In Kentucky The Insured Is Your Client - Not The Insurer!

An Awkward Fix To An Awkward Problem

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One of the longest running conflict of interest gun fights concerns the tripartite relationship of insured, insurer, and defense counsel who is appointed and paid by the insurer. The conflict problem is well described by one commentator as follows:

> The premise underlying much of the law that has developed in the insurance defense practice is that defense counsel generally cannot loyally and competently represent the insured in any situation where there is a conflict or potential conflict between the interests of the insured and the insurer. A typical example of the judicial mindset is the following: Even the most optimistic view of human nature requires us to realize that an attorney employed by an insurance company will slant his efforts, perhaps unconsciously, in the interest of his real client -- the one who is paying his fee and from whom he hopes to receive future business -- the insurance company.[i]

Some states approach the issue as a dual representation and apply conflict of interest rules to determine whether the conflict is disqualifying or may be consented to by the insured and insurer. A recent California decision is representative of this approach. The court held that "... where an insurer hires counsel to defend its insured and does not raise or reserve any coverage dispute, and where there is otherwise no actual or apparent conflict of interest between the insurer and the insured that would preclude an attorney from representing both, the attorney has a dual attorney-client relationship with both insurer and insured."[ii]

Other states declare the tripartite relationship a per se conflict of interest. They implement this policy through opinions of courts and bar ethics committees holding that the defense counsel's client is the insured and not the insurer. This is both a paternalistic and prophylactic approach. It protects insureds from overreaching insurers and self-serving lawyers, while protecting lawyers from themselves. It also results in restrictions on choice of lawyer for both the insured and insurer and restricts a lawyer's right to practice -- matters of public policy condemned in the Kentucky Rules of Professional Conduct (Rules).[iii]

The KBA Ethics Committee in two recent opinions has emphatically ruled that the Kentucky defense counsel represents the insured and not the insurer.[iv] Both opinions include guidance that the attorney-client relationship is governed by the Rules and not by the terms of the insurance contract. Kentucky also forbids defense services by salaried-lawyer employees of an insurer.[v] The opinions seem to leave no room for client consent

to a dual representation after full disclosure. In short the insurer is odd man out in Kentucky.

The purpose of this piece is not to dispute the position taken by the Ethics Committee. I wish it were otherwise, but coping in law and life requires recognition of a decision by competent authority and getting on with it. What I hope to do is provide some useful analysis for the practicing lawyer who must work with a solution that may be as good as any, but creates some awkwardness in application.

1. Formation Of The Attorney-Client Relationship Is A Matter Of Substantive Law

The existence of the attorney-client relationship is governed primarily by the substantive law of contract and agency. The lawyer's duty of care is a function of tort law. Kentucky's Rules do not include a rule on when the attorney-client relationship is formed. This is consistent with the overarching policy of the Rules not to cover matters of substantive law to which ethics rules are subordinate. The Rules do establish the lawyer's professional responsibility to a client once the relationship comes into existence.

Typically ethics committees shy away from positions that cross over into substantive law issues. The nature of the insurance tripartite relationship, however, may defy strict adherence to this policy. In any event Kentucky's recent ethics opinions are inextricably joined with gut substantive law questions impacting on the ability of lawyers and insurers to form attorney-client relationships and the interpretation of insurance contract obligations. Defense counsel is in the bind of having strong guidance on the fiduciary obligation owed the insured, but at risk that the courts will preserve for insurers substantive law rights that these recent ethics opinions appear to diminish.

While it may seem likely that the Kentucky courts will endorse the KBA Ethics Committee's position, that is not a lock. The Tennessee Supreme Court recently reversed the Tennessee Board of Professional Responsibility on the issue of salaried-lawyer employees of an insurer representing the insured.[vi] Thus, until the courts of Kentucky are heard from on the only-the-insured is client rule, defense counsel remains in a bind over competing fiduciary duties to insureds and legal obligations to insurers.

2. Confidentiality And The Only-The-Insured Is Client Rule

a. ***From the Insured's Perspective***:

The Rules provide that all matters related to the representation are confidential. Disclosure is allowed primarily on the basis of those impliedly authorized to carry out the representation and with client consent. Since in most insurance defense representations the insured's and insurer's interests are aligned, the defense lawyer will have no practical or ethical problem in gaining the insured's consent to cooperate fully with the insurer as the contract requires. This fortunately moots most of the awkwardness of the only-the-insured is client rule. Practitioners should routinely explain the situation to the insured and get client consent to cooperate fully with the insurer.

If there is a divergence in interest between insured and insurer, defense counsel must be careful to obtain authority to reveal information to the insurer. If the divergence involves implications of client fraud, defense counsel must follow the professional responsibility rules on rectification and withdrawal. Whether a defense counsel's (read insured's agent's) failure to cooperate with the insurer as required by the contract, but forbidden by fiduciary duties to the insured (read principal), will have legal consequences for the insured and counsel is a matter of undecided substantive law. Issues of lawyer liability to the insurer for breach of contract, misrepresentation, and malpractice are some of the concerns raised in this professional dilemma.

b. From the Insurer's Perspective:

If the insurer is not defense counsel's client, does it follow that the attorney-client privilege evidence rule, the work product exclusion to discovery rule, and the client confidentiality professional responsibility rule do not apply to defense counsel-insurer communications? Does this mean that everything that goes on between the defense counsel and the insurer is subject to discovery and that the defense counsel has no obligation to keep discussions with the insurer confidential? Such things as the reserve amount the insurer has set for the claim with the help of defense counsel or what the insurer has approved for settlement would all be fair game for discovery or negotiations between defense counsel and claimant. The awkwardness these confidentiality questions pose for working relations within the tripartite relationship is obvious and counterproductive.

