The Ins and Outs of the Tripartite Relationship

I. Introduction to the Tripartite Relationship

A “tripartite relationship” arises when a liability insurance carrier (insurer) hires defense counsel to represent a policyholder (insured). The multiplex relationship that emerges when an insurer retains counsel to defend its insured has generated confusion among many insurance defense attorneys, such that counsel is often unsure of which duties are owed to whom. Texas Supreme Court Justices Raul Gonzalez and Gregg Abbott aptly noted:

The duty to defend in a liability policy at times makes for an uneasy alliance. The insured wants the best defense possible. The insurance company, always looking for the bottom line, wants to provide a defense at the lowest possible cost. The lawyer the insurer retains to defend the insured is caught in the middle. There is a lot of wisdom in the old proverb: He who pays the piper calls the tune. The lawyer wants to provide a competent defense, yet knows who pays the bills and who is most likely to send new business. This so-called tripartite relationship has been well documented as a source of unending, ethical, legal, and economic tension.¹

Contractual, statutory, and regulatory obligations, as well as the rules of professional conduct, have therefore been enacted to guide counsel navigating this multifaceted relationship. And common law derived from custom and judicial precedent has interpreted the governing statutes and regulations to aid counsel’s application of the relevant law to the facts presented.

As a threshold matter, the relationship arises out of an insurance policy, a contract. In most liability insurance contracts, the liability carrier undertakes two fundamental obligations: a duty to defend and a duty to indemnify the policyholder against certain risks and losses. When an insurer is put on notice of a potential lawsuit alleging liabilities that may fall within the scope of policy coverage, the duties to defend and indemnify obligate the insurer to retain competent defense counsel to represent the insured. In exchange, the insured is required to notify the insurer of all claims and to cooperate with investigation, defense, and settlement. That representation gives rise an attorney-client relationship between the insured and counsel that is governed by professional rules promulgated by the state bar. Generally, the Rules of Professional Conduct state that the duties flowing from the attorney-client relationship attach only after the client has requested the lawyer to render services and the lawyer has agreed to do so. When a policyholder cedes defense to the insurance carrier, the insurer creates the attorney-client relationship for the benefit of the insured.²

II. Scope of the Tripartite Relationship

The scope of the attorney’s relationship with the insured presents a much more subtle and often problematic question: whether defense counsel retained on behalf of the insured also represents the insurer. The answer to that question is dependent upon state statutes, rules of professional conduct, and common law—and it is defense counsel’s responsibility to understand the scope of his or her representation and to ensure that scope is clearly communicated to both the policyholder and insurer.\(^3\)

The American Bar Association (ABA) Model Rules of Professional Conduct shed light on the ethical rules by which counsel are bound, laying the foundation for the attorney-client relationship. Being deemed a “client” is very advantageous as only a client is entitled to sue for malpractice. Simply stated, a client may hold an attorney accountable for malpractice, while non-clients have no recourse in the event defense counsel fails to satisfy his or her obligations. A client is also entitled to confidentiality, ensuring any discussions with counsel will not be disclosed on a future date or used against the client. Lastly, clients are permitted to define the objectives and scope of the representation, must be informed of all activities related to the litigation, and are entitled to determine the appropriateness of settlement.\(^4\)

It is the insurer’s status that is in question when most parties enter into the tripartite relationship. If the insurer is a non-client, the insurer may become frustrated by defense counsel’s ethical obligations to the policyholder. For example, the insurer, who pays counsel’s fees, may wish to know details with regard to a particular action taken, but counsel’s ethical obligations may preclude disclosure of the requested information. More importantly, at least to the insurance carrier, the insurer may wish to reduce the costs incurred in defending the action. But counsel must act in the best interest of the insured, regardless of the insurer’s wish to cap expenses. Furthermore, the insurer may wish to retain the right to pursue relief against the lawyer if counsel is incompetent or careless, given that the insurer will be responsible for the loss.\(^5\)

Three theories are commonly accepted on the topic of tripartite relationship: (1) the two-client theory (dual client theory), (2) the one-client theory, and (3) the third-party-payor theory.

