

## Counsel Error and the Tripartite Relationship

A liability carrier retains a law firm to defend its insured in an underlying lawsuit. The law firm commits an error and as a result, the insured is found liable for damages that would not have been awarded, but for the malpractice. However, all of those damages are still within the limits and breadth of the policy coverage, so the only one "hurt" by the mistake is the insurer. What right, if any, does the insurer have to recoup its losses from the law firm? What duty does the law firm owe to the liability insurer? Are there alternative theories that permit such a recovery?

It is beyond cavil that when a law firm is retained by a liability carrier to defend its insured, the insured becomes the lawyer's client. *See, for example, First American Carriers v. Kroger Co.*, 787 S.W.2d 669, 671 (Ark. 1990) ("when a liability insurer retains a lawyer to defend an insured, the insured is the lawyer's client"); *Atlanta Int. Ins. Co. v. Bell*, 475 N.W.2d 294, 297 (Mich. 1991) (declaring that "the relationship between the insurer and the retained defense counsel [is] less than a client-attorney relationship"); *Continental Cas. v. Pullman, Comley*, 929 F.2d 103, 108 (2d Cir. 1991) ("[i]t is clear beyond cavil that in the insurance context the attorney owes his allegiance, not to the insurance company that retained him but to the insured defendant"); *Point Pleasant Canoe Rental v. Tinicum Tp.*, 110 F.R.D. 166, 170 (E.D.Pa. 1986) ("[w]hen a liability insurer retains a lawyer to defend an insured, the insured is considered the lawyer's client") and *In Re Petition of Youngblood*, 895 S.W.2d 322, 328 (Tenn. 1995) (counsel's sole client is the insured). On the other hand, there is healthy debate as to whether the insured is the "sole client" or a "dual client."

Client or not, sole or dual, the courts have examined and reexamined the relationship between and among insurers to determine whether an insurer has a remedy against the law firm if hired counsel fails in its duties of representation and that conduct imposes additional financial obligations on the carrier.

*Lavanant v. General Acci. Ins. Co.*, 164 A.D.2d 73, 75-81 (N.Y. App. Div. 1st Dep't 1990), *aff'd*, 79 N.Y.2d 623 (1992), is best known in New York as the case that established that emotional distress damages were recoverable under a liability policy, even in the absence of a physical injury. However, it also raised an interesting question about the tripartite relationship between and among a liability carrier, insured and defense counsel.

Lavanant owned a brownstone in New York City and was insured by General Accident on a primary basis over which was a Federal Insurance Company (Federal) umbrella policy. Two tenants commenced a personal injury action against Lavanant for emotional distress caused by a ceiling collapse in their apartment and sought recovery for property damage sustained. General Accident acknowledged coverage for some but not all of the claims. Because of potential conflict between the carrier and the insureds on coverage issues, Lavanant was able to have Brownstein, its designated lawyer, step into the defense of the matter on its behalf, its fees paid by General Accident. Eventually, there was a \$400,000+ verdict by the tenants against Lavanant.

General Accident then brought a third-party complaint against the defense counsel, Brownstein, alleging that the verdict was due largely to Brownstein's negligence. In affirming the dismissal of the malpractice claim, the appellate division found that the lack of an attorney-client relationship between the carrier and the insured precluded recovery:

*New York courts impose a strict privity requirement to claims of legal malpractice; an attorney is not liable to a third party for negligence in performing services on behalf of his client. (Harder v Arthur F. McGinn, Jr., P.C., 89 AD2d 732, 733, affd 58 NY2d 663; National Westminster Bank v Weksel, 124 AD2d 144, 146-147, lv denied 70 NY2d 604.)* Nor may General Accident succeed on a theory of implied indemnification since it was not sued nor held liable on a theory of vicarious liability ... Since the third-party complaint failed to allege that General Accident may be "unfairly required to discharge a duty that should have been discharged by another, such that a contract to indemnify should be implied by law" (*Board of Educ. v Sargent, Webster, Crenshaw & Folley*, 71 NY2d 21, 29), a claim for implied indemnity does not lie. *See also, Federal Ins. Co. v. North Am. Specialty Ins. Co.*, 47 A.D.3d 52 (1st Dep't 2007). (Absent attorney/client relationship, cause of action for legal malpractice cannot be stated).

