

**ETHICS AND
THE TRIPARTITE RELATIONSHIP:
Disclosure of Confidential Information
and the Right to Control the Litigation**

**BY
DAVID W. ELROD
JONATHAN C. POLAK**

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I. SCOPE OF ARTICLE

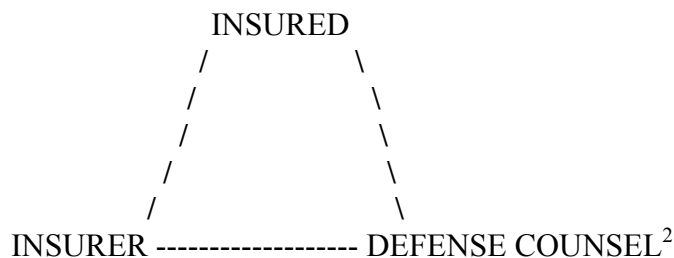
This paper is about the ethical tension that exists between a policyholder (“Insured”), an insurance company (“Insurer”) and the counsel for the Insured retained by the Insurer (“Defense Counsel”). This paper is intended to provide a general understanding of the dynamics of this “*tripartite*” relationship, as well as examine the ethical issues resulting from the competing interests of the parties. Additionally, commentators* suggestions for resolution of these conflicts and/or potential conflicts of interest are presented for consideration by counsel in the context of their own practices. The breadth of this topic is vast, and it would be difficult to adequately address all of the issues arising out of this arguably unique relationship.

Thus, this paper will focus on the question of “Who is the Client?” of Defense Counsel in this relationship, and will survey the conclusions of various commentators, legal opinions and statutes. The paper will then examine how the answer to this question affects two critical issues: (1) disclosure of confidential communications by the Insured to Defense Counsel that is adverse to the Insurer; and (2) the right of the Insurer to control the litigation and materially influence the means in which the litigation is carried out.

II. THE “TRIPARTITE” RELATIONSHIP

A. The “Tripartite” Relationship.

The relationship between Insured, Insurer and Defense Counsel has often been depicted as a triangular, “Tripartite” relationship.¹ It is triangular because each of the three parties owe, in some respect, either contractual, statutory or common law duties to the other, simultaneously and concurrently, as discussed below. The triangular relationship looks something like this:



It is unresolved in Texas as to whether both the Insurer and the Insured are “clients” of the Defense Counsel. Some would argue that the only attorney/client relationship that exists is between the Defense Counsel and the Insured, while others have taken the position that the Insurer and Insured are “co-clients” of the Defense Counsel.

Usually, this relationship does not result in a conflict of interest between these three parties. Defense Counsel zealously represents the Insured in the underlying litigation and is never faced with any sort of ethical questions regarding his role in this arrangement. In the

opinion of one court, “[t]he three parties may be viewed as a loose partnership, coalition or alliance directed toward a common goal, sharing a common purpose which lasts during the pendency of the claim or litigation against the insured.”³ Nonetheless, the potential for disaster also looms on the horizon for the parties to this tenuous relationship, giving rise to reference to the above diagram as the “Bermuda Triangle” of professional ethics for Defense Counsel.⁴

B. The Relationship Between Insurer and Insured.

The rights and obligations by and between an Insurer and an Insured are primarily set forth in the insurance policy issued by the Insurer. Therein, the Insurer sets forth the terms and conditions of coverage, as well as the parties* obligations and duties in the event of a claim. Included in these obligations is the duty of the Insurer to provide the Insured a defense of any claims potentially covered under the policy that are asserted against the Insured in a lawsuit. Further, the Insurer agrees to indemnify the Insured for any judgment on any claim entered against the Insured for a claim covered on the policy. These duties are commonly known as the “Duty to Defend” and the “Duty to Indemnify.” The Insured also owes certain duties to the Insurer under the policy, such as a duty to cooperate in the defense of any third-party claim as well as the duty to promptly notify the Insurer in the event of a claim.

In addition to these contractual duties, Texas law also recognizes the fiduciary relationship between Insurer and Insured. The Texas Insurance Code also recognizes the importance of the Insurer/insured relationship, and contains certain statutory penalties against an Insurer for breaches of the statutory standards imposed.⁵ The extent to which an Insured may hold an Insurer responsible either on the insurance policy or extra-contractually is outside the scope of this paper.

C. The Relationship Between Insured and Defense Counsel.

The relationship between the Insured and Defense Counsel is that of attorney and client.⁶ It is a fiduciary relationship where the Defense Counsel owes the Insured the highest duty of loyalty and disclosure.⁷ However, this relationship does not exist in a vacuum, and the role of Defense Counsel is often, at least in the eyes of the Insurer, limited in certain respects by Defense Counsel*’s responsibilities to the Insurer. These responsibilities manifest themselves in everyday practice in the form of status reports, cost containment policies, litigation guidelines and standardized billing procedures. The seminal Texas authority on conflicts of interest arising between Insured and Defense Counsel is the Texas Supreme Court*’s opinion in *Employers Cas. Co. v. Tilley*.⁸ The *Tilley* opinion is discussed in more detail below.

D. The Relationship Between Insurer and Defense Counsel.

Under most circumstances, when the Insurer receives notice of a claim from an Insured, the Insurer will, after investigating the underlying facts of the claim, either: (1) deny coverage or alternatively, (2) assume the defense of the Insured or, if there is a coverage question, assume the Insured*’s defense under a reservation of rights. If the Insurer accepts the defense of the Insured for any reason, then it will hire Defense Counsel to represent the Insured on the underlying action at the Insurers expense. Under most circumstances, the Insurer retains the right to control

and direct the litigation. As discussed above, Defense Counsel is often requested by an Insurer to comply with certain litigation guidelines that, under certain circumstances, require approval of the Insurer before certain discovery is undertaken in the defense of the Insured by Defense Counsel. Further, the Insurer often requests that Defense Counsel supply the Insurer with detailed status reports discussing the discovery occurring in the litigation. What happens if the Defense Counsel informs the Insurer of facts that take the claims out of coverage? Does this breach Defense Counsel's fiduciary duty to the Insured? Similar ethical dilemmas arise creating serious questions for Defense Counsel. Further complicating this is the often long-term relationship between Insurer and Defense Counsel.⁹ At the very least, this situation can give rise to appearances of impropriety.¹⁰

III. LEGAL PRINCIPLES REGARDING THE "TRIPARTITE" RELATIONSHIP

A. The Tilley Doctrine.

As stated above, *Tilley* is the seminal Texas case on the limitations placed on Defense Counsel in its representation of the Insured. Although not comprehensive of every issue conceivably arising out of this complex matter, *Tilley* does attempt to provide some guidance to Texas counsel.

1. *The facts.*

Douglas Starky sued Joe Tilley for recovery of personal injury damages. Tilley notified his insurer that he had been sued, but that he had not ever been notified of the injury which had occurred nearly two years earlier. Tilley's insurer, Employers* Casualty Company, tendered Tilley a defense despite having evidence that Tilley had knowledge of the injuries much earlier. The attorney retained by Employers* Casualty to represent Tilley in the underlying matter knew of the insurer's investigation into the late notice issue and that Employer's* Casualty was preparing to litigate the coverage issues. Despite this knowledge, the defense counsel never informed Tilley of the insurer's intent or actions. Thereafter and during the pendency of the underlying litigation, Employers*' Casualty Company brought a declaratory judgment action against Tilley seeking to have it relieved of any obligations to defend or indemnify Tilley in the underlying action.

interestingly, in addition to failing to inform Tilley of his insurer's plans to contest coverage in court, defense counsel also engaged in a course of conduct identified by the court as "adverse to Tilley on the question of coverage."¹¹ Specifically, the court determined that Tilley's defense counsel had committed the following acts adverse to Tilley:

- * taking a statement from Tilley's foreman to establish that Tilley had notice of the accident giving rise to the lawsuit;

- * taking statements from four other Tilley employees seeking to establish that they had informed Tilley of the accident, knowing at the time that it was contrary to Tilley's position;
- * briefing the legal question of late notice for Employers' Casualty without advising Tilley of his actions or findings;
- * interviewing two other persons at the request of Employers' Casualty to establish the late notice defense now asserted by Employers' Casualty against Tilley; and
- * writing numerous letters and engaging in numerous conversations with Employers' Casualty pertaining to the development of its coverage defense, suggesting additional investigation, and advising as to the legal possibilities of establishing such a defense.¹²

When Tilley discovered that his own attorney had been engaging in such conduct for the benefit of and at the direction of his insurance company, he argued to the court that this activity estopped Employers' Casualty from avoiding coverage under the policy.

2. *The holding.*

The Texas Supreme Court agreed with Tilley. It held that despite the fact that the defense counsel was "selected, employed and paid by the insurance company", the "attorney becomes the attorney of record and the legal representative of the insured, and as such owes the insured the same type of unqualified loyalty as if he had been originally employed by the insured."¹³ The Court further noted that "[i]f a conflict arises between the interests of the insurer and the insured, the attorney owes a duty to the insured to immediately advise him of the conflict."¹⁴

The *Tilley* Court, in reaching its conclusion, relied, in part, on the Code of Professional Responsibility in effect in Texas at the time and on a set of "Guiding Principles" issued by the American Bar Association National Conference of Lawyers and Liability Insurers.¹⁵ With respect to the Code of Professional Responsibility, the *Tilley* court looked specifically to Canon 5 dealing with the conduct of a lawyer representing multiple clients with conflicting or potentially conflicting interests.¹⁶ Ethical Consideration 5-16, a subpart of Canon 5, provided as follows:

In those instances in which a lawyer is justified in representing two or more clients having differing interests, it is nevertheless essential that each client be given the opportunity to evaluate his need for representation free of any potential conflict and to obtain other counsel if he so desires. Thus before a lawyer may represent multiple clients, he should explain fully to each client the implications of the common representation and should accept or continue employment only if the clients consent. If there are present other circumstances that might cause any of the multiple clients to question the undivided loyalty of the lawyer, he should

also advise all of the clients of those circumstances.¹⁷

In citing this section, the Court noted that “[r]epresentation of ‘an insurer and an insured*’ is mentioned [throughout the Code of Professional Responsibility] among typically recurring situations involving potentially differing interests.”¹⁸

In reaching its opinion, the Court also looked to the “Guiding Principles” established by the American Bar Association in 1970, which at that time were recent considerations on the law of this issue.¹⁹ The Court noted that the American Bar Association National Conference of Lawyers and Liability Insurers had “made a careful study of this recurring problem” and had issued these Guiding Principles “for the guidance of liability insurers furnishing legal counsel for their insureds.”²⁰ The Court then set forth, in part, the following two excerpts from the Guiding Principles:

IV. CONFLICTS OF INTEREST GENERALLY -- DUTIES OF ATTORNEY. In any claim or in any suit where the attorney selected by the company to defend the claim or action becomes aware of the facts or information which indicate to him a question of coverage in the matter being defended or any other conflict of interest between the company and the insured with respect to the defense of* the matter, *the attorney should promptly inform both the company and the insured, preferably in writing, of the nature and extent of the conflicting interest*

V. CONTINUATION BY ATTORNEY EVEN THOUGH THERE IS A CONFLICT OF INTEREST. Where there is a question of coverage or other conflict of interest, the company and the attorney selected by the company to defend the claim or suit should not thereafter continue to defend the insured in the matter in question unless, *after a full explanation of the coverage question*, the insured acquiesces in the continuation of such defense...²¹