The two-client theory appears to be the predominant view of the tripartite relationship, under which an attorney owes a duty of care to the insured and the insurer, provided the clients jointly retain counsel to act as a common agent on a legal matter of common interest. Under the two-client theory, defense counsel represents two clients: the insured and the insurer. The rationale underlying this theory is that both entities are beneficiaries of the services rendered.\(^6\)

\(^3\) Id.  
\(^4\) Id.  
\(^5\) Id.  
\(^6\) Id.
Recent articles, however, suggest the judiciary is moving away from the two-client theory in favor of the one-client theory. Proponents of the one-client theory argue that creating an attorney-client relationship for the insurer weakens defense counsel’s loyalty to the insured:

The professional judgment of a lawyer should be exercised, within the bounds of the law, solely for the benefit of the client and free of compromising influences and loyalties. Neither the lawyer’s personal interests, nor the interests of other clients, nor the desires of third persons should be permitted to dilute the lawyer’s loyalty to the client.\(^7\)

Some advocates, however, support the third-party-payor theory (one-and-half-client theory), under which, defense counsel is deemed to represent the insurer and insured until a conflict arises. In essence, if the insurer is able to oversee litigation strategies without compromising defense counsel’s obligations to the insured, a duty of care is owed to the insurer.\(^8\) Accordingly, the \textit{Restatement (Third) of the Law Governing Lawyers} imposes limitations on the control an insurer may exercise and indicates that if an insurer exercises exclusive control over litigation, the insurer forfeits the right to sue for legal malpractice.\(^9\) The theory has been described as an “either/or” theory because the insurer may manage the litigation and thereby lose the right to sue for malpractice or forego management and sue for malpractice in the event litigation goes amiss.

On the following pages is a chart provides a quick reference to the principal duties created under the tripartite relationship in the surrounding states and to explain to whom those duties are owed.

\footnotesize

8 \textbf{Ethical Considerations within the Tripartite Relationship of Insurance Law—Who is the Real Client?} 74 Def. Couns. J. 172 (2007).

<table>
<thead>
<tr>
<th>State</th>
<th>Characterization of the Tripartite Relationship</th>
<th>Statutory Law</th>
<th>Common Law Precedent</th>
<th>Ethics Rules/Regulatory Opinions</th>
</tr>
</thead>
<tbody>
<tr>
<td>State</td>
<td>Characterization of the Tripartite Relationship</td>
<td>Statutory Law</td>
<td>Common Law Precedent</td>
<td>Ethics Rules/Regulatory Opinions</td>
</tr>
<tr>
<td>-------</td>
<td>------------------------------------------------</td>
<td>---------------</td>
<td>----------------------</td>
<td>---------------------------------</td>
</tr>
<tr>
<td>IL</td>
<td>One-Client Theory</td>
<td></td>
<td>Maryland Causalty Co v. Peppers, 355 N.E.2d 24, 30-31 (Ill. 1976) (dual representation is permitted if the insured either waives the conflict after full disclosure or the insurer waives its defense of noncoverage. Once a conflict arises, the insurer is divested of its right to control the defense).</td>
<td></td>
</tr>
<tr>
<td>State</td>
<td>Characterization of the Tripartite Relationship</td>
<td>Statutory Law</td>
<td>Common Law Precedent</td>
<td>Ethics Rules/Regulatory Opinions</td>
</tr>
<tr>
<td>-------</td>
<td>-----------------------------------------------</td>
<td>---------------</td>
<td>---------------------</td>
<td>---------------------------------</td>
</tr>
</tbody>
</table>
| SD    | One-Client Theory                             |               | *St. Paul Fire and Marine Ins. Co. v. Engelmann*, 639 N.W.2d 192, 199, 2002 S.D. 8, ¶ 18, n.7 (S.D.) (attorneys representing insureds on behalf of carriers owe an undeviating fealty to the insureds).  