There are decisions in other jurisdictions that do not protect insurer confidences when the insured is the lawyer's only client. Fortunately, there are Kentucky decisions that indicate confidentiality will be given to tripartite communications. They rely on the insured's contractual duty to cooperate and reason that communications between an insured and an insurer are in effect an attorney-client relationship (how strange under the circumstances). These decisions are not squarely on point.[vii]

3. Malpractice Liability To Insurer Under The Only-The-Insured Is Client Rule

The general rule is that lawyers have malpractice liability only to clients. If the insurer is not defense counsel's client, it follows that the insurer has no claim for malpractice. The anomaly is that the insurer typically is the only loser in insurance defense malpractice. The insured's loss is covered by the insurance policy and thus the insured has no incentive to go after the malpracticing lawyer. This leaves the insurer holding the bag. Michigan is a good example of the difficulties the only-the-insured is client rule presents when defense counsel malpractices.

In *Atlanta International Insurance Company v. Bell*, 475 N.W.2d 294 (Mich. 1991), a Michigan lawyer failed to raise comparative negligence as a defense in a wrongful death claim against Security Services and others responsible for the safety of a worksite. A judgment was entered against Security Services which Atlanta as its insurer was required to pay. Atlanta then brought a malpractice claim against defense counsel who in his

deposition admitted malpractice. At trial defendant lawyer moved for and was granted summary judgment on the basis that no attorney-client relationship existed between the defendant and Atlanta. The Michigan Court of appeals affirmed, holding: "No attorney-client relationship exists between an insurance company and the attorney representing the insurance company's insured.... Rather, an attorney's sole loyalty and duty is owed the client alone, the client being the insured and not the insurance company."

This result was so blatantly inequitable that the Michigan Supreme Court balked. While doing its best to preserve intact the only-the-insured is client rule, the Court reasoned that this case demonstrated the inadequacy of predicating malpractice liability on the lack of an attorney-client relationship. It went on to announce a policy of equitable subrogation allowing Atlanta to step into the shoes of the insured for purposes of a malpractice claim. The Court held that "Equitable subrogation best vindicates the attorney-client relationship and the interests of the insured, properly imposing the social costs of malpractice where they belong."

In California, an insurance defense counsel dual representation jurisdiction, a court recently addressed the issue of the insurer's independent right to bring a malpractice action against a lawyer it hired to defend an insured. Citing the *Atlanta* rationale as good policy, the court found no need for an equitable subrogation remedy because a direct malpractice action was available to the insurer based on the dual attorney-client relationship.[viii]

The key point to remember is that there are several theories for liability to the insurer outside the attorney-client relationship. In addition to the Michigan subrogation approach, lawyer nonclient liability may be based on intentional and negligent misrepresentation, breach of contract, agency fiduciary principles, and that the insurer was an intended beneficiary of the defense counsel's legal services. Accordingly, don't let your guard down thinking you have a free ride if things go wrong. Its just as important as ever to carefully risk manage your insurance defense work.

SUMMING UP

Kentucky is with the national trend with its only-the-insured is client solution to the conflict problems posed in the tripartite relationship of insured, insurer, and defense counsel.

Since in the typical insurance defense case there is no divergence of interests between insured and insurer, Kentucky lawyers may ethically avoid most confidentiality and good faith problems by carefully obtaining consent from the insured to cooperate with the insurer as the insurance contract requires. In divergent interests cases where complete cooperation is not feasible care must be taken to avoid either assisting an insured with a false claim or tortuously misrepresenting the situation to the insurer. Withdrawal may be good risk management in some situations.

It is reasonable to assume that communications within the tripartite relationship are confidential in Kentucky.

Risk manage insurance defense work as carefully as ever. Michigan and California would not let a malpracticing lawyer get over and Kentucky should not either.

If you are doing insurance defense work out of Kentucky, be sure to know what the rules of that jurisdiction are for insurance defense counsel. Plenty of states follow a dual representation rule which alters your fiduciary responsibilities to the insurer considerably.

Finally, consider whether the only-the-insured is client rule is such a significant interpretation of Kentucky's conflict of interest rules that it should be codified with a Rules change. Rule 1.8 Conflict of Interest: Prohibited Transactions is designed to cover special conflict situations and would make a good home for the only-the-insured is client rule. Additionally, a proposed rule change will stimulate discussion within the bar on how the rule should work and lead to guidance from the Supreme Court. That would be a blessing.

Endnotes

[i]Robert E. O'Malley, *Ethics Principals for the Insurer, the Insured, and Defense Counsel: the Eternal Triangle Reformed,* 66 Tul. L. Rev. 511 (1991).
[ii]*Unigard Insurance Group v. O'Flaherty & Belgum,* Calif CtApp 2Dist, No. B074284, 9/29/95.
[iii]*E.G.*; SCR 3.130, Ky. Rules of Professional Conduct, Rule 5.6 Restrictions On The Right To Practice, Comment 1.
[iv]Opinion KBA E-368 (1994)(Kentucky Bench & Bar, Fall 1994); Opinion KBA E-377(1995)(Kentucky Bench & Bar, Summer 1995).
[v]Opinion KBA E-368 (1994)(Kentucky Bench & Bar, Fall 1994).
[vi]*In re Petition of Youngblood,* Tenn., 895 S.W.2d 322(1995).
[vii]*Asbury v. Beerbower,* Ky., 589 S.W.2d 216 (1979); *Commonwealth of Ky. v. Melear,* Ky.App., 638 S.W.2d 290 (1982).
[viii]*Unigard Insurance Group v. O'Flaherty & Belgum,* Calif CtApp 2Dist, No. B074284, 9/29/95.