The Court expressly approved both principles, and noted that “[c]onduct in violation of the above principles by the insurer through the attorney selected by it to represent the insured has been condemned by the highest courts of several other jurisdictions.”²²

3. *Construction of Tilley by Texas Courts.*

Texas courts, in construing *Tilley*, are unanimous in their conclusion that an attorney-client relationship exists between an Insured and its Defense Counsel retained by the Insured’s Insurer.²³ The existence of such a relationship between Insurer and Defense Counsel, however, is not so clear. For example, in *Bradt v. West*, the First District Court of Appeals in Houston, citing *Tilley*, held that “[t]here is no attorney-client relationship between an insurer and an attorney hired by the insurer just to provide a defense to one of the insurer’s insureds.” The court continued that “[e]ven though such an attorney is typically selected by the insurer, paid by the insurer, and periodically reports to the insurer about the progress of the case against the insured, these facts do not mean that the insurer is the client.”²⁴ Further, the Texas Supreme Court in *American Physicians v. Garcia* noted in a footnote that despite an insurance company’s payment

of legal fees on behalf of its insured, the attorney-client relationship was between Insured and Defense Counsel, and no such relationship existed between Defense counsel and Insurer.²⁵ However, the *Bradt* and *Garcia* courts did not perform any independent analysis of whether the factual circumstances surrounding the Insurer/Defense Counsel relationship satisfied the test for an attorney-client relationship. Also, the language used by *Bradt* does not discount the possibility of a co-client status by the Insurer on different facts. Finally, the *Garcia* court cited Rule 1.06 of the Texas Disciplinary Rule of Civil Procedure which specifically addresses conflicts arising between concurrent representation of two clients.²⁶ The effect of this has not yet been discussed in any subsequent published opinions of Texas courts.

Further complicating this issue is the Texas Supreme Courts opinion in *American Centennial Ins. Co. v. Canal Ins. Co.*, where it held that “[d]efense counsel must be particularly sensitive to the various interests of the insured and the insurer which produce complex and often conflicting relationships.²⁷ This cryptic statement could be argued to suggest that the Defense Counsel should consider the interests of the Insurer in the performance of its duties. Interestingly, no Texas court has addressed the issue of whether an insurance company is a “co-client” of the Insured. Nor has any Texas opinion discussed the implication in the *Tilley* opinion that the Insurer and Insured could be co-clients of the Defense Counsel.

B. Texas Disciplinary Rules of Professional Conduct.

The Texas Disciplinary Rules of Professional Conduct also provide guidance in analyzing conflict of interest issues arising in the insurance context.²⁸ The following is an identification of several of the more relevant provisions to this issue.

1. *Rule 1.05: Confidentiality of Information.*

Rule 1.05 expressly prohibits the disclosure of “confidential information” under certain circumstances.²⁹ “Confidential Information” is defined as both “privileged” and “unprivileged” information.³⁰ “Privileged” means that information protected by the attorney-client privilege as contemplated by the Texas Civil Rules of Evidence, Texas Criminal Rules of Evidence and the Federal Rules of Evidence.³¹ Further, “Non-privileged” means “all information relating to a client or furnished by the client, other than privileged information, acquired by the lawyer during the course of or by reason of the representation of the client.”³²

Rule 1.05 states that a lawyer may not knowingly reveal confidential information under any of the following circumstances, unless expressly permitted otherwise under the rule:

- * to anyone the client expressly prohibits the telling of the confidential information;
- * to anyone other than the client, the client’s representatives, or the members, associates or employees of the lawyer’s law firm;
- * where the confidential information is to be used to the disadvantage of the client unless the client consents after consultation;

- * where the confidential information is to be used to the disadvantage of a former client after the representation is concluded unless the former client consents after consultation or the confidential information has become generally known;
- * where disclosure is to be used for the advantage of the lawyer or of a third person, unless the client consents after consultation.³³

However, pursuant to Rule 1.05, a lawyer may reveal confidential information in any of the following situations:

- * when the lawyer has been expressly authorized to do so in order to carry out the representation;
- * when the client consents after consultation;
- * when the disclosure is made to the client, the client's representatives, or the members, associates and employees of the lawyer's firm, except when otherwise instructed by the client;
- * when the lawyer has reason to believe it is necessary to do so in order to comply with a court order, a Texas Disciplinary Rule of Professional Conduct, or other law;
- * to the extent reasonably necessary to enforce a claim or establish a defense on behalf of the lawyer in a controversy between a lawyer and a client;
- * to establish a defense to a criminal charge, civil claim or disciplinary complaint against the lawyer or the lawyer's associates based upon conduct involving the client or the representation of the client;
- * when the lawyer has reason to believe it is necessary to do so in order to prevent the client from committing a criminal or fraudulent act;
- * to the extent revelation reasonably appears necessary to rectify the consequences of a client's criminal or fraudulent act in the commission of which the lawyer's services had been used.³⁴

Finally, Rule 1.05 provides that an attorney may reveal "nonprivileged" information in the following circumstances:

- * when impliedly authorized to do so in order to carry out the representation;
- * when the lawyer has reason to believe it is necessary to do so in order to: (1) carry out the representation effectively; (2) defend the lawyer or the

lawyer's employees or associates against a claim of wrongful conduct; (3) respond to allegations in any proceeding concerning the lawyer's representation of the client; or (4) prove the amount and reasonableness of fees charged to a client in an action regarding those fees.³⁵

2. *Rule 1.06: Conflict of Interest: General Rule.*

Although the Texas Rules of Disciplinary Procedure contain several sections specifically dealing with conflicts of interest, Rule 1.06 sets forth the general principles relating to this subject.³⁶ Specifically, Rule 1.06 provides that a lawyer is generally prohibited from representing "opposing parties to the same litigation."³⁷ Further, a lawyer may not represent a person if the representation of that person either: (1) involves a substantially related matter in which that person's interests are materially and directly adverse to the interests of another client of the lawyer or the lawyer's law firm; or (2) reasonably appears to be or to become adversely limited by the lawyer's or law firm's responsibilities to another client or to a third person or by the lawyer's or law firm's own interests.³⁸ With respect to these last two limitations in particular, a lawyer may continue in the representation provided the lawyer "reasonably believes the representation of each client will not be materially affected" *and* each affected client consents after "full disclosure of the existence, nature, implications, and possible adverse consequences of the common representation and the advantages involved, if any."³⁹ Interestingly, Comment 12 to Rule 1.06 provides that a lawyer may not be paid from a source other than the client unless the client is informed of the arrangement and the lawyer's duty of loyalty is not compromised.⁴⁰

One commentator has suggested that in the insurance defense context, Rule 1.06 "can be interpreted to mean that insurance defense counsel cannot represent the insured if: (1) the insured's interests are materially and directly adverse to the insurer's interests; or (2) defense counsel's ability to represent the insured appears to become or actually does become limited by the lawyer's duties and responsibilities to the insurer."⁴¹ Further, the "defense counsel can continue to represent the insured where there is a conflict between the policyholder and the insurer only if the policyholder consents after full disclosure of the conflict."⁴² This view, however, assumes that there is a preexisting attorney-client relationship between the Insurer and the Defense Counsel, which, based on *Tilley*, may or may not exist. However, it could be argued that Rule 1.06 supports the principle that Defense Counsel should never knowingly reveal to the Insurer any information that would establish a coverage defense without disclosing the existence of the conflict to both the Insurer *and* the Insured.

3. *Rule 1.08: Payment of Fees by a Third Party.*

Rule 1.08, in part, relates to payment of legal fees and expenses by a third party, and is directly applicable to the insurance defense context.⁴³ Comment 12 to Rule 1.06 specifically refers to Rule 1.08(e) as authority for limitations on a third-party's ability to pay the legal fees of another.⁴⁴ Rule 1.08(e) provides that "[a] lawyer shall not accept compensation for representing a client from one other than the client unless: (1) the client consents; (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and (3) information relating to representation of a client is protected as required by Rule 1.05."⁴⁵ Comment 5 of Rule 1.08 further explains that the disclosure of third-party fee payment is usually

made in the insurance contract itself between the Insurer and the Insured.⁴⁶

4. *Rule 5.04(c): Professional Independence of a Lawyer.*

Rule 5.04(c) of the Disciplinary Rules re-emphasizes the importance of maintaining the independence of a lawyer's legal judgment.⁴⁷ Specifically, it prohibits a third-party payor of legal fees from interfering, directing or regulating "the lawyer's professional judgment in rendering legal services."⁴⁸ The commentary to Rule 5.04(c) not only warns against the influence of a third-party payor's "economic, political, or social goals," but more interestingly instructs attorneys "to decline to accept direction of the lawyer's professional judgment from any non-lawyer in the organization" when the organization is paying the lawyer on a third-party payor basis.⁴⁹ This raises a troubling issue for defense counsel coordinating litigation strategy with non-lawyer adjusters.

C. **The Restatement (Third) of the Law Governing Lawyers.**

1. *Purpose of the Restatement.*

Nearly a decade ago, the American Law Institute ("ALI"), embarked on a mission to draft a RESTATEMENT (Third) OF THE LAW GOVERNING LAWYERS.⁵⁰ The ALI is a Philadelphia-based organization of lawyers, judges and law professors, which publishes treatises, or "Restatements," on various areas of the law intended to be cited as authority on the given subject. These treatises generally are drawn from the ABA's Model Rules of Professional Conduct, the ABA's Code of Professional Responsibility, and various states' rules and codes. The Restatement aims to "restate" the law in accordance with these sources, and further seeks to articulate black letter principles of the law governing lawyers.

2. *Section 215.*

Section 215 of the Proposed Final Draft No. 2 of the Restatement (Third) of the Law Governing Lawyers provides as follows:

§ 215 Compensation or Direction by Third Person

- (1) A lawyer may not represent a client under circumstances in which someone other than the client will wholly or partly compensate the lawyer for the representation, unless the client consents under the limitations and conditions provided in §202, with knowledge of the circumstances and conditions of the payment.
- (2) A lawyer's professional conduct on behalf of a client may be directed by someone other than the client when:
 - (a) the direction is reasonable in scope and character, such as by reflecting the obligations borne by the person directing the lawyer;

and

- (b) the client consents to the direction under the limitations and conditions provided in §202.⁵¹

At the recent Annual Meeting where Final Draft No. 2 was voted upon by the ALI membership, it was determined that § 215(2)(a) should remain in its current form but add the requirement that “the direction does not interfere with the independent professional judgment of the lawyer.”⁵²

3. *Comments to § 215.*

Along with the draft language of § 215, the Restatement provides additional commentary intended to provide guidance in interpretation of its provisions. This commentary provides not only substantive elaboration, but also illustrative examples relating to specific issues potentially raised by its language. The following is a discussion of several of the comments most relevant to this discussion.

a. Comment b: Initial Client Consent.