<table>
<thead>
<tr>
<th>State</th>
<th>Characterization of the Tripartite Relationship</th>
<th>Statutory Law Precedent</th>
<th>Ethics Rules/Regulatory Opinions</th>
</tr>
</thead>
</table>
| NE    | One-Client Theory                            | *Hawkeye Cas. Co. v. Stoker*, 48 N.W.2d 623, 632 (Neb. 1951) (attorney cannot represent both insurer and insured when interests conflict—except by express consent given after full disclosure of the facts).  
*Shahan v. Hilker*, 488 N.W.2d 577, 581 (Neb. 1992) (“[C]ommunication made by an insured to his liability insurance company, concerning an event which may be made the basis of a claim against him covered by the policy, is a privileged communication, if the policy requires the company to defend him through its attorney, and communication is intended for the information or assistance of the attorney). | NE Code of Professional Responsibility Cannon 4: Confidentiality: A lawyer must preserve the confidences of client.  
NE DR 4-101 – Disciplinary Rules for failure to preserve confidences of client.  
NE Cannon 5: Lawyer must exercise independent professional judgment on behalf of client.  
DR 5 – Corresponding disciplinary Rule. |
<table>
<thead>
<tr>
<th>State</th>
<th>Characterization of the Tripartite Relationship</th>
<th>Statutory Law</th>
<th>Common Law Precedent</th>
<th>Ethics Rules/Regulatory Opinions</th>
</tr>
</thead>
<tbody>
<tr>
<td>WI</td>
<td>Two-Client Theory (Dual client)</td>
<td>WI SCR 20:1.8 Conflict of Interest: prohibited transactions (“A lawyer shall not accept compensation for representing client from one other than client unless: (1) client gives informed consent . . . or consent pursuant to terms of agreement or policy requiring . . . insurer to retain counsel on client’s behalf, (2) there is no interference with lawyer’s independence of professional judgment or with the client-lawyer relationship, and (3) information relating to representation of client is protected by SCR 20:1.6.”). SCR 20:1.6 – Confidentiality Requirements.</td>
<td>Juneau County Star-Times v. Juneau County, 345 Wis. 122, ¶ 48, 824 N.W.2d 457, 467 (2013) (“Insurance defense counsel are generally recognized as having two clients in any given case: the insurer and the insured.”) (citation omitted). But see, Marten Transport Ltd. v. Hartford Specialty Co., 184 Wis.2d 1, 13, 533 N.W.2d 452, 455 (attorney-client relationship is based on agency, and no such relationship exists when the insurer does not select defense counsel, pay counsel’s fees on behalf of insured, or maintain the right to control the defense).</td>
<td>State Bar of WI Ethics Opinions, Formal Opinion E-99-1 (2011) (“Wisconsin lawyers retained by insurers under a policy of insurance typically represent both the insurer and the insured in the defense. . . . Counsel who regularly represent insureds usually have ongoing attorney-client relationships and economic ties to those insurers.”)</td>
</tr>
</tbody>
</table>
III. Potential Conflicts of Interest

There is an inherent risk of conflicting interests in the tripartite relationship. Insurance defense coverage is the only area of the law in which parties are routinely represented by counsel selected and paid for by a third party whose interests may differ from those of the entity or individual counsel was retained to defend. The nature of the conflicts posed as a result of that relationship—and the potential exposure to legal malpractice claims—varies depending upon the extent of the representation offered, i.e., whether the insured and the insurer are deemed clients. The fundamental malpractice danger postured by that relationship is that the insured will claim that defense counsel protected the interests of the insurer to the detriment and at the expense of the insured. What follows is concise summary of the most common potential conflicts of interest attributable to that relationship:

A. Reservation of Rights

Situations may arise where an insurer may undertake an insured’s defense, despite unresolved coverage questions or issues. To foreclose potential waiver or estoppel arguments, the insurer frequently sends a reservation of rights letter to the policyholder. An effective reservation of rights letter must reference the policy defenses that may be asserted and inform the insured of the potential conflict of interest that arises as a result of the reservation.

Generally, the conflict presented by a reservation of rights is the possibility that the insurer will have a diminished interest in the insured’s defense due to the potential to prevail on the coverage issue. And defense counsel may steer litigation toward a coverage result that favors the insurer. For example, defense counsel has been known to elicit deposition testimony that supports a coverage defense. To avoid a conflict, defense counsel must then withdraw or the insured must (in some jurisdictions) be permitted to select independent counsel at the expense of the insurer.10

B. Claimed Damages Exceed Coverage

This conflict typically occurs when defense counsel believes the jury verdict may exceed coverage and defense counsel knows that solid liability defenses exist, but that the case may be settled within policy limits. The insured is entitled to counsel who will advance the interests of the insured. The insurer, however, has a strong economic incentive to aggressively litigate the action to obtain a low verdict or settle within limits, despite the insured’s interests.