**If There Is No Privity of Contract, Is There No Remedy Whatsoever?**  
**Consider the Doctrine of Equitable Subrogation**

The Indiana Court of Appeals, in *Querrey & Harrow, Ltd. v. Transcon. Ins. Co.*, 861 N.E. 2d 719, *opinion adopted*, 885 N.E.2d 1235 (Ind. 2008), considered whether CNA, as an excess carrier could maintain a malpractice claim against the defense counsel retained by the primary insurer to defend their mutual insured. The court found that the lack of privity doomed that lawsuit as well. The court pointed out that, whether retained directly or by assignment, the duty of the defense firm was to the insured, its client, not the insurer. "Public policy concerns dictate that a legal malpractice claim may not be assigned. Assignment of legal malpractice claims would weaken at least two standards that define the lawyer's duty to the client: the duty to act loyally and the duty to maintain client confidentiality," 861 N.E.2d at 722 (internal citations omitted).

CNA then tried a different approach. It attempted to recover by asserting the doctrine of equitable subrogation, based on principles of "equity and justice." The theory propounded was that equity dictates that a claim should be permitted in "every instance in which one party, not a mere volunteer pays debt for another, primarily liable, which in good conscience should have been paid by the latter." *Id.* CNA argued that it should step into the shoes of its insured, because CNA had fulfilled the duties of its insured by providing coverage. CNA argued "that Indiana law pertaining to privity and the prohibition against assignment of legal malpractice actions does not pertain to legal malpractice claims pursued under the doctrine of equitable subrogation. CNA further argued that the law should not create a class of special, protected defense attorneys who commit malpractice with impunity." *Id.*

Citing case law in Colorado, *Essex Insurance Co. v. Tyler*, 309 F. Supp. 2d 1270, 1274 (D. Colo. 2004) and *California, Fireman's Fund Insurance Co. et al. v. McDonald, Hecht & Solberg et al.*, 30 Cal.App. 4th 1373, 36 Cal. Rptr. 2d 424 (1994), the Indiana court rejected the argument as

"public policy would not allow insurers to violate the sanctity of the attorney-client relationship by pursuing an action against the insured's attorneys)." In *Essex Insurance Co. v. Tyler*, 309 F.Supp. 2d 1270 (D. Colo. 2004), the United States District Court for the District of Colorado concluded that the Colorado Supreme Court would not permit an equitable subrogation claim based on an attorney's professional negligence for the same policy reasons that prohibit the assignment of such claims. There, the insurance company sued the attorneys retained to defend the insured for legal malpractice, alleging that they failed to file vital pleadings and to adequately protect against surprise testimony at trial. The insurance company argued that it was equitably subrogated to the rights of the insured by having had to pay a \$237,000 judgment. See also *State Farm Fire & Cas. Co. v. Weiss*, 194 P.3d 1063 (Colo. Ct. App. 2008).

Courts in Kentucky, Michigan and several other states are consistent in rejecting equitable subrogation claims. See *American Continental Insurance Co. v. Weber & Rose, P.S.C.*, 997 S.W.2d 12,45, 13 KY.L.SUMMARY 18 (Ky. Ct. App. 1998); *American Employer's Insurance Co. v. Medical Protective Co.*, 165 Mich. App. 657, 419 N.W.2d 447 (1987).