The issue of consent has been hotly debated by the ALI. It is fundamental that the client must consent to the third-party payor arrangement whereby the third party retains control over the direction of the litigation.⁵³ In the Final Draft No. 2 version, Comment b provides that the insured’s tender of the defense to his carrier is typically sufficient to satisfy the consent requirement.⁵⁴ Consent under this circumstance would only be limited by the existence of a coverage defense by the insurer whereby the attorney would either withdraw or consult with the client-insured to obtain additional, more comprehensive, consent.⁵⁵ At the recent ALI Annual Meeting, the membership voted to change this language and add the following instruction: “consent other than that inferred from an informative letter to the client at the outset of a representation, should be all that is required.” This amendment attempted to bring § 215 in line with ABA Standing Committee on Ethics and Professional Responsibility, Formal Opinion 96-403, which instructs the attorney representing an insured to provide to the insured, in writing, a statement of the nature of the attorney’s relationship with the insurance company and the limits of that representation.

b. Comment c: Third-Person Fee Payment.

In this comment, the Reporters openly acknowledge “two values” to be balanced when fees are paid by a third party.⁵⁶ First, regardless of the fee arrangement, the “lawyer’s loyalty to the client [must] not be compromised by the person paying the lawyer’s fee” because the “lawyer’s duty of loyalty is to the client alone.”⁵⁷ However, the Reporters suggest that the Defense Counsel’s duty of loyalty to the insured must not preclude the ability to contractually arrange in advance for payment of legal fees by a third party.⁵⁸ The Reporters recognize that this is an important benefit of all insurance arrangements and should not be undermined by the Restatement’s language.⁵⁹ Absent a complete indemnity agreement, control over the direction of

the litigation is subject to greater scrutiny, and greater deference is given to the interests of the client-insured. The Restatement also provides guidance in the circumstance where the lawyer considers both the insured and the insurer as his “co-clients.” Specifically, comment c states that an attorney may owe his undivided duty of loyalty concurrently and simultaneously to *both* insurer and insured, so long as that relationship is consistent with the duties running to each client individually and each client consents to the arrangement.⁶⁰ Consent in addition to that implied by the tender of the defense would most likely be appropriate in such a situation.

c. Comment d: Third-Person Direction of Representation.

“The principle that a lawyer must exercise independent professional judgment on behalf of the client generally requires that no third person control or direct a lawyer’s professional judgment on behalf of the client.”⁶¹ Nonetheless, §215 is intended to permit a third-party paying for the services to direct the lawyer’s representation subject to certain limitations. The purpose of § 215 is to provide a balance between the interests of the third-party payor and the person on whose behalf the payments are made.⁶² The interests of the client are adequately protected, by the requirement of client consent to the control and direction.⁶³ Under such circumstances, the insured-client would, in effect, transfer the right to direct the litigation to the third-person payor.⁶⁴ The scope of direction, however, must be “reasonable” and reflect “the obligations borne by the person directing the lawyer.”⁶⁵ With respect to the issue of external cost controls imposed on the attorney, so long as the third-party payor agrees to completely indemnify the insured-client for any adverse judgment against him, such controls are permissible so long as they do not “significantly change the likely outcome.”⁶⁶ In circumstances involving a dual-client relationship, the attorney must balance his obligations to both parties. Regardless, it would seem that under the Restatement that the degree of control exercised by the third-party will be greater where the third-party “bears substantially all of the consequences of the result of the litigation.”⁶⁷

d. Comment e: Preserving Confidential Client Information.

Comment e specifically addresses the preservation of certain confidential information received from the client where the client’s fees are being paid by a third-party.⁶⁸ The comment provides that the “lawyer must protect the confidential information of the client.”⁶⁹ Further, the informed consent from the client obtained by the lawyer to the general proposition of payment of the fees by a third person *may not* be enough to permit disclosure of confidential information, To the contrary it must meet separate requirements dealing with disclosure of confidential client information.⁷⁰ Thus, if any attorney learns of coverage-sensitive information that is obtained via a confidential communication, a new and independent consultation should occur with the insured-client to confirm the client’s intent with respect to the information.⁷¹

e. Comment f: Representing Insured.

Comment f has undoubtedly prompted the most controversy of all the conflict of interest sections, has undergone the most substantive changes and provides the most relevant and on-point guidance to the insurance defense bar.⁷² This comment deals specifically with the issues relating to retention of Defense Counsel by an Insurer to represent an Insured.⁷³ The Restatement

draws several important conclusions in this commentary: (1) status reports, case evaluations and other standard communications between the Defense Counsel and the Insurer are privileged communications regardless of whether there exists an attorney-client relationship between Defense Counsel and the Insurer;⁷⁴ (2) an independent examination of the facts underlying the relationship between the Defense Counsel and the Insurer must be undertaken to determine whether it rises to the status of attorney and client;⁷⁵ and (3) because the Insurer has a direct financial stake in the quality of the representation, the Insurer has standing to bring suit directly against Defense Counsel for his malpractice in defending the insured.⁷⁶

Further, with respect to the occurrence of any “material divergence in interest” between the Insurer and the Insured, comment f states the following: (1) if the possibility of liability in excess of the policy limits exists, the “lawyer may not follow the directions of the insurer if doing so would put the insured at significantly increased risk of liability in excess of the policy coverage”; (2) if there is a question of coverage under the policy and the only client is the client-insured, then the lawyer “may not reveal adverse confidential client information of the insured to the insurer concerning the questions... without explicit informed consent of the insured...”; and (3) if there is a question of coverage under the policy, and the insurer and insured are co-clients, the lawyer may not act inconsistently with the interests of either client.⁷⁷

The situation involving the insured and insurer as “co-clients” presents a complex ethical dilemma for the insurance defense practitioner when the co-clients* interests are adverse. The Restatement is clear that under such circumstances, Defense Counsel must act in the “best interests” of the client-insured, but his conduct must be consistent with his obligation not to assist in fraud as well as duties to the insurer-client.⁷⁸ If this is not possible, Defense Counsel must withdraw from both representations.⁷⁹ The duty to not convey confidential information of the insured is reciprocated by Defense Counsel’s* obligation to the insurer not to provide coverage advice to the insured, or to advise the insured regarding potential claims against the insurer.⁸⁰ Under such circumstances, Defense Counsel must remind the insured as to the limited scope of the representation and “the importance of obtaining assistance of other counsel with respect to such matters.”⁸¹

IV. TENSION IN THE “TRIPARTITE” RELATIONSHIP.

A. Who is the Client?

The question of “Who is the client?” is fundamental when examining the issue of conflicts of interest in the tripartite relationship. Based on the foregoing, there appears to be three schools of thought on the answer to this question: (1) the Insured and Insurer are co-clients of Defense Counsel and Defense Counsel owes full fiduciary duties to both under all circumstances; (2) the Insured and Insurer are co-clients of Defense Counsel, but the interests of the Insurer are to be subordinated in the face of any conflict of interest; or (3) the Insured is the only client of the Defense Counsel. The paradigm selected in all likelihood determines the approach to resolve a potential conflict of interest.

As discussed above, Texas courts look to *Tilley* for guidance in answering this question, and based on the strong language contained in the opinion conclude that the only attorney/client

relationship that exists is between the Defense Counsel and the Insured. But, as discussed above, *Tilley* may or may not support this conclusion because of its reference to rules that refer to situations involving two or more clients. Further, the Texas Disciplinary Rules of Professional Conduct are silent on whether an Insurer is the client of Defense Counsel. Once the Restatement is finalized, it may provide a new answer to this question.

1. *Problems with Tilley.*

It should be clear from the above discussion of *Tilley* that the Texas Supreme Court strongly enunciated the fundamental principle that the duty of loyalty in the insurance defense context runs between the Defense Counsel and the Insured. However, *Tilley* may or may not provide support for the complete disregard of the rights of the Insurer in all situations. Several critical facts possibly distinguish its holding. First, *Tilley* is based on Canon 5 of the old Texas Code of Professional Responsibility which concerned conflicts of interest arising between concurrent representation of *two or more* clients. Therefore, it could be argued that implicit from the citation of this code as authority the Texas Supreme Court presumed that the Insurer was a client *in addition* to the Insured. If *Tilley* is not read to confirm the existence of “co-client” status of the Insurer with the Insured, then it could be argued that *Tilley* is limited only to the proposition that an attorney has an unqualified duty of loyalty to the Insured, and there is *no* opinion as to whether the Insurer loses its “client” status, if any such status exists, upon the existence of any conflict of interest. Further, several recent Texas opinions have indicated that an excess insurer has a cause of action against Defense Counsel for malpractice resulting in economic loss to the Insurer, a right Texas law has traditionally only afforded to clients.⁸²

2. *Requirements for Establishing an Attorney/Client Relationship.*

An attorney-client relationship is established when the attorney and prospective client *agree* to create the relationship:

The legal relationship of attorney and client is purely contractual and results from the mutual agreement and understanding of the parties concerned, based upon the clear and express agreement of the parties as to the nature of the work to be undertaken and the compensation to be paid therefor.⁸³

A contract between an attorney and client may be implied when the parties “*by their conduct* manifest an intention to create the attorney-client relationship.”⁸⁴ It is not enough that the purported client attends meetings in the attorney’s office or that the attorney makes statements to the alleged client concerning the probable legal consequences of certain actions.⁸⁵ Further, an attorney-client relationship cannot be imposed unilaterally by a person claiming to be a client, and his subjective intent is insufficient to establish the relationship.⁸⁶

In *Castillo v. First City Bancorporation of Texas, Inc.*, the Fifth Circuit held that, as a matter of law, no attorney-client relationship giving rise to a fiduciary duty existed when an attorney representing First City “discussed freely and gave advice” and opinions to the plaintiffs regarding First City’s loan transaction and the sale of the plaintiffs’* properties.⁸⁷ The Fifth Circuit relied upon the fact that the plaintiffs were represented by their own legal counsel during

the loan negotiations to conclude that no attorney-client relationship existed between the lawyer who represented First City and the plaintiffs, stating as follows:

But even if [the lawyer] was especially helpful to [the plaintiffs] and freely gave advice, *the fact that [the plaintiffs] may have subjectively trusted [the lawyer] and relied on him, without more, is insufficient to create a fiduciary relationship.* We agree with the district court that as a matter of law, [the lawyer's] *legal discussions with [the plaintiffs] did not create an attorney-client relationship* giving rise to a fiduciary duty.⁸⁸

Similarly, in *Thompson v. Vinson & Elkins*, the court held that attorneys retained to represent a trustee are not in privity with the beneficiaries of the trust and owed no fiduciary duty to them, even though the trustee himself may owe a fiduciary duty to those beneficiaries.⁸⁹ The Fifth Circuit also has held that if an attorney represented only an agent, no privity of contract would exist with the agent's principal and no claim could be made by the principal for legal malpractice.⁹⁰

An attorney-client relationship also may be based on an express or implied contract.⁹¹ The relationship may be implied from the conduct of the parties.⁹² "All that is required is that the parties explicitly or by their conduct manifest an intention to create the attorney-client relationship."⁹³ The contract may result if the client makes an offer or request of the attorney and the attorney accepts or assents.⁹⁴ In addition, an attorney may be held negligent when he fails to advise a party that he is not representing that party, when circumstances lead the party to believe that the attorney is representing him.⁹⁵

Although the Texas Disciplinary Rules of Professional Conduct do not provide a standard for when an attorney-client relationship is formed, they do provide guidance on the activities an attorney performs for a client.⁹⁶ An attorney evaluates the client's affairs and reports on them to the client or to others.⁹⁷ In addition, as an advisor, the attorney informs the client of his or her legal rights and obligations and explains their practical implications.⁹⁸ Thus the existence of an attorney-client relationship can be inferred when an attorney performs acts contemplated under the Rules.