An attorney defending a case with a potential excess judgment must, at a minimum, inform both the insured and the insurer of any settlement offer so that they may take the steps necessary to protect their interests. Defense counsel, however, must be careful to avoid violating the “absolute, nondelegable responsibility not to urge, recommend or suggest any course of action to the carrier which violates his conflict of interest obligation.”11 Moreover, defense counsel who fails to


11 Hartford Accident & Indemnity Co. v. Foster, 528 So.2d 255 (Miss. 1988).
recommend settlement within policy limits—despite the opportunity to do so—may be personally liable for any excess judgment, if the insurer is a dual client.12

C. Defense Costs Reduce Available Coverage

Liability coverage may be provided under a “defense within limits,” “wasting,” or “ultimate net loss” policy, which establishes that defense costs, including attorney fees, are paid out of policy limits. Defense costs therefore eat into or diminish available coverage. So, an insured is potentially prejudiced each time defense counsel acts, thereby reducing the amount available under the coverage policy. To avoid a conflict, the insured must be timely informed of defense expenditures and the amount of coverage remaining.13

D. Representation of Multiple Parties

Representation of multiple parties may also present conflicts as two or more insureds may have adverse interests. For example, counsel representing multiple parties who discovers a conflict during discovery must cease representation of both parties because counsel owes a duty of loyalty to his clients. Counsel therefore may not continue to represent parties with conflicting interests without the consent of the parties after full disclosure of the facts. Such circumstances generally require independent counsel be obtained and paid for by the insurer.14

E. Defense Counsel’s Activities Generate Information Suggesting Possible Coverage Defense

Even with informed consent, dual representation may generate disclosure and communication issues for defense counsel. When defense counsel discovers information that suggests a possible coverage defense during the course of litigation, defense counsel is generally barred from disclosing that information to the insurer—regardless of the means by which that information is discovered (i.e., independent activities or shared in confidence).15 For example, when presented with such a conflict, one court held:

When an attorney . . . uses the confidential relationship between an attorney and a client to gather information so as to deny the insured coverage under the policy . . . we hold that such conduct constitutes a waiver of any policy defense, and is so contrary to public policy that the insurance company is estopped as a matter of law from disclaiming liability under an exclusionary clause in the policy.16

---

13 Id.
14 Id.
15 Id.
F. Punitive Damages Claimed

Depending upon the jurisdiction in which the lawsuit is commenced and the particular facts of the pending litigation, pursuit of punitive damages by a plaintiff may create a conflict of interest. In some states, liability insurers are not obligated to indemnify for punitive damage awards. Insureds, however, are deeply vested in avoiding an award of punitive damages. When such a claim is brought, defense counsel must inform the insurer and the insured of the punitive damage exposure so that they may take appropriate action to protect their respective interests.17

G. Insurer Attempts to Limit Discovery to Reduce Expenses

Restrictions on discovery or instructions to forgo depositions or not propound discovery requests create potential conflicts of interest if the limitations inhibit counsel’s ability to provide an adequate defense. Such conflicts are aggravated when the potential damages are expected to exceed coverage.18

Ethics rules preclude counsel from representing a client (insured) if representation is materially limited by counsel’s responsibilities to another client (insurer). By way of example, Rule 5.4(c) of the Model Rules of Professional Responsibility establishes that counsel may not allow a third party who employs or pays counsel to “direct or regulate the lawyer’s professional judgment in rendering such legal services.” To avoid such conflicts, counsel may have to conduct discovery—regardless of an insurer’s refusal to pay—and may have to inform the insured of the potential discovery limitations and obtain written consent to provide continued representation.19

IV. Ethics Rules Governing Insurance Defense Counsel

Insurance defense counsel are subject to the same ethics rules that govern all attorneys, and most states have adopted the American Bar Association’s Model Rules of Professional Conduct. Below are three rules that directly apply to insurance defense:

A. Model Rule 1.7

Model Rule 1.7 pertains to conflicts of interest and states:

(a) A lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless:

(1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and

(2) each client consents after consultation.

18 Id.
19 Model Rules of Professional Conduct 5.4(c).
(b) A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer’s responsibilities to another client or to a third person, or by the lawyer’s own interests, unless:

(1) the lawyer reasonably believes the representation will not be adversely affected; and

(2) the client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.

