in a jurisdiction that requires it may not be satisfied by splitting the file. *See Armstrong Cleaners, Inc. v. Erie Ins. Exchange*, 364 F.Supp.2d 797 (S.D. Ind. 2005). In Armstrong, the court held that the insurer's assignment of two adjusters to separately handle the liability and coverage issues and the construction of a Chinese Wall between these two aspects of the case was not an adequate substitute for providing the insured with independent counsel. In so ruling, the court noted that even though the adjusters were prohibited from interacting, there was no indication that supervisors "or others who would exercise final authority" on settlement or trial strategy were prohibited from interacting. *Id.* at 805. In support of its ruling, the court further noted that the defense adjuster had a copy of the reservation of rights letter laying out the coverage issues.

- **Reservation of Rights –** Due to timing issues, an insurer may need to undertake its insured's defense with coverage questions still under investigation or unresolved because a declaratory judgment action must be filed. Under such circumstances insurers routinely send reservation of rights letters to deny coverage for indemnity and perhaps for a continuing defense while providing defense counsel. The insurer must specifically reference policy defenses which may ultimately be asserted and inform the insured of the potential conflict of interest its reservation creates. Another option for preserving an insurer's right to contest coverage is a non-waiver agreement by which the insured acknowledges that the insurance company does not waive its right to challenge coverage. As a practical matter, reservation of rights letters and non-waiver agreements achieve the same goal: they provide the insurer with some breathing room to investigate claims while simultaneously defending the insured without foregoing the right to later deny coverage.

- **Communications Between Adjusters -** In *Specialty Surplus Ins. Co. v. Second Chance, Inc*., 2006 WL 2459092, * 16 (W.D. Wash. 2006), the court did not object to communications between adjusters relating to purely "internal procedures." Care should be taken to avoid liability adjusters from receiving any information regarding coverage concerns and, in some states, even the reservation of rights. The segregation of coverage from liability issues may allow the insurance company to maintain attorney client privilege regarding coverage communications with coverage counsel. *See, Cedell v. Farmers Ins. Co. of Washington*, 295 P.3d 239 (Wash. 2013)

III. Conflicts and Tensions that Arise Within the Tripartite Relationship – Whether the defense attorney is deemed to represent both the carrier and the insured, solely the insured or primarily the insured, the reality of the matter is that the insurance company is paying the bills and expecting to control the cost of defense and indemnity. The insurance company's desire to end the litigation in the most cost-effective manner may not necessarily gel with the insured's desired outcome of vindication or, in some instances, in bringing compulsory counterclaims. Without question, defense lawyers owe to their insured client the utmost loyalty and zealous representation. However, such representation does not necessarily require that the lawyer run up excessive bills. The ability to focus on results, will often serve the best interests of all parties, by achieving a prompt resolution for the insured and by controlling costs for the third-party insurer. This at times, requires defense counsel to work with coverage counsel in crafting an effective strategy to bring the case to a resolution that protects both the insured and the insurance carrier.

A. Multiple Insureds – Adding complexity to the conflicts that may arise, consider the situation when a single defense attorney is representing

multiple defendants, one with coverage and one whose coverage is in dispute.

B. Multiple Theories of Liability – The existence of covered and non-covered claims may also give rise to conflicts of interest and care must be taken to ensure that defense counsel is not placed in a situation in which he/she is asked to attack claims which, if dismissed, would obliterate insurance coverage.

C. Declaratory Judgment Actions – If the carrier commences a declaratory judgment action while the liability action is proceeding, it is imperative that files be split, and information be walled off from the liability adjuster and defense counsel.

D. Right to Reimbursement of Defense Costs – The ability and/or the right to seek reimbursement of defense costs if a claim is ultimately determined to not be covered under the policy, will depend on the policy and the jurisdiction. In Texas, for example, an insurer that settles a claim against its insured when coverage is disputed may seek reimbursement from the insured should it later be determined that no coverage exists. The insurer may seek reimbursement if the insurer "obtains the insured's clear and unequivocal consent to the settlement and the insurer's right to seek reimbursement." *Excess Underwriters at Lloyd's v. Frank's Casing Crew & Rental Tool, Inc.*, 246 S.W.3d 42 (Tex. 2008); *Tex. Ass'n of Counties County Gov't Risk Mgmt. Pool v. Matagorda County*, 52 S.W.3d 128, 135 (Tex. 2000). However, unless an insurance policyholder's contract provides the insurer with the right to reimbursement of settlement proceeds following a coverage dispute, then the insurer cannot unilaterally create such a right.

IV. Case Study

A. *Myers v. Robertson*, 891 P.2d 199 (Alaska 1995) – Parents, as beneficiaries of their son's estate, who would receive any funds paid by their homeowners' liability insurance carrier arranged a suit by their son's estate against themselves. The insurer had a duty to defend and appointed counsel.

1. The parents testified in a way that was calculated to emphasize their negligence in the death of their son.
2. The insurer intervened in the action to highlight the conflict.
3. The court required the insurer to pay for independent counsel who nevertheless impeached the insureds' testimony with exculpatory statements the parents had previously made to the police.

B. How Could This Case Have Been Handled Differently?

1. Role of Coverage Counsel and Potential Investigation and Declaratory Judgment Action

2. Role of Defense Counsel and Ethical Considerations in Providing Defense

3. What Control Could Insurance Company Exercise Over the Defense?