3. *The Texas Disciplinary Rules of Professional Conduct.*

Rules 1.05, 1.06, 1.08 and 5.04(c) fail to directly address whether an Insurer is a client in the insurance defense context. While they are helpful in narrowing the issues related to how Defense Counsel may conduct himself regardless of whether the Insurer is a client, they avoid the fundamental question of whether an Insurer is a "client" of the Defense Counsel.

For example, Rule 1.06 details the obligations of an attorney when representing two clients with adverse interests. However, the commentary to this rule does not state whether an insurance company is a "client" under the rules. If the Insurer is not a client, then it is difficult to see how Rule 1.06 would apply because it governs conflicts arising between two or more *concurrent representations*. However, *Tilley* clearly did apply the ancestor of Rule 1.06, Canon 5, and therefore it could be argued that Rule 1.06 does cover the Insurer/Defense Counsel relationship.⁹⁹ If so, we are back to the conclusion that the Insurer is a co-client. Conversely, if

an Insurer is not a co-client of the Insured, then perhaps Rule 1.08 is the proper standard for resolution of conflicts of interest. If so, then the Insurer is merely a third-party payor and its rights are limited by the constraints of Rule 1.08. Regardless, it too fails to directly answer the question of “who is the client?” and only provides rules for dealing with conflicts of interest once they arise.

4. *The Restatement.*

Section 215 of the Restatement is the first codification expressly recognizing that an Insurer can, under certain circumstances, be a client of the Defense Counsel. Comment f to § 215 of the Restatement specifically provides that an Insurer can be the client of Defense Counsel retained to represent the Insured so long as that relationship satisfies the criteria for the creation of such a relationship.¹⁰⁰ Thus, one could argue that when Defense Counsel takes instructions from the Insurer, advises the Insurer, receives confidences from the Insurer, imparts confidences to an Insurer, renders legal services to the Insurer and otherwise treats an Insurer as a client, then the inference can be drawn that an attorney/client relationship exists between the Insurer and Defense Counsel. Whether this satisfies the Restatement or common-law requirements for the formation of an attorney-client relationship is open for debate, but the Restatement is clear that the mere retention and selection of Defense Counsel by the Insurer to represent the Insured is in itself insufficient to give rise to an attorney-client relationship.¹⁰¹ Further, the commentary implies that the common procedure of status reports and case evaluations may not give rise to such a relationship, despite the obvious sharing and exchange of confidential information and legal advice on issues ranging from probable success at trial to litigation strategy to settlement options.¹⁰² Further, Defense Counsel’s retention by the insurer for direct representation of the insurer in bad faith or coverage disputes in other matters further complicates this analysis.

5. *So, Who is the Client?*

Thus, the question still begs, “Who is The Client?” The ambiguities in *Tilley* prevent any positive determination one way or the other. The Texas Disciplinary Rules do provide some guidance regarding what to do regardless of whether the Insurer is a co-client, but fail in answering the fundamental question of client status. Although the Restatement does at least allow for the possibility of co-client status, it correctly stops short of categorically placing an attorney-client tag on all relationships between Insurer and Defense Counsel. With this in mind, we next examine the specific issues of disclosure of confidential communications to either Insurer and Insured by Defense Counsel, as well as who has the right to control and direct the litigation.

B. Communication of Confidential Communications.

When Defense Counsel represents an Insured, he will undoubtedly receive and analyze critical confidential information relating to the representation. After receipt of this information, the Defense Counsel will normally synthesize the information and pass it on to the Insurer in the way of status reports and case evaluations. In this process, it is possible that the Defense Counsel could inadvertently pass on confidential information from the Insured to the insurer that directly and adversely affects coverage for the Insured. This raises the critical question of what

responsibility Defense Counsel has for protecting client confidences. Likewise, during this representation, Defense Counsel may receive certain confidential information from the Insurer relating to its coverage analysis. Thus, this raises the mirror question as to whether the Defense Counsel has the obligation to forward this information to the insured.

1. *Information received from the Insured and the Duty of Loyalty to the Insurer.*

The *Tilley* case provides an interesting illustration of the conflicting roles of Defense Counsel, Insured and Insurer where there is a coverage question under the policy. If the Insurer is not a client, then there is arguably no duty of loyalty running to the Insurer from the Defense Counsel because there is no attorney/client relationship. However, assuming that there is such a fiduciary relationship, then the question becomes whether Defense Counsel breaches his fiduciary duty to the Insured by releasing the adverse confidential information to the Insurer. This conflict comes to a head in the context of disputed coverage under the insurance policy.

- a. The argument for disclosure.

- (i) Disclosure required if co-clients.

If the Defense Counsel fails to disclose the information, then this unfairly requires him to withhold critical information from the Insurer to which Defense Counsel owes a fiduciary duty of loyalty and disclosure. Some have argued that this is not required in any other area of the law.¹⁰³ Specifically, despite § 215, the Restatement § 112 requires disclosure of any information obtained from any co-client to the other co-client even if the information is adverse.¹⁰⁴ In fact, the duty to communicate “includes information adverse to a co-client learned from the lawyer’s own investigation or learned in confidence from the co-client.”¹⁰⁵ This is true even where the co-client specifically requests that the information be held in confidence:

In the absence of an agreement among the co-clients to restrict sharing of information, a co-client might provide material information to the common lawyer with the direction that it not be communicated to another co-client. . . . If the information is material to another client, failure to communicate the information would compromise the lawyer’s duties of loyalty, diligence, and communication. While sharing the communication might compromise the communicating client’s hope of confidentiality and risks impairing that client’s trust in the lawyer, in the circumstances an expectation of such confidentiality is unreasonable.¹⁰⁶

However, insurance companies and Defense Counsel are treated the same under the Restatement.¹⁰⁷ Pursuant to § 215, Defense Counsel is specifically prohibited from disclosing confidential information that is adverse to coverage to the insurer, and equally prohibited from providing coverage advice adverse to the insurer to the insured. If consent to disclosure is not obtained from both parties, Defense Counsel has no choice but to withdraw from the representation(s).

(ii) Facts relevant to both liability and coverage.

A second problem with non-disclosure is a practical one. Specifically, how does Defense Counsel sift through the information and determine whether or not it relates to coverage. On some occasions, the issue of coverage will be obvious, i.e., intentional conduct on the part of the insured. But even if the facts clearly relate to coverage, such as in the case of intentional conduct, the problem still remains:

The hard question is how a defense lawyer must act upon receiving information from any source, including the insured, that relates to the investigation, defense, or settlement of the liability suit but that also jeopardizes the existence of coverage for the insured. For example, if the defense lawyer learns that the insured intentionally caused a collision, must the lawyer communicate that information to the insured's automobile carrier or keep it secret to protect the insured? Clearly, the information relates to the defense of the liability suit against the insured. It bears on the likelihood, character, and size of a liability judgment against the insured. At the same time, automobile liability policies typically exclude coverage for bodily injury and property damage intentionally caused by an insured, and insuring agreements typically cover only accidents. What ought the defense lawyer do in this situation?¹⁰⁸

The problem is further compounded by the subtlety of some coverage issues. Unless the practitioner is well-versed in the law regarding these coverage defenses, he runs the risk of inadvertent disclosure of coverage-sensitive information. If Defense Counsel has an obligation to withhold coverage-sensitive information under all circumstances, then must not Defense Counsel not only be an expert in trial of the underlying issues but also policy coverage questions?

The problem with prohibiting disclosure on this basis is that Defense Counsel will be forced to sift through the information assembled through discovery and determine what information is coverage sensitive. The effect of this is that Defense Counsel, who is retained per the policy to defend the Insured against the claims asserted by the plaintiff(s) in the underlying litigation, finds himself suddenly transformed into coverage counsel for the Insured as well. Although the Restatement § 215 provides that Defense Counsel is not obligated to advise the insured as to coverage issues, *Tilley* and the Texas Disciplinary Rules of Professional Conduct may not be so generous. Regardless, it seems a good argument can be made for limiting the scope of Defense Counsel's representation to only trial of the underlying litigation, leaving coverage issues to the Insured and Insurer's personal attorneys.

(iii) *Tilley*

A liberal reading of *Tilley* could lead to the conclusion that disclosure of the confidential information is, in fact, *required*.¹⁰⁹ Remember that the *Tilley* court endorsed in full the ABA Guiding Principles, which provided that in the event of discovery of facts that could call coverage under the insurance policy into question, Defense Counsel had the obligation to "promptly inform both the company and the insured, preferably in writing, of the nature and extent of the conflicting interest..."¹¹⁰ However, even assuming that *Tilley* supports the "co-

client” relationship, it is also possible that *Tilley* does not require the disclosure to the Insurer of the nature or substance of the conflict, but only that the Defense Counsel must withdraw from the representation if the Insured fails to consent to the disclosure. Under such a reading of *Tilley*, no confidences could be disclosed to the Insurer by Defense Counsel absent consent from the Insured to do so.

(iv) Consent and the Texas Rules.

The Texas Disciplinary Rules of Professional Conduct essentially provide that so long as the requisite consent is obtained from the Insured for disclosure of the information, then disclosure is acceptable. An argument could be made that Rule 1.06 provides that Defense Counsel, under these circumstances, cannot represent the Insured if the Insured’s interests are “materially and directly adverse to the interests of” the Insurer, or Defense Counsel’s ability to represent the Insured appears to become or actually does become limited by the lawyer’s duties and responsibilities to the insurer.¹¹¹ But Defense Counsel may continue in the dual representation on a concurrent and dual basis, if “each affected or potentially affected client consents to such representation *after full disclosure of the existence, nature, implications, and possible adverse consequences of the common representation and the advantages involved, if any.*”¹¹² A liberal reading of this provision could permit Defense Counsel to disclose this confidential information. A more moderate reading would require the Defense Counsel to, at the very least, notify the Insured and Insurer of the existence of “a” conflict and seek their consent to permit disclosure of the substance of the conflict. In the event the Insured agrees to the disclosure, then the Insurer may be informed of the confidences. However, if the Insured refuses, then Defense Counsel probably should withdraw.

Further Rule 1.08 also provides that client confidences may be disclosed, so long as the requisite consent is obtained.¹¹³ Therefore, unless the Insured consents to disclosure of the information to the Insurer, Rule 1.08 expressly prohibits any release of the confidential information. In fact, even if the Insurer is construed by Texas courts to be one of the client’s “representatives” to whom confidential information may be released, such disclosure cannot occur where the Insured expressly prohibits disclosure to the Insurer.¹¹⁴

b. The argument against disclosure.

The argument against disclosure rests on the presumption that the duty of loyalty owed by Defense Counsel to the Insured is higher than any obligation running to the Insurer from Defense Counsel. Arguably, this is true whether or not an attorney-client relationship exists between the Defense Counsel and the Insurer. Authority for this position can be found in several sources.

(i) Ethics Opinion 482.