The majority of jurisdictions that have addressed this issue- 10 of 16, excluding *Essex*-prohibit the equitable subrogation of professional negligence claims against attorneys. The seven of these 10 that prohibit assignment conclude that equitable subrogation is similar enough to assignment that the policies supporting a prohibition on assignments are equally applicable to equitable subrogation. See *Capitol Indem. Corp. v. Fleming*, 203 Ariz. 589, 58 P.3d 965, 969 (Ariz. Ct. App. 2002); *Great Am. Ins. Co. v. Dover, Dixon Horne, P.L.L.C.*, 456 F.3d 909, 912 (8th Cir. 2006)(Arkansas law); *Fireman's Fund Ins. Co. v. McDonald, Hecht & Solberg*, 30 Cal. App. 4th 1373, 36 Cal. Rptr.2d 424, 426-30 (Cal. Ct. App. 1994); *Cont'l Cas. Co. v. Pullman, Comley, Bradley & Reeves*, 929 F.2d 103, 106-07 (2d Cir. 1991) (Connecticut law); *Nat'l Union Fire Ins. Co. v. Salter*, 717 So. 2d 141, 142 (Fla. Dist. Ct. App. 1998).

Others find similar policy reasons for prohibiting equitable subrogation of such claims. See *Swiss Reinsurance Am. Corp. v. Roetzel & Andress*, 163 Ohio App. 3d 336, 2005 Ohio 4799, 837 N.E.2d 1215, 1224 (Ohio Ct. App. 2005) ("Ohio's zealous guarding of the attorney-client relationship compels a holding that equitable subrogation is not available"); *Am. Cont'l Ins. Co. v. Weber & Rose, P.S.C.*, 997 S.W.2d 12, 13, 45 13 Ky. L. Summary 18 (Ky. Ct. App. 1998) (allowing equitable subrogation "would be inimical to the preservation of traditional and longstanding concepts associated with attorney-client relationship"); *St. Paul Ins. Co. v. AFIA Worldwide Ins. Co.*, 937 F.2d 274, 279 (5th Cir. 1991) (in Louisiana, "[a]bsent privity of contract, an attorney may make himself personally liable to third parties only if he exceeds the limits of his agency").

Other jurisdictions have acknowledged a willingness to permit such claims, including, for example, *National Union Insurance Co. v. Dowd & Dowd, P.C.*, 2 F.Supp. 2d 1013 (N.D. Ill. 1998), where federal district court predicted that the Illinois Supreme Court would conclude that an excess insurer "should be allowed to assert a legal malpractice claim against its insured's defense attorney under the doctrine of equitable subrogation."

## **A Minority of Jurisdictions Allow Equitable Subrogation Claims, Lest the Negligent Law Firm Be Immune from Any Claims**

The jurisdictions that allow equitable subrogation have favored the shifting of responsibility for the loss to the responsible attorney over the potential jeopardy to the sanctity of the attorney-client relationship. *St. Paul Fire & Marine Ins. Co. v. Birch, Stewart, Kolasch & Birch, LLP*, 379 F. Supp.2d 183,193-96 (D. Mass. 2005) (finding that insurer and client interests were aligned and that client had waived its confidentiality privilege); *Allianz Underwriters Ins. Co. v. Landmark Ins. Co.*, 13 A.D.3d 172, 174-75 (1st Dept. 2004); *Ohio Casualty Ins. Co. v. Southland Corp.*, 1999 U.S. Dist. LEXIS 5564,1999 WL 236733 (Pennsylvania courts elevate "policy of protecting clients' rights [to competent representation] over the policy of protecting the personal and confidential nature of the attorney-client relationship"); *Atlanta Int'l Ins. Co. v. Bell*, 438 Mich. 512, 475 N.W.2d 294, 298 (Mich. 1991) ("to completely absolve a negligent defense counsel from malpractice liability would not rationally advance the attorney-client relationship"); *American Centennial Ins. Co. v. Canal Ins. Co.*, 843 S.W.2d 480, 483-84, 36 Tex. Sup. Ct. J. 339 (Tex. 1992) (no new burdens imposed and that attorneys should not be relieved of these obligations merely because the insurer rather than the client must pay); *National Union Ins. Co. v. Dowd & Dowd, P.C.*, 2 F.Supp. 2d 1013 (N.D. Ill. 1998) (subrogation allows the insurer to enforce the duties the attorney already owes to the insured, who might have little incentive to sue because of the insurance coverage; moreover, the social cost of legal malpractice is best borne by the negligent attorney).

In New York's *Allianz Underwriters* case, *supra*, the decedent was fatally injured while working for his employer on the owners' (Dunlop's) property. Allianz claimed that the owners and Allianz repeatedly demanded that the law firm, Underberg Kessler, LLP, assigned to defend the insured, commence a third-party action against the employer on the ground that the employer was liable in the underlying wrongful death action under the New York Workers' Compensation Law; that the employer was contractually liable to the owners for indemnification; and that the employer was liable to the owners for common-law indemnification. Allianz and Dunlop asserted that the law firm breached its fiduciary duty by manipulating the litigation process for the benefit of other insurers, without regard to the rights of the owners or Allianz. On appeal, the court found that the firm owed no fiduciary duty to Allianz, but the complaint stated a cause of action against the law firm based upon principles of equitable subrogation. Further, Allianz alleged a *near privity* relationship with the law firm, sufficient to overcome the motion to dismiss. The court held:

However, where the relationship is so close as to touch the bounds of privity, an action may be maintained (*see State of Cal. Pub. Employees' Retirement Sys. v Shearman & Sterling*, 95 N.Y.2d 427, 434, 741 N.E.2d 101,718 N.Y.S.2d 256 [2000]; *Prudential Ins. Co. of Am. v Dewey, Ballantine, Bushby, Palmer & Wood*, 80 N.Y.2d 377, 382, 605 N.E.2d 318, 590 N.Y.S.2d 831 [1992]).

In order for a relationship to approach "near" privity's borders, for the purpose of maintaining a professional negligence claim, the professional must be aware that its services will be used for a specific purpose, the plaintiff must rely upon those services, and the professional must engage in some conduct evincing some understanding of the plaintiff's reliance (*see State of Cal. Pub. Employees' Retirement Sys., supra*). Here, Allianz sufficiently pleaded that Underberg knew that the insurers and excess insurer relied on its representation of Dunlop. In addition, Allianz adequately alleged Underberg understood that

reliance by virtue of its continued correspondence with Allianz, in which Allianz and Dunlop insisted that a third-party action be commenced, while Underberg declined. 13 A.D.3d at 175.

In 2007, in *Federal Ins. Co. v. North Am. Specialty Ins. Co.*, 47 A.D.3d 52 (1st Dep't 2007), the same New York appellate department seemed to limit the *Allianz* decision, finding that an excess carrier could not maintain an equitable subrogation claim in its own right and that a "near privity" relationship requires specific elements of negligent misrepresentation relied upon by the insurer. Indeed, the court strongly supported the majority rule stating:

Strict adherence to the rule prohibiting legal malpractice claims by non-clients serves an important policy consideration. An attorney's paramount duty is to protect zealously the interests of his or her client, and if that duty is breached and the breach proximately causes injury, the attorney may be subject to a malpractice claim, but only by his or her client. While, concededly, third parties may be interested in the actions by another's attorney and even benefit therefrom, that circumstance does not give rise to a duty on the part of the attorney to the third party. Were it otherwise, the attorney would be faced with the constant burden of weighing all the competing interests attendant upon such diverse obligations to the potential detriment of his or her client, to whom he owes undivided fidelity.

47 A.D.3d at 60.

In *Kumar v. American Tr. Ins. Co.*, 49 A.D.3d 1353 (4th Dep't 2008), the issue was addressed again. Tisack was the American Transit insured. When sued by Kumar, American hired the Hiscock firm to defend Tisack. It appears that Hiscock failed to appear and defend the insured and a judgment was entered against Tisack. There was also a claim that the carrier failed to settle the claim within the policy limits. Tisack considered the acts of American Transit to be in bad faith and assigned the bad faith claim to Kumar, likely in exchange for a promise not to enforce the judgment.

Kumar, as assignee of the bad faith claim, then sued American Transit. The insurer then commenced a third-party action against Hiscock claiming that if American Transit was in bad faith, Hiscock's negligence was responsible. Hiscock moved to dismiss the third-party claim and the lower court agreed that the third-party action by the carrier against the defense counsel could not stand. An appeal was taken to the Fourth Department, the Hiscock attorneys argued successfully that American Transit was not in privity with the law firm and relied on the *Federal Ins. Co.* case for that proposition.

However, after holding that American Transit was not owed a duty by the defense firm it hired, the Fourth Department majority nevertheless reinstated the complaint against the law firm on the principle of *equitable subrogation*. The third-party complaint alleged that the loss sustained by American's insured resulted from the malpractice of the Hiscock attorneys, specifically their failure to appear and defend the insured. The court determined that the complaint alleged sufficient facts to withstand the motion to dismiss, inasmuch as it stated a cause of action for equitable subrogation, citing to *Allianz*. The court distinguished the *Federal Ins. Co.* decision, which did not permit a claim for equitable subrogation to proceed, based on the pleadings that alleged that the carrier was standing in the shoes of the insured and the insured's loss arose from the alleged malpractice of the attorneys.

The sole dissenting judge in *Kumar*, Justice Erin M. Peradotto, agreed with the majority that American Transit was not in strict privity with Hiscock and also would have held that American Transit was not in "near privity" with Hiscock, a concept the majority did not reach. However, Justice Peradotto disagreed with the majority's holding that a claim for *equitable subrogation* could be maintained. In the dissent's view, the majority essentially was asserting the existence of a cause of action for legal malpractice based on a theory of equitable subrogation and the third-party complaint submitted by American in opposition to the motion did not contain legally sufficient averments supporting such a cause.

The Arizona Supreme Court was troubled with the absence of an apparent remedy against the defense counsel whose conduct led to the carrier's loss, but not the insured's. *In Paradigm Ins. Co. v. Langerman Law Offices, P.A.*, 200 Ariz. 146 (Ariz. 2001) Paradigm issued an insurance policy covering a Dr. Vanderwerf for medical malpractice liability. Vanderwerf and his employer, Samaritan, were sued by Renee Taylor, who alleged that Vanderwerf and Samaritan, as his employer, were negligent.

Paradigm had assigned Langerman to defend Taylor's claims. During the course of representation, Langerman advised Paradigm that it believed there was "no viable theory of liability against Samaritan" but apparently Langerman failed to determine whether Vanderwerf was covered by Samaritan's liability insurance policy and whether his defense could be tendered to that carrier.

When Paradigm learned that Langerman had undertaken representation of a claimant who was bringing an action against another Paradigm-insured doctor, in violation of an informal agreement that its defense counsel not sue its insured doctors, Paradigm had Langerman replaced as defense counsel in the Taylor lawsuit.

The newly retained counsel determined that Samaritan had liability coverage through Samaritan Insurance Funding (SIF) that not only covered Vanderwerf for Taylor's claim but probably operated as the primary coverage for the claim. The claim was tendered to SIF but that company denied on late notice grounds and that denial was upheld when challenged.

*Taylor v. Vanderwerf* settled for an amount within Paradigm's policy limits, thus Vanderwerf was not *injured* by Langerman's failure to make a timely tender to SIF (assumed by the court to be malpractice). Paradigm, as primary carrier, was required to pay without being able to look to SIF as its primary carrier. Langerman then tendered its bill for defense work to Paradigm. Paradigm refused to pay it, citing Langerman's malpractice. Langerman sued for the defense fees and Paradigm counterclaimed for malpractice.

The trial court dismissed the malpractice claim, determining that there was no attorney-client relationship between the law firm and the insurer that would give the carrier standing to sue. The appellate court reversed in part, determining that there was a dual attorney-client relationship, *Paradigm Ins. Co. v. Langerman Law Offices*, 196 Ariz. 573, 2 P.3d 663 (Ariz. Ct. App. 1999). The Arizona Supreme Court took a slightly different approach, determining that whether or not an attorney-client relationship existed between the defense firm and the insurer, there was still a duty, resting its finding, in part, on the injustice of there being a wrong without a remedy.

If a lawyer's liability to the insurer depends entirely on the existence of an attorney-client relationship and for some reason the insurer is not a client, then the lawyer has no duty to the insurer that hired him, assigned the case to him, and pays his fees. *There are many problems with that result: if that lawyer's negligence damages the insurer only, the negligent lawyer fortuitously escapes liability. Or if the lawyer's negligence injures both insurer and insured in a case in which the insured is the only client but refuses to proceed against the lawyer, the insurer is helpless and has no remedy. Such unjust results are not just bad policy but unnecessary.* The RESTATEMENT [(THIRD) OF THE LAW GOVERNING LAWYERS] holds the view that lawyers may, in certain circumstances, owe a duty to a nonclient. Specifically, RESTATEMENT section 51(3) reads, in pertinent part: [A] lawyer owes a duty of care... to a nonclient 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 nonclient; (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.

Comment g to this section advises; [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.... *RESTATEMENT section 14 states: Because and to the extent that the insurer is directly concerned in the matter financially, the insurer should be accorded standing to assert a claim for appropriate relief from the lawyer for financial loss proximately caused by professional negligence or other wrongful act of the lawyer.* (Emphasis added)

...

We hold again today that a lawyer has a duty, and therefore may be liable for negligent breach, to a non-client under the conditions set forth in previous case law and the RESTATEMENT.

*Paradigm Ins. Co. v. Langerman Law Offices, P.A.*, 200 Ariz. 146, 153 (Ariz. 2001).

In *Pine Island Farmers Coop v. Erstad & Riemer, P.A.*, 649 N.W.2d 444 (Minn. 2002), the Supreme Court of Minnesota found that a carrier cannot maintain a legal malpractice action against defense counsel because there had never been discussions between and among the insured, the insurer and the law firm considering and agreeing to dual representation, which it found necessary to create that dual relationship. The court did not reach the issue of alternative remedies since the insured had, itself, commenced a malpractice action against the defense firm. *See also State & County Mut. Fire Ins. Co. v. Young*, 490 F. Supp. 2d 741, 746 (N.D. W. Va. 2007) and *Unigard Ins. Group v. O'Flaherty & Belgum*, 38 Cal. App. 4th 1229, 1235 (Cal. App. 2d Dist. 1995), *petition for review den'd, request of order direction depublication den'd, Unigard Ins. Group v. O'Flaherty & Belgum*, 1996 Cal. LEXIS 151 (Cal. Jan. 4, 1996), where the court concluded:

[W]hen, pursuant to insurance policy obligations, an insurer hires and compensates counsel to defend an insured, provided that the interests of the insurer and insured are not in conflict, the retained attorney owes a duty of care to the insurer which will support its independent right to bring a legal malpractice action against the attorney for negligent acts committed in the representation of the insured.

## Conclusion

Should an insurer have a remedy against counsel representing its insured where the attorney has committed malpractice? In other contexts, courts have recognized the insurer's rights as one of the real parties in interest.

Surely, an excess carrier, even one step further removed from the selection of defense counsel, is even more at risk if not permitted any remedy when its policy proceeds are put into play because of practice failures by defense counsel. Perhaps in certain circumstances its remedy maybe against the primary carrier for breach of that relationship, assuming that the jurisdiction recognizes such claims and the facts justify.

If insurance procurement is truly about risk shifting, one can ask who has accepted the premium for the risk for which compensation is required. A cogent argument can be made that the insured's liability and/or excess carrier accepted, primarily, the risk of the insured's conduct and not that of the counsel's misfeasance, malfeasance or nonfeasance. Perhaps the responsibility for any escalated loss should be better placed with the insurer whose policyholder caused the loss.

It is posited that there is a fundamental unfairness that protects the negligent lawyer from liability when counsel's failures damage the insurer only. Similarly, if the assigned counsel's negligence injures both insurer and insured in jurisdictions where the insured is recognized as the only client, the insurer is helpless if the insured refused to proceed. Surely, many lawyers may "make good" the insurer's loss, voluntarily, to preserve the flow of business. However, whether it be under a theory of "near privity," "dual clients," or "equitable subrogation," there ought to be a recognition by the courts that a remedy must be available.