

THE POLICYHOLDER ADVOCATE

Jan/Feb 2003



Internet Resources

- ◆ J. Jarman, The Tripartite Relationship, <http://www.converium.com/web/converium/converium.nsf/2a1b7a462af6c00185256ad2000da28c/cd465271d1a2848885256b130078373f?OpenDocument&Highlight=0,tripartite>
- ◆ Publications and Articles Published by DRI on the Tripartite Relationship, www.dri.org/dri/about/tripartiterelationshipphid-den.cfm
- ◆ M. Nebel & J. Horstman, High Stakes and Hard Decisions: Serving The Tripartite Relationship, www.iwancray.com/articles/tripartite.pdf
- ◆ D. Cordon, The Insurance Triangle: The Tripartite Relationship Between The Insurer, Insured and The Defense Lawyer, www.blaney.com/files/article_insurance_triangle.pdf

THREE'S A CROWD: ADVENTURES IN THE TRIPARTITE RELATIONSHIP

By Lee M. Epstein

An insurance company's duty to defend its policyholder is at least as important as its duty to indemnify -- if not more so. Indeed, it has been estimated that 55 cents out of every claim dollar is paid for defense.

The not insignificant expense associated with defending claims has caused insurers to seek greater control over the defense of claims asserted against policyholders. With increasing frequency, insurers are insisting on the use of panel defense counsel, the adherence to strict billing guidelines and the pre-approval of even the most basic costs. The resulting tensions have led defense counsel to seek guidance from their bar associations and policyholders to seek relief from the courts. Those tensions are exacerbated even further when conflicts of interest between insurers and policyholders arise.

This article discusses the nuances of the tripartite relationship involving insurers, policyholders and defense counsel and examines the current state of the law governing that relationship.

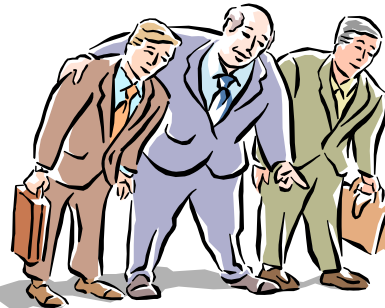
I. The Policyholder Is Always The Client

Even when an insurer is defending an action without reservation, the policyholder remains the client of the defense counsel retained and paid by the insurer. In certain jurisdictions, however, the in-

surer is also considered the client when a tripartite relationship is formed. Notwithstanding whether the insurer is also considered the client, insurers will invariably insist that they are entitled to control that defense, especially when they are defending without reservation.

According to insurers, the right to control will include the right to select defense counsel, approve all tactical decisions and settle any claim within policy limits. At times, however, the policyholder and insurer may have divergent views on how to defend a case or the policyholder may have business reasons for not wanting to settle a case within policy limits. In those situations, the Model Rules of Professional Conduct for attorneys provide necessary guidance for defense counsel and their clients.

Rule 1.2(a) of the Model Rules dictates that the lawyer must consult with and abide by a client's decisions concerning the representation. Moreover, Model Rule 5.4(c) provides that a lawyer "shall not permit a person who recommends, employs or pays a lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering . . . legal services." Thus, irrespective of whether the insurer is also deemed the client, defense counsel must consult with the policyholder, and not permit the insurer to interfere with counsel's judgment in defending the interests of the policyholder.



Three's A Crowd cont. from page 1

II. An Insurer May Not Insist On Unfettered Compliance With Its Billing Guidelines

In an effort to reduce litigation costs, insurers are increasingly insisting that defense counsel comply with stringent billing guidelines. Those guidelines typically impose strict reporting requirements and require defense counsel to seek prior insurer approval of any significant costs to be incurred. The insurer's interest in reducing costs will, in many instances, diverge from the policyholder's interests in obtaining the best possible defense.

When compliance with insurer-imposed billing guidelines will compromise the defense, defense counsel must protect the policyholder's interests. In those circumstances, defense counsel must first consult with both the insurer and the policyholder. If the insurer is unwilling to modify or withdraw the limitation a billing guideline places on the defense, and the policyholder is unwilling to accept that limitation, Rule 1.7(b) requires that defense counsel withdraw from representation of both the policyholder and the insurer. Rule 1.7(b) provides, in pertinent part, that "[a] lawyer shall not represent a client if the representation of that client will be materially limited by the lawyer's responsibilities to another client or to a third person"

A specific cost-reduction mechanism employed by insurers, which has come under fire recently, is the use of third-party auditors to review defense counsel bills. Such "legal bill audits," typically involve an examination of hourly rates charged, time spent and defense counsel's work product to determine the reasonableness of the amounts charged.

In the usual case, defense counsel may share this type of information with the insurer because such sharing is either required by the insurance policy or it is permissible in those jurisdictions in which the insurer is also considered the client of defense counsel. When the disclosure would affect a material interest of the policyholder, however, defense counsel may not share such information with the insurer, absent informed consent from the policyholder. For example, defense counsel are usually prohibited from disclosing information to the insurer that could adversely affect the policyholder's coverage under the insurance policy at issue. An apt example was provided by the Pennsylvania Bar Association:

The majority of jurisdictions have concluded that defense counsel may not disclose confidential information to a third-party auditor, absent the policyholder's informed consent.

Generally, an attorney representing an insured need only inform the Insurer of the information necessary to evaluate a claim. For example, assume an attorney represents an Insured in a premise liability slip and fall. During the course of the representation, the attorney discovers that the subject property is a rental property, not a residential property as set forth in the policy.

Although this information may radically affect coverage, the attorney is prohibited from releasing this information to the Insurer or any other third parties. In the foregoing hypothetical, the attorney would simply inform the Insurer of the nature of the injuries claimed by plaintiff and the circumstances surrounding the incident. The insurer would have all of the information necessary to evaluate the value and basis for the claim and the Insured's confidentiality would be protected.

Pa. Bar Assoc. Comm. On Legal Ethics and Prof. Resp. Informal Op., No. 97-119, 1997 WL 816708 at *2 (Oct. 7, 1997).

Moreover, the majority of jurisdictions have concluded that defense counsel may not disclose confidential information to a third-party auditor, absent the policyholder's informed consent. Unlike the case with insurers, disclosure of such information to third-party auditors, with whom defense counsel have no employment or contractual relationship, may result in a waiver of any applicable privilege. In order to secure informed consent from the policyholder, defense counsel must discuss the nature of the disclosures sought by the third-party auditor as well as the consequences of disclosure (*i.e.*, potential waiver of privilege) and non-disclosure (*i.e.*, insurer may view non-disclosure as a breach of the duty to cooperate under the insurance policy).

III. When Conflicts Arise, The Insurer Must Relinquish Control Over The Defense

When a conflict of interest between the insurer and policyholder arises, an insurer must typically relinquish any right to control the defense, including the right to select defense counsel. "It is settled law that where conflicts of interest between an insurer and policyholder

Three's A Crowd

cont. from page 2

arise, such that a question as to the loyalty of the insurer's counsel to that policyholder is raised, the policyholder is entitled to select its counsel, whose reasonable fee is to be paid by the insurer." St. Peter's Church v. American Nat. Fire Ins. Co., No. 00-2806, 2002 WL 59333 at *10 (E.D. Pa. Jan 14, 2002).

A classic example of a conflict necessitating the retention of independent counsel may arise where the insurer reserves the right to deny coverage for certain of the underlying claims, but not others. In that situation, an insurer "would be tempted to construct a defense which would place any damage award outside policy coverage." Public Serv. Mut. Ins. Co. v. Goldfarb, 442 N.Y.S.2d 422, 427 (N.Y. 1981).

Another prime example of a conflict sufficient to cause an insurer to relinquish the control over the defense is where the insurer lacks the economic motive for mounting a vigorous defense. This situation may arise where the underlying claimant prays for damages that are well in excess of the insurer's policy limits. See, e.g., Emons Indus., Inc. v. Liberty Mut. Ins. Co., 749 F. Supp. 1289, 1297 (S.D.N.Y. 1990).

IV. Conclusion

The tripartite relationship between the insurer, policyholder and defense counsel provides fertile ground for confusion and abuse. Even when an insurer defends a matter without reservation, the policyholder remains the client and can properly object to any limitations placed on the defense by the insurer. If defense counsel reasonably believes that an insurer-imposed limitation will materially impair the defense, defense counsel must withdraw from representing both the insurer and the policyholder.

When a conflict of interest between the insurer and policyholder arises, the insurer must relinquish control over the defense and the policyholder is entitled to select defense counsel. Such a conflict may arise where an insurer reserves the right to deny coverage for only certain of the underlying claims, or where the insurer does not have an economic incentive to defend vigorously, or where the insurer could construct a defense placing any damage award outside of coverage.

The Policyholder Advocate is published by Fried & Epstein, LLP for informational purposes only and is not intended as either legal advice or opinion. Should you wish legal advice or opinion, please contact us directly to discuss your specific factual situation.

We will be exhibiting this year at the
41st RIMS Annual Conference &
Exhibition

April 6-10, 2003

Chicago, IL



Please join us at **Booth 530** for a one-on-one discussion on how you can maximize your insurance assets.

We also are presenting the following two seminar sessions:

- **Business Interruption: Lessons Learned At Ground Zero (IN205)**
Coordinator/Speaker:
Lee Epstein
Moderator: Richard Mannarino
Speaker: John Dempsey
- **Cover Your Boss: D&O Insurance Coverage (IN204)**
Coordinator/Speaker:
Irene Warshauer
Speaker: Suzanne Murray
Speaker: Joseph Montelone

To register for the 41st RIMS Annual Conference & Exhibition, go to:
www.rims.org



Constitution Place
325 Chestnut Street, Suite 900
Philadelphia, PA 19106
215.625.0123
215.625.0764 Fax

Herald Square Building
1350 Broadway, Suite 1400
New York, NY 10018
212.268.7111
212.268.3110 Fax

www.fried-epstein.com