First, the State Bar Ethics Committee concluded that the duty of loyalty to the Insured is paramount. State Bar Ethics Opinion 482 discusses Rule 1.05 and conflicts arising out of the insurance defense context.¹¹⁵ There, an insurance defense firm was defending an insured and two of the insured’s former employees. The firm tape-recorded its interviews with the former employees, a regular practice for the firm. During one particular taped conversation, one of the

employees complained about the way the employer had treated him, refused to sign his interrogatories, indicated that he was arranging for his own defense counsel, instructed the firm retained by the insurer to withdraw on his behalf, and suggested that “his recollection of the facts” surrounding the incident might change to the detriment of the insured if he did not receive a “financial reward” from the insured.¹¹⁶ The firm then sent to the former employee a copy of the motion to withdraw, a copy of the transcript of the telephone conversation, and a letter warning him that he could be charged with perjury if he lied under oath. The firm stated that the transcript would remain confidential “at that point.”¹¹⁷

On these facts, the State Bar Ethics Committee discussed two issues: (1) whether the law firm would be permitted to “release the contents of the transcript to either the insurer,” the former employer (the insured), or the other former employee and, “if so, under what circumstances”; and (2) whether a conflict of interest sufficient to require the law firm to withdraw had arisen.¹¹⁸ The Committee concluded that Rule 1.05 prohibited the “disclosure of the contents of the transcript to the insurer”, the former employer, or their former employee because the transcript contained privileged attorney-client communications that may not be disclosed without the client’s consent.¹¹⁹ However, if the former employee had perjured himself in open court, then the firm would have been permitted to disclose the transcript “to avoid assisting the client’s commission of a criminal or fraudulent act.”¹²⁰ In addition to this holding, the Committee concluded that the firm must withdraw under these circumstances because the situation had created a conflict of interest requiring the firm to withdraw from the representation of any of the parties.¹²¹ Interestingly, the committee did not address the relationship between the Defense Counsel and the Insurer, nor did it open on the conflict, if any, created by the existence of such a relationship. In addition, the Committee did not discuss or cite *Tilley* in reaching its conclusions.

(ii) The Primary Client Rule.

Some authorities endorse the “Primary Client Rule” (PCR).¹²² This rule requires Defense Counsel to side with the Insured, the “primary client”, when there is an unwaived or unwaivable conflict between the Insurer and the Insured. Proponents of this rule argue that Defense Counsel must act against the interests of the Insurer when necessary to protect the insured.¹²³ This rule is contrasted with the “No Subordination Rule” (NSR), which provides that “a lawyer may not subordinate one co-client’s interest to another’s.”¹²⁴ The difference between these two approaches is illustrated by the following example:

Suppose the insured wants the carrier to accept a demand from the claimant to settle quickly at a particular price but the carrier is inclined to reject the demand. In this situation, NSR would not allow the lawyer to take a position on settlement. The lawyer could offer an evaluation of the expected trial outcome, but the lawyer could not advise the company to accept or reject the settlement demand. By contrast, PCR would require the defense lawyer to urge the carrier to settle for the sake of the insured. The lawyer would have to encourage settlement even if the lawyer expected to prevail at trial and even if the company, by rejecting the demand, would not violate the duty to settle. By failing to take up the cudgels for the insured, the lawyer would violate PCR, be guilty of malpractice, and expose

the insurance company to a charge of bad faith.¹²⁵

2. *Information received from the Insurer and the Duty of Loyalty to the Insured.*

There is equal potential for a conflict arising out of Defense Counsel's failure to inform the Insured of confidential information received from the Insurer. In fact, this was a principal issue in *Tilley*, where Defense Counsel failed to inform the Insured that the Insurer was investigating facts on which to deny coverage, had been communicating with the Defense Counsel specifically about coverage-sensitive information, and had been directing the activities of Defense Counsel in a way adverse to the interests of the Insured.

a. The argument for disclosure.

If both the Insurer and the Insured are co-clients of the Defense Counsel, the duty to disclose confidential information is equally applicable. Therefore, under this theory, should Defense Counsel learn that the Insurer is intending to deny coverage, or that the Insurer is surreptitiously attempting to use Defense Counsel to investigate coverage issues, then Defense Counsel should notify both the Insured and the Insurer of the situation and obtain their consent before continuing in the representation. If *Tilley* is read to find a co-client relationship, then some might argue that *Tilley* supports this conclusion. Further, those refusing to recognize the co-client theory would most likely agree that the Defense Counsel still has a duty to inform the Insured of the Insurer's intent and/or actions based on the higher duty owed to the Insured. Whether the Insurer's consent is necessary prior to disclosure is yet to be answered.

b. The argument against disclosure.

An argument could be made that disclosure should not be made of confidences given to Defense Counsel by the Insurer. As with disclosure of Insured's confidences, it adds coverage representation and analysis to the responsibilities of Defense Counsel.

C. Control of the Defense.

The issue of control of the litigation fuels the debate over the ethical questions inherent in the Tripartite relationship. This issue often manifests itself as cost-containment programs or reporting requirements. Nearly all insurance companies now have some type of Litigation Guidelines directed toward controlling litigation costs as well as general strategy. With Insurers continually seeking new ways to improve efficiency in their litigation management systems, it is inevitable that every Defense Counsel will be forced to personally assess their ethical obligations to the insurer who pays their bills and to the insured they are hired to represent.

1. *The right to direct the litigation generally.*

As discussed above, there are several sources of authority relating to the right to control litigation. The Texas Disciplinary Rules of Professional Conduct make clear that although an Insurer may pay the legal fees of its Insured, in no way may it affect the independence of the

Defense Counsel in the representation of the Insured. Specifically, Rule 1.08(e) states that this fee arrangement is only acceptable where, in addition to client consent and protection of confidential information in accordance with Rule 1.05, there must be “no interference with the lawyer’s independence of judgment or with the client-lawyer relationship.”¹²⁶ Precisely what constitutes “interference” has yet to be decided by the courts. Clearly, the extent to which an Insurer may participate in management of the underlying litigation relates to the extent consent from the Insured to do so is obtained. Under such an arrangement, the specific policy provisions relating to consent may generally set forth limitations, if any, on the control of the litigation by the Insurer.¹²⁷

At least one commentator has argued that whether a reservation of rights letter has been issued can also affect the issue of control.¹²⁸ Under this theory, a policyholder has a right to control its defense and select its own attorney when confronted with a reservation of rights letter.¹²⁹ Further, “[n]ot only does the insured have a right to select counsel, it is also the carrier’s duty to pay for it.”¹³⁰ A separate but related question is whether the Defense Counsel, who has knowledge of the reservation of rights letter has a duty to inform and/or educate the Insured on the legal effect of the letter. More importantly, Defense Counsel must also determine whether he has an obligation to inform the Insured of his right to an independent counsel paid for by the Insurer.

The issue of control may arguably be tied to the financial interest of the Insurer versus the Insured in the underlying litigation. Although Insureds are entitled to a full and adequate representation by Defense Counsel, it is equally reasonable that the Insurer, who is paying the bill and whose policy limits are at stake, be entitled to control the way the litigation is defended. It has been argued that the right of control should belong to the party with the most at stake in the litigation.¹³¹ Section 215 of the Restatement recognizes this reality. Therefore, in cases involving damages that are less than policy limits, the Insured arguably has no similar direct economic interest in the litigation to that of the Insurer.¹³² However, the case of damages in excess of limits raises a more complex circumstance. There, both the Insured and Insurer have a strong economic interest in the litigation.

And this is the rub. The problem with this approach is that it perhaps unfairly presumes that all suits can be placed into two categories: those within policy limits and those in excess of policy limits. The practical reality of insurance defense practice, as with all other litigation, is that the very nature of a jury trial makes litigation unpredictable. Further complicating this situation is the added burden that such a system would place on Defense Counsel. Consider the implications for Defense Counsel forced to determine upon receipt of the file which category the damages fall into. This would surely place the Defense Counsel in the unenviable position of predicting the outcome of litigation at the moment of receipt of the file. Further, even if Defense Counsel were able to overcome these obstacles, in cases falling into the excess of policy limits category, the issue of how the control is apportioned in these cases remains largely open. Is it based on a sliding scale which gives the insured greater control to the degree it is exposed over policy limits? This would be difficult, if not impossible, to determine.

2. *Stowers liability and the decision to settle.*

In the settlement process, Defense Counsel seeks to negotiate the best possible settlement for its client. Defense Counsel should realize, however, that the settlement process contains numerous legal malpractice traps, in addition to those discussed above. In large part, these traps are based on conflicts of interest that frequently arise during the litigation process.¹³³ For example, the Insured may want to fight until the end, while the Insurer may want to avoid the risk of a large judgment by settling. As a result, the same settlement offer can be viewed very differently by the Insurer and the Insured. The Defense Counsel is caught in the middle and left to deal with the conflict.

As noted above, one school of thought is that the right to control should inure to the party with the most significant financial stake in the litigation. Thus, in situations where the damages claimed by the plaintiff are within policy limits, the control of the litigation is properly placed in the hands of the Insurer. In those circumstances where the claimed damages exceed policy limits, control is shifted in favor of the Insured.

This approach has several shortcomings. First, it fails to recognize the intangibles resulting from settlement. The most striking example of this occurs with physicians or other professionals sued for malpractice. Certainly, in most cases these persons not only have an economic stake in the litigation because of the high damage awards associated with this type of claim, but they also have an interest in preserving their professional reputation. For an Insurer, the settlement analysis under most circumstances is largely economic. However, for the professional, it relates to assessing the potential for damage to her professional reputation in the community. The issue for Defense Counsel is what position he takes if the Insurer should decide to settle without the consent of the Insured.

This specific issue has not yet been directly addressed by Texas courts. One court of appeals has held that in the context of a “no consent” professional liability policy, the Insurer has the absolute right to settle any claims against its Insured regardless of the Insured’s objections to the settlement.¹³⁴ In that case, the court noted that where an Insured elects to purchase the less expensive “no consent” policy, he gave up the right to object to any settlement.¹³⁵ Because an Insurer has an unambiguous contractual right to settle the claims against an Insured, the Insurer cannot be liable under any theory for exercising that right.¹³⁶ Although the Insured also sued his Insurer-retained attorneys for their role in the settlement process, the Court did not reach the liability of the attorneys in that circumstance.¹³⁷

This issue has not gone unaddressed in other jurisdictions, however. For example, in *Rogers v. Robson, Masters, Ryan, Brumand & Belom*,¹³⁸ an Illinois court of appeals analyzed the issue of Defense Counsel’s role in a contested settlement.