Rule 1.7(b) governs matters in which an insurer attempts to limit discovery in an effort to reduce litigation costs. Section (b)(2) requires defense counsel who anticipate future conflicts of interest to obtain the consent of both to ongoing representation. Rule 1.7 also mandates that the insured and insurer are fully informed of possible conflicts of interest and risks associated with dual representation before consent is obtained. Likewise, comment 10 to Rule 1.7 states: “A lawyer may be paid from a source other than the client, if the client is informed of that fact and consents and the arrangement does not compromise the lawyer’s duty of loyalty to the client.”

B. Model Rules 1.8(f) and 5.4(c)

A lawyer shall not accept compensation for representing a client from one other than the client unless:

(1) the client consents after consultation;

(2) there is no interference with the lawyer’s independence of professional judgment or with the lawyer-client relationship; and

(3) Information relating to representation of a client is protected as required by rule 1.6.

Compliance with Rule 1.8(f)(2) may therefore require defense counsel to disregard the insurer’s instructions with regard to strategic litigation decisions.

Rule 5.4 governs a lawyer’s professional independence. Paragraph (c) states: “A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer’s professional judgment in rendering such legal services.” Rule 5.4(c) takes effect when an insurer attempts to limit defense counsel’s undertakings in an effort to reduce litigation costs.
C. Confidentiality and Fraud: Model Rules 1.2, 1.16, and 1.6

Model Rule 1.2(d) unambiguously precludes defense counsel from assisting or supporting an insured who is attempting to defraud an insurer. Under Model Rule 1.2(d), “[a] lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent . . . .”

Model Rule 1.16(a)(1) is similarly related to fraud and requires defense counsel’s resignation from an insured’s representation under such circumstances. The rule states counsel “shall not represent a client or, where representation has commenced, shall withdraw” if representation “will result in violation of the rules of professional conduct or other law . . . .”

Model Rule 1.6 pertains to defense counsel’s obligation to maintain confidentiality. In the face of an insured’s fraud, Rule 1.6 further bars counsel from revealing the fraud to the insurer. Comment 16 of the Rule states:

After withdrawal, the lawyer is required to refrain from making disclosure of the client’s confidences, except as otherwise provided in Rule 1.6. Neither this Rule nor Rule 1.8(b) nor Rule 1.16(d) prevents the lawyer from giving notice of the fact of withdrawal, and the lawyer may also withdraw or disaffirm any opinion, document, affirmation or the like. Apparently, then, Rule 1.6 authorizes indirect or discreet disclosure of an insured’s fraud by way of a “noisy withdrawal.” Some scholars have described such a withdrawal as waving “the red flag.”

V. Possible Resolutions

Generally, defense counsel must exercise great caution when asked to represent an insured. At the outset, and before agreeing to provide such representation, defense counsel must analyze potential conflicts, disclose any identifiable conflicts to both the insured and the insurer, and should obtain valid waivers from the policyholder and insurer to engage in dual representation. We recommend that defense counsel draft a joint defense agreement that encompasses the aforementioned issues and clearly articulates the scope of the anticipated litigation.

As litigation progresses, defense counsel must continue to closely monitor the representation, identifying possible conflicts as they arise, informing the insured and insurer of such conflicts, and taking appropriate action based on the nature of the conflict. In the event that defense counsel is no longer able to represent either or both entities, withdrawal is mandated. Moreover, there are times at which defense counsel must engage in certain activities, regardless of the insurer’s willingness to pay. Lastly, defense counsel must be mindful of the obligations owed to the insured when determining how to resolve the pending litigation, even when the proposed settlement falls within policy limits and controlling policy reserves exclusive control over settlement decisions to the carrier.
For 40 years, Bradley Jones has represented clients in a variety of litigation matters and transactions. He is recognized nationally, and locally as a leader in several practice areas. He has been involved in the management of the law firm for more than 20 years.

Bradley focuses his practice on litigation, including (1) general commercial disputes; (2) director and officer claims; (3) professional liability defense; (4) employment claims; (5) products liability claims; and (6) insurance coverage and extra-contractual liability disputes arising out of a variety of liability, property, life, and accident and health insurance products. His clients include businesses and individuals, self-insureds, third-party administrators and insurers.

Kate Johnson joined the firm in August 2017 and works in our Professional Liability – Health Care practice group. Prior to joining our firm as an associate attorney, Kate was a Law Clerk to the Honorable Denise Reilly of the Minnesota Court of Appeals and she completed a Judicial Externship for U.S. Magistrate Judge Becky R. Thorson.