Comment f to § 215 of the Restatement further recognizes that the right of control by an Insurer is affected by the amount of financial risk faced by the Insured. “Material divergence of interest might exist between a liability insurer and an insured, for example, when a claim substantially in excess of policy limits is asserted against an insured, If the lawyer knows or should be aware of such an excess claim, the lawyer may not follow the directions of the insurer if doing so would put the insured at significantly increased risk of liability in excess of the policy coverage.”¹³⁹ Professors Charles Silver and Michael Sean Quinn provide the following criticism

of this approach:

Indeed, we think the Restatement should allow the lawyer to do what the company wants even if the company bears less than all the costs, as long as the company is authorized to give the instruction. The lawyer should not have to second-guess the company at every turn. An insurance company retains a defense lawyer to fulfill a duty to defend and to exercise its right to defend. It does not employ a defense lawyer to impede its exercise of its contract rights to monitor its performance of its contract obligations. By casting defense lawyers as cops, the Reporters use professional responsibility law to frustrate consensual arrangements between insurance companies and defense lawyers and to defeat insurance law. They require defense lawyers to bust tightwad insurance companies even when insurance law allows insurers to be stingy.¹⁴⁰

Similarly, the Supreme Court of Mississippi provided the following justification for total control by the Insurer:

A liability insurance policy undertakes to insure a person up to a specified sum of money caused by his negligence. The policy requires the company to defend any lawsuit charging negligence, and also authorizes the company to select the attorney and conduct the defense of the action. The insured is required to fully cooperate with the company in undertaking the defense. Because the company is footing the bill for the defense, and will be obligated to pay any judgment rendered (if it does not settle the case), it is clearly entitled to select the attorney and conduct the defense.¹⁴¹

Another perspective is provided in ABA Formal Opinion 96-403.¹⁴² There the ABA Standing Committee on Ethics examined the issue of Defense Counsel's obligations where the Insured objects to a settlement acceptable to both the Insurer and the Plaintiff.¹⁴³ In such a situation, the Committee concluded that the Defense Counsel should consult with the Insured "as to the likely consequences of his actions" and advise the Insured to seek independent counsel.¹⁴⁴ For example, "the lawyer might remind the insured that the policy gives the insurer the right to control the defense and settle the claim without the consent of the insured or that rejecting the proposed settlement might result in a forfeiture of his rights under the policy."¹⁴⁵ Further, in the event that the Insured does reject the defense offered under the policy by opposing the settlement, the ABA Committee found that Model Rule 1.9 dealing with conflicts of interest with former clients would preclude the lawyer from participating in the settlement on behalf of the insurer alone without the consent of the insured, his former client.¹⁴⁶ The Committee further suggests that the lawyer may advise the court of the status of settlement and the fact the Insured objects to the settlement.¹⁴⁷

It would seem that Texas courts may take a different direction than Illinois and the ABA. Because the Insurer has an absolute right to settle the litigation, any cause of action against the Insurer-retained attorneys would be subject to attack on causation grounds. The question begs -- what could defense counsel do to stop the settlement from going forward? The Insured has given up the right to object to the settlement, and if the damages flow from the settlement itself then

defense counsel could not have caused the damages. It would seem that the only option the Insured would have is to withdraw his notice of claim to his Insurer and hire a new attorney to represent his interests without the Insurer's involvement, Lost in this process would be the Insured's right to the Insurer-retained counsel, but also coverage under the policy. If Illinois and the ABA are to be followed, then Defense Counsel should advise the insured of this option, to the extent this is a viable option at all. Whether Texas courts would follow their lead is still unresolved.

3. *Litigation Guidelines.*

It is common to find Insurers imposing Litigation Guidelines on its retained Defense Counsel. These Litigation Guidelines, in part, set forth discovery limitations, billing procedures, and means of periodic reporting on the status of the litigation to the Insurer by Defense Counsel. To the Insurer, these Litigation Guidelines serve two purposes: (1) enhanced communication; and (2) cost containment.¹⁴⁸ For Defense Counsel, it is a part of doing business with the insurance industry and must be followed if Defense Counsel is to enjoy a long relationship with the Insurer.

Debate over the viability and ethics of these Litigation Guidelines is vigorous. At the core of this debate is whether an Insurer, by virtue of providing the Insured a defense, holds total control over the course of the litigation. To be certain, the issue of control ranges everywhere from decisions on settlement to caps on how much in legal fees may be spent in defending a case. Unfortunately, this poses a dubious question for Defense Counsel: assuming Texas law places a premium on the interests of the Insured over the Insurer, what role do the Litigation Guidelines play in the direction of litigation? Or alternatively, even if the Insured and Insurer are co-clients of Defense Counsel, what role do these Litigation Guidelines play in the interplay of the concurrent fiduciary duties?

Rule 1.08(e) offers some aid in this situation. So long as the Litigation Guidelines do not interfere with the "lawyer's independence of professional judgment or with the lawyer client relationship", then there is no conflict.¹⁴⁹ However, in the event such interference begins to invade the lawyer's independence or his relationship with the Insured, a conflict arises which the Defense Counsel must resolve. Unfortunately no Texas law exists on this issue. Ultimately, the burden of objecting to Litigation Guidelines that go too far lies with Defense Counsel.

The Restatement offers a similar approach to this issue. Section 215 expressly allows control and direction by the Insurer provided it is "reasonable in scope and character" and the client consents to the control.¹⁵⁰ Comment f provides the following illustration of the proper exercise of control and direction by an Insurer:

Insurer, a liability insurance company, has issued a policy to Policyholder under which Insurer is to provide a defense and otherwise insure Policyholder against claims covered under the insurance policy. A suit filed against Policyholder alleges that Policyholder is liable for a covered act and for an amount within the policy's monetary limits. Pursuant to the policy's terms, Insurer designates lawyer to defend Policyholder. Lawyer believes that doubling the number of depositions

taken, at a cost of \$5,000, would somewhat increase Policyholder's chances of prevailing and Lawyer so informs insurer and Policyholder. If the insurance contract confers authority on Insurer to make such decisions about expenses of defense, and lawyer reasonably believes that the additional depositions can be foregone without violating the duty of competent representation owed by Lawyer to Policyholder, Lawyer may comply with Insurer's direction that taking the depositions would not be worth the cost.¹⁵¹

This illustration provides the easy example of where the Defense Counsel recommends additional depositions, *but does not believe that they are necessary*. The harder case is where the depositions are *essential* in the mind of Defense Counsel yet the Insurer disregards Defense Counsel's recommendations and denies their authorization. A less clear situation arises where defense counsel believes the additional investigation would increase the likelihood of success at trial by 15%. The issue is at what level the increase in likelihood of success becomes material. The answer is relative to the point of view of the parties involved. Section 215 and Comment f do not directly address these more complicated situations, although it could be inferred that it would require disclosure to both the Insurer and the Insured of the consequences of failing to take the additional discovery and place both on notice of the apparent conflict of interest. Again, informed consent would be the key to protection against malpractice.

V. CONCLUSION.

In short, the "Bermuda Triangle" of insurance law contains many traps for the unwary. The status of the relationship between Insured, Insurer and Defense Counsel is open to several interpretations, and there is vigorous debate over what constitutes proper conduct of counsel in the face of potential conflicts of interest. As this debate progresses, finer lines will most certainly be drawn, regardless of whether it is through a codification such as the Restatement, or an opinion of a court. For the time being, however, it is up to Defense Counsel to be cautious in the exercise of their professional judgment when it comes to representation of the Insured.

¹ See Robert B. Gilbreath, *Caught in a Crossfire Preventing and Handling Conflicts of Interest: Guidelines for Texas Insurance Defense Counsel*, 27 TEX. TECH. L. REV. 139, 140-144 (1996). The topic of conflicts of interest arising from this relationship has been widely addressed. See David F. Wood, *Conflicts of Interest and the Right of Independent Counsel*, 39 No. 3 FOR THE DEFENSE 25 (1997); *Defense Counsel and the Tripartite Relationship: A Dialogue*, 39 No.2 FOR THE DEFENSE 12 (1997); Charles Silver and Michael Sean Quinn, *All Clients Are Equal But Some Are More Equal Than Others: A Reply to Morgan and Wolfram*, 6 No. 3 COVERAGE 47 (1996); Leo J. Jordan & Hilde Kahn, *Ethical Issues Relating to Staff Counsel Representation of Insureds*, 30 TORT & INS. L.J. 25 (1994); Statton Shartel, *Tensions Between Insurers, Outside Counsel Remain Near the Boiling Point*, 7 No. 10 INSIDE LITIG. 1 (1993); Richard L. Neumeier, *Serving Two Masters: Problems Facing Insurance Defense Counsel and Some Proposed Solutions*, 77 MASS. L. REV. 66(1992); John Leubsdorf, *Pluralizing the Client-Lawyer Relationship*, 77 CORNELL L. REV. 825 (1992); William T. Barker, *The Right and Duty to Defend: Conflicts of Interest and Insurer Control of the Defense*, Tort & Ins. Practice Section, American Bar Ass'n, Litigating the Coverage Claim: Denial of Coverage and Duty to Defend 195 (1992).

² Under this view, the Insured stands at the pinnacle of the triangle, evidencing that it is owed the highest duty of both Insurer and Defense Counsel. As discussed herein, there is another school of thought that places Defense Counsel as the attorney for *both* Insurer and Insured. Under this paradigm, the triangle should probably be inverted with Defense Counsel at the bottom point of the inverted triangle.

³ *American Mut. Liab. Ins. Co. v. Superior Court*, 113 Cal. Rptr. 561, 571 (Cal. Ct. App. 1974); see also Charles Silver, *Does insurance Defense Counsel Represent the Company or the Insured?*, 72 TEX. L. REV. 1583, 1609 (1994) (“most representations are cooperative affairs” between the parties to the triangular relationship).

⁴ Gilbreath, *Caught in a Crossfire*, 27 TEX. TECH. L. REV. at 140-144.

⁵ See TEX. INS. CODE ANN. § 21.21 (Vernon's Supp. 1997).

⁶ See *Employer Cas. Co. v. Tilley*, 496 S.W.2d 552 (Tex. 1973); see also *American Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 847 (Tex. 1994); *Bradt v. West*, 892 S.W.2d 56, 77 (Tex. App.-- Houston [1st Dist.] 1994, writ denied).

⁷ *Id.*

⁸ 496 S.W.2d at 552.

⁹ Gilbreath, *Caught in the Crossfire*, 27 TEX. TECH. L. REV. at 145 (“Insurance defense attorneys normally desire to maintain long lean relationships with the insurers who send them business and are sometimes friends with the insurance company representatives.”).

¹⁰ In the context of disqualification of counsel motions, the appearance of impropriety standard has been a factor used by courts to decide whether counsel has engaged in distasteful conduct. See *In re American Airlines*, 972 F.2d 605(5th Cir. 1992), *cert denied*, 113 S. Ct. 1262(1993); *Islander East Rental Program v. Ferguson*, 917 F. Supp. 504 (S.D. Tex. 1996). It may be inferred from this that such a standard is applicable here as well. However, the Texas Disciplinary rules of Professional Conduct do not expressly provide for application of this standard.

¹¹ 496 S.W.2d at 554.

¹² *Id.* at 556.

¹³ *Id.* at 558.

¹⁴ *Id.*

¹⁵ *Id.* at 558-559.

¹⁶ SUPREME COURT OF TEXAS, CODE OF PROFESSIONAL RESPONSIBILITY, Canon 5 (1971).

¹⁷ SUPREME COURT OF TEXAS, ETHICAL CONSIDERATIONS ON CODE OF PROFESSIONAL RESPONSIBILITY, EC- 15 (1972); *Id.* at 558.

¹⁸ *Id.* at 558.

¹⁹ The Guiding Principles were rescinded in 1980 by the ABA under pressure from the Antitrust Division of the Justice Department. *See* Robert G. O' Malley, *Ethics Principles for the Insurer, the Insured, and Defense Counsel: The Eternal Triangle Reformed*, 66 TUL. L. REV. 511, 513 (1991). "The Guiding Principles are now widely disregarded, having been contradicted by subsequent case law, ethics opinions, and the widespread adoption of the Model Rules of Professional Conduct." Douglas R. Richmond, *Walking a Tightrope: The Tripartite Relationship between Insurer, Insured, and Insurance Defense Counsel*, 73 NEB. L. REV. 265, 289(1994).

²⁰ *Id.* at 559 (citing the National Conference of Lawyers and Insurers -- Guiding Principles, 20 FEDERATION OF INSURANCE COUNSEL JOURNAL 95 (1970)).

²¹ *Id.* at 559 (emphasis added).

²² *Id.* at 559

²³ *See American Centennial Ins. Co. v. Canal Ins. Co.*, 843 S.W.2d 480, 484 (Tex. 1992) (finding that in the insurance context, "The attorney owes the insured the same type of unqualified loyalty as if he had been originally employed by the insured.") (citing *Tilley*, 496 S.W.2d at 558); *Bradt v. West*, 892 S.W.2d 56,77 (Tex. App. -- Houston [1st Dist] 1994, writ denied) (holding that "[i]n the context of insurance, the client is the insured."); *Costley v. State Farm Fire & Cas. Co.*, 894 S.W.2d 380, 385 (Tex. App. --Amarillo 1994, writ denied) (holding that retained defense counsel owes the insured "the same type of unqualified loyalty he would owe if originally employed by the insured.").

²⁴ *See Canal* 843 S.W.2d at 484; *Costley*, 894 S.W.2d at 385.

²⁵ 876 S.W.2d at 844, n. 6.

²⁶ *Id.*

²⁷ 843 S.W.2d at 484.

²⁸ TEX. DISC. R. PROF.. CONDUCT, *reprinted in* *TEX. GOV'T CODE ANN., tit. 2, subtit. G. App. (Vernon Supp. 1997)(State Bar Rules art. X., § 9) (hereinafter Tex. Disc. R. Prof. Conduct).

²⁹ TEX. DISC. R. PROF. CONDUCT 1.05 (1991).

³⁰ *Id.*

³¹ *Id.*

³² *Id.*

³³ *Id.* Several important Texas cases have been decided using Rule 1.05 to determine disqualification motions. *See National Medical Enterprises v. Godbey*, 924 S.W.2d 123 (Tex. 1996); *In re American Airlines*, 972 F.2d 605 (5th Cir. 1992), *cert denied*; 113 S.Ct. 1262(1993); *Islander East Rental Program v. Ferguson*, 917 F.Supp. 604 (S.D. Tex. 1996). It is clear that Texas law recognizes the importance of an attorney's duty to protect the sanctity of confidential* client communications.

³⁴ TEX. DISC. R. PROF. CONDUCT 1.05.

³⁵ *Id.*

³⁶ TEX. DISC. R. PROF. CONDUCT 1.06 (1990).

³⁷ *Id.* 1.06(a).

³⁸ *Id.* 1.06(b)(1), (2). The term “directly adverse” is defined as a situation where “the representation of another client if the lawyer’s independent judgment on behalf of a client or the lawyer’s ability or willingness to consider, recommend or carry out a course of action will be or is reasonably likely to be adversely *affected by the lawyer’s representation or, or responsibilities to, another client.” *Id.* cmt. 6.

³⁹ TEX. DISC. R. PROF. CONDUCT 1.06(c)(1), (2).

⁴⁰ *Id.* 1.06, cmt. 12.

⁴¹ Gilbreath, *Caught in the Crossfire*, 27 TEX. TECH. L. REV. at 153

⁴² *Id.*

⁴³ TEX. DISC. R. PROF. CONDUCT 1.08 (1991). Rule 1.08 generally addresses the conflict of interest arising out of certain “Prohibited Transactions”, such as entering into business transactions with a client or obtaining an interest in the results of the litigation. *Id.*

⁴⁴ TEX. DISC. R. PROF. CONDUCT 1.06, cmt. 12.

⁴⁵ TEX. DISC. R. PROF. CONDUCT 1.08(e).

⁴⁶ *Id.* cmt. 5.

⁴⁷ TEX. DISC. R. PROF. CONDUCT 5.04(c).

⁴⁸ *Id.*

⁴⁹ *Id.* cmt. 5.

⁵⁰ There is no RESTATEMENT (First) or RESTATEMENT (Second) OF THE LAW GOVERNING LAWYERS. The A-LI refers to this as the RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS because it intends to publish a new “third” edition covering all of the Restatements. The language contained in the Restatement has undergone significant changes over the last decade. The ALI issued Proposed Final Draft No. 1 in March, 1996. This draft was presented for approval to the general ALI membership in May 1996 for approval at its annual meeting. It was rejected and sent back to committee for further revisions. The Reporters (those persons charged by the ALI to draft the actual language) subsequently issued their* “Proposed Movants’-Reporters’ Text on Liability-Insurance Issues” which addressed many of the criticisms of Proposed Final Draft No. 1. Proposed Final Draft No. 2 was released on April 6, 1998, and was later amended on the floor of the ALI Annual Meeting in May of this year. For a good discussion of the history of the RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS, see David R. Anderson, *Ten Years Later, The Restatement’s Attempt to Define Counsel’s Role in the Tripartite Relationship Is Still a Work In Progress*, 10 No. 47 MEALEY’S LITIG. REP.: INS. 17(1996). That article does not include some of the latest developments. For purposes of this article, the latest version of the RESTATEMENT (Third) OF THE LAW GOVERNING LAWYERS found in Proposed Final Draft No. 2 as recently amended at the ALI Annual Meeting, will be simply referred to as the “Restatement.”

⁵¹ *Id.* Interestingly, Tentative Draft No. 4, April 10, 1991, provided that “a lawyer’s professional judgment on behalf of a client may be **“materially influenced* by a third party, subject to certain restrictions. RESTATEMENT (Third) OF THE LAW GOVERNING LAWYERS § 215, Tentative Draft No. 4 (April 10, 1991) (emphasis added). It would

appear that the Reporters to the Restatement withdrew from this position in replacing “judgment” with “conduct,” and “materially influence” with “directed.”

⁵²This additional language was added upon motion of Lawrence J. Fox. Mr. Fox argued that similar language could be found in the Model Rules and Model Code. Motion to Amend § 215(2)(a), Lawrence J. Fox, ALI Annual Meeting, May 1998.

⁵³ RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS, Final Draft No. (April 6, 1998) § 215 cmt. b.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.* § 215, cmt. c.

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.* The area of civil rights is another example of how third-party payment of legal fees achieves a public policy goal. *See Id.* (“Lawyers paid by civil rights organizations have helped citizens pursue their individual rights and establish legal principles of general importance”).

⁶⁰ *Id.* § 215, cmt. c.

⁶¹ *Id.* § 215, cmt. d.

⁶² *Id.*

⁶³ *Id.* The Reporters offer the following non-insurance illustration of how this arrangement should work:

Resettle, a non-profit *organization, works to secure better living conditions for refugees. Resettle’s board of directors believes that a case should be filed to test whether a federal policy of detaining certain refugees is legally justified. Client is a refugee who has recently been detained under the federal policy, and Resettle has offered to pay Lawyer to seek Client’s release from detention. With the* informed consent of Client, Lawyer may accept payment by Resettle and may agree to make non-frivolous contentions that Resettle wishes to have tested by the litigation.

⁶⁴ *Id.* § 215, cmt. d.

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.* § 215, cmt. e.

⁶⁹ *Id.*

⁷⁰ *Id.* RESTATEMENT (Third) OF THE LAW GOVERNING LAWYERS § 114.

⁷¹ The Restatement does not address the situation where coverage-sensitive information is obtained through open discovery such as a deposition. An issue arises as to whether the attorney should disclose the information in the routine status reports she is obligated to prepare. The insurer may never know of the information absent such a report. Although the information is no longer “confidential,” it is unknown as to the critical party, the insurer.

⁷² Comparison of the Proposed Final Draft No. 2 and Proposed Final Draft No. 1 illustrates the significant changes that were made. Although this paper is not intended to explore and discuss the implications of each revision, specific examples of the *more significant changes are presented throughout for the readers’ consideration.

⁷³ RESTATEMENT (Third) OF THE LAW GOVERNING LAWYERS § 215, cmt. f.

⁷⁴ *Id.* Although this language is slightly different than that used in Proposed Final Draft No. 1, the result is the same. Here, the information is protected because the insurer is deemed an agent of the insured per other provisions of the Restatement.

⁷⁵ Specifically, the text reads that “[t]he insurer is not, simply by the fact that it designates the lawyer, a client of the lawyer.” RESTATEMENT (Third) OF THE LAW GOVERNING LAWYERS, § 215, cmt. f.

⁷⁶ This is not currently the rule in Texas. Although the Insurers have sued Defense Counsel for malpractice, it has been under a theory of equitable subrogation and not a direct action. *See Canal*, 843 S.W.2d at 484.

⁷⁷ Interestingly, the Proposed Movants’-Reporters’ Restatement added a recognition that “many jurisdictions” permit the Insured to retain independent counsel, *at the expense of the Insurer*, who “is not subject to the direction of the insurer.” This was not included in Proposed Draft No. 2. This has been codified by the California Legislature in CAL. CIV. CODE ANN. § 2860(b) which provides that:

[W]hen an insurance company 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 a claim, a conflict of interest may exist.

⁷⁸ RESTATEMENT (Third) OF THE LAW GOVERNING LAWYERS, §215, cmt. f.

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *See American Centennial Ins. Co. v. Canal Ins. Co.*, 843 S.W.2d 480 (Tex. 1992). However, it is worth noting that these cases were decided on a theory of equitable subrogation. Under this theory, the Insurer steps into the shoes of the Insured and is therefore entitled to the benefits of the fiduciary relationship between the Insured and Defense Counsel. Thus, it is questionable whether these opinions support any conclusion that an Insurer and Insured are co-clients. If the courts considered Insurers and Insureds to be co-clients, then the Insurer (as a client) would have a direct cause of action without the necessity to decide the case on the theory of equitable subrogation.

⁸³ *Parker v. Carnahan*, 772 S.W.2d 151, 156 (Tex. App. -- Texarkana 1989, writ denied). Compare the following criteria from the RESTATEMENT (Third) OF THE LAW GOVERNING LAWYERS:

§ 26 Formation of Client-Lawyer Relationship.

A relationship of client and lawyer arises when:

-
- (1) *a person manifests to a lawyer the person's intent that the lawyer provide legal services for the person; and either
 - (a) The lawyer manifests to the person consent to do so; or
 - (b) The lawyer knows or reasonably should know that the person reasonably relies on the lawyer to provide the services; or
 - (2) a tribunal with power to do so appoints the lawyer to provide the services.

RESTATEMENT (Third) OF THE LAW GOVERNING LAWYERS § 26,

⁸⁴ *Id.* at 156 (emphasis added); *see also Ins. Co. of North America v. Westergren*, 794 S.W.2d 812 (Tex. App.-- Corpus Christi 1990, orig. proceeding [leave denied]).

⁸⁵ *Parker*, 772 S.W.2d at 156.

⁸⁶ *State v. Lemon*, 603 S.W.2d 313, 317 (Tex. App. -- Amarillo 1980 no writ).

⁸⁷ 43 F.3d 953 (5th Cir. 1994).

⁸⁸ *Id.* at 958 (citations omitted; emphasis added); *see also Berry v. Dodson, Nunley & Taylor*, 717 S.W.2d 716, 719 (Tex. App.-- San Antonio 1986), *writ dismissed by agr.*, 729 S.W.2d 690 (Tex. 1987) (an attorney does not owe a duty to a third party, even if that third party is an intended beneficiary of the attorney's advice);* *Vaccaro v. MSG (Illinois), Inc.*, 789 F.Supp. 924, 927 (N.D. 111, 1992) (an attorney representing a financial advisor s*was held to not have an attorney-client relationship with the advisor's customer, even though the customer was given some legal advice by the attorney). Even though *Vaccaro* was decided under Illinois law, Texas law similarly holds that asking questions of someone's else's attorney does not create an attorney-client* relationship. *Parker v. Carnahan*, 772 S.W.2d 151, 156 (Tex. App. -. Texarkana, 1989, writ denied).

⁸⁹ 859 S.W.2d 617 (Tex. App. -- Houston [1st Dist.] 1993, writ denied).

⁹⁰ *Randolph v. Resolution Trust Corp.*, 995 F.2d 611,616 (5th Cir. 1993), *cert. denied*, 114 S. Ct. 1294(1994) (an agent may employ counsel for his principal); *see also Polland & Cook v. Lehmann*, 832 S.W.2d 729,738 (Tex. App. -- Houston [1st Dist.] 1992, writ denied) (finding that agent had authority to hire counsel for principal).

⁹¹ *Simpson v. James*, 903 F.2d 372, 376 (5th Cir. 1990).

⁹² *Kotzur v. Kelly*, 791 S.W.2d 254, 257-58 (Tex. App. -- Corpus Christi 1990, no writ).

⁹³ *Parker v. Carnahan*, 772 S.W.2d at 156 (citing *Nolan v. Foreman*, 665 F.2d 738 (5th Cir. 1982)); *see Simpson*, 903 F.2d at 376 (“[T]he evidence was sufficient for a reasonable jury to conclude that an *attorney-client relationship existed, as manifested through the parties conduct.”).

⁹⁴ *Simpson*, 903 F.2d at 376 (citing *State v. Lemon*, 603 S.W.2d at 318).

⁹⁵ *Randolph*, 995 F.2d at 615 (citing *Kotzur*, 791 S.W.2d at 257-58); *Parker*, 772 S.W.2d at 157.

⁹⁶ TEX. DISC. R. PROF. CONDUCT preamble ¶ 2 (1989); *Clarke v. Ruffino*, 819 S.W.2d 947, 949 (Tex. App. — Houston [14th Dist.] 1991, writ dismissed w.o.j.)

⁹⁷ TEX. DISC. R. PROF. CONDUCT preamble ¶ 2 (1989).

⁹⁸ *Id.*

⁹⁹ Interestingly, this same analysis was made by the Texas Supreme Court in *Garcia*, 876 S.W.2d at 844, n. 6. There, the Court held that although the insurer was paying the bills, the insured was defense counsel's client, not the insurer. *Id.* However, the Court cited Rule 1.06, as well as Rules 1.07 and 1.08(f) in support of its conclusion. The

implications of this have not yet been discussed in any subsequent opinions issued by any Texas court.

¹⁰⁰ RESTATEMENT (Third) OF THE LAW GOVERNING LAWYERS § 215, cmt. f, (referring to the criteria set forth in § 26 of the RESTATEMENT.

¹⁰¹*Id.* cmt. f.

¹⁰² *Id.* “Whether or not such an [attorney-client] relationship exists,” all progress reports and case evaluations will still be considered privileged. *Id.* Therefore, it is logical to conclude that circumstances could exist where such activities and communications may not necessarily give rise to an attorney-client relationship. This is consistent with Texas’ approach to this issue. See *Traver v. State Farm Mut. Auto. Ins. Co.*, 930 S.W.2d 862, 867 *(Tex.App. -- Fort Worth 1996, writ grant’d) (holding that attorney retained by insurer is the sub-agent to the insured, and the insurer is the agent of the insured.).

¹⁰³ This argument has been propounded by Professors Charles Silver and Michael Sean Quinn, both of whom have written extensively on this subject. See Charles Silver and Michael Sean Quinn, *Are Liability Carriers Second-Class Clients? No But They May Be Soon --A Call to Arms Against the Restatement (Third) of the Law Governing Lawyers*, 6 No. 2 COVERAGE 21 (March/April 1996); Michael Sean Quinn and Nicole Chaput, *Tort Liability and Reinsurance Contracts*, 8 ENVIRONMENTAL CLAIMS. J. 67 (1995); Charles Silver and Kent D. Syverud, *Special Project on Professional Responsibilities of Insurance Defense Lawyers, Part 1: Full-Coverage Representations*, 62 Def. Couns. J. 503 (1995); Charles Silver and Kent D. Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 DUKE L.J. 255(1995); Silver & Quinn, *Wrong Turns on the Three-Way Street: Dispelling Nonsense About Insurance Defense Lawyers*, 5 No. 6 COVERAGE 1 (Nov/Dec 1995); Silver, *Does Insurance Defense Counsel Represent the Company or the Insured?*, 72 TEX. L. REV. 1583 (1994). For an opposing view, see Thomas D. Morgan and Charles W. Wolfram, *Lawyers Retained by Liability Carriers to Represent Insureds in the Restatement of the Law Governing Lawyers*, 6 No. 2 COVERAGE 44 (1996).

¹⁰⁴ RESTATEMENT (Third) OF THE LAW GOVERNING LAWYERS § 112 Proposed Final Draft No. 1 (March 29, 1996). Section 112 provides as follows:

- (1) Except as provided in §§ 113-117A, during and after representation of a client:
 - (a) the lawyer may not use or disclose confidential client information as defined in § 111 if there is a reasonable prospect that doing so will adversely affect a material interest of the client or if the client has instructed the lawyer not to use or disclose such information;
 - (b) the lawyer must take steps reasonable in the circumstances to protect confidential client information against impermissible use or disclosure by the lawyer’s associates or agents that may adversely affect a material* interest of the client or otherwise than as instructed by the client.
- (2) Except as stated in § 114, *a lawyer who uses confidential information of a client for the lawyer’s pecuniary gain other than in the practice of law must account to the client for any profits made.

Id.

¹⁰⁵ *Id.*

¹⁰⁶ RESTATEMENT (Third) OF THE LAW GOVERNING LAWYERS § 215, cmt. 1.

¹⁰⁷ Silver and Quinn, *Second Class Clients*, supra n. 91, at p. 30-33. Professors Silver and Quinn asserted this argument in critique of Proposed Draft No. 1. Proposed Final Draft No. 2 attempts to solve this problem by prohibiting confidential information to flow either direction through Defense Counsel, absent consent of the parties.

Such a rule, however, places the Defense Counsel in the middle of these two competing parties to whom he may owe fiduciary duties of complete loyalty and full disclosure.

¹⁰⁸ See Silver and Quinn, *Second Class Clients*, supra n. 91, at 31-32.

¹⁰⁹ See *Id.*, supra n. 91.

¹¹⁰ *Tilley*, 496 S.W.2d at 559.

¹¹¹ TEX. DISC. R. PROF. CONDUCT 1.06.

¹¹² *Id.* (emphasis added).

¹¹³ *Id.* 1.08(e).

¹¹⁴ *Id.*

¹¹⁵ State Bar of Texas, Comm. On Interpretation of the Cannons of Ethics, Op. 482 (1994).

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² See Silver and Quinn, *Second Class Clients* supra n. 91, at p.36 for a description of this rule. However, it should be noted that the authors do not endorse the rule, See, e.g., *Montanez v. Irizarry-Rodriguez*, 641 A.2d 1079, 1084 (N.J. App. 1994) (“[W]hen the interests of the insurer and the insured differ, the insurance defense lawyer’s ethical duty of undivided loyalty to the client is owed to the insured.”) (quoting Brooke Wunicke, *The Eternal Triangle: Standards of Ethical Representation by the Insurance Defense Lawyer*, FOR THE DEFENSE, Feb. 1989, at 7,9)); cf. 1 Allen D. Windt, INSURANCE CLAIMS AND DISPUTES § 4.19 (1995) (an attorney who represents both an insurer and a policyholder “should not. . . subordinate the interests of one of those to the other in conflict situations.”)

¹²³ See Robert H. Jerry II, UNDERSTANDING INSURANCE LAW, Vol. 2, 615 (1987) (contending that when advising the insured of developments relating to settlement, defense counsel must “sometimes act contrary to the insurer’s interests”); Karon O. Bowdre, *Conflicts of Interest Between Insurer and Insured: Ethical Traps for the Unsuspecting Defense Counsel*, 17 AM. J. TRIAL ADVOC. 101, 112 (1993) (arguing that when a conflict arises, defense counsel “must recognize that his client is the insured and not the insurance company”); Jason A. Reschly, Note, *Attorney Malpractice—Wrongful Settlement by the Insured’s and Insurer’s Joint Defense Attorney*, 45 Mo. L. REV. 739, 743-44 (1980) (citing cases holding that defense counsel’s loyalty must run primarily to the insured).

¹²⁴ Silver and Quinn, *Second-Class Clients*, supra n. 91, at 35-36.

¹²⁵ *Id.* at 91.

¹²⁶ TEX. DISC. R. PROF. CONDUCT 1.08(e).

¹²⁷ See Rule 1.02, cmt. 4 (providing, in part, that “[t]he scope of representation provided by a lawyer may be limited

by agreement with the client or by the terms under which the lawyer's services are made available to the client"). How narrowly drafted these policy provisions are is another question. The typical policy does not address this issue in any detail. Any shortcomings in the policy language should be accounted for in the Defense Counsel's engagement letter to the client-insured.

¹²⁸ Werner A. Powers, *Lawyers as Targets*, The University of Texas Insurance Law Institute (September 1996).

¹²⁹ *Id.* (citing *Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 120(5th Cir. 1983); *Britt v. Cambridge Mut. Fire Ins. Co.*, 717 S.W.2d 476, 481 (Tex. Civ. App. -- San Antonio 1986, writ ref 'd n.r.e.); *Steel Erection Co. v. Travelers Indemnity Co.*, 392 S.W.2d 713 (Tex. Civ. App. -- San Antonio 1965, writ ref'd n.r.e.)).

¹³⁰ Powers, *Lawyers*, supra n. 116.

¹³¹ See Silver and Quinn, *Second Class Clients*, supra n. 91, at p. 37-39.

¹³² However, an Insured may still have non-economic and indirect economic interests in the litigation. A professional's reputation in the community, time off of work, and* other indirect costs of litigation directly affect the Insured.

¹³³ See generally Leake, Jr., *The Role of Defense Counsel Regarding Settlement Demands and Opportunities*, 48 INS. COUNS. J. 169(1981); Gonzales & Myers, *Suits (Or Threatened Suits) Against the Insured's Lawyer; What are the Attorney's Duties and How Do they Appear in the Real World?*, G-18, Advanced Insurance Seminar (University of Houston Law Foundation, April 1995); Ball, *Surprise! I Settled Your Case! Ethical and Malpractice Considerations in Insurance Settlements*, Advanced Insurance Seminar (University of Houston Law Foundation, April 1995).

¹³⁴ *Dear v. Scottsdale Ins. Co.*, 947 S.W.2d 908, 915 (Tex.App.--Dallas 1997, no writ).

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *Id.* at 917-19.

¹³⁸ 392 N.E.2d 1365 (Ill. App.--1979), *aff'd*, 407 N.E.2d 47(Ill.1980).

¹³⁹ RESTATEMENT (Third) OF THE LAW GOVERNING LAWYERS §215, cmt. f.

¹⁴⁰ Silver and Quinn, supra n. 91, at p.39.

¹⁴¹ *Hartford Accident & Indemnity Co. v. Foster*, 528 So.2d 255 (Miss.1988).

¹⁴² ABA Comm. On Ethics and Professional Responsibility Formal Opinion 96-403 (1996).

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ *Id.*

¹⁴⁶ *Id.*. The Committee does note, however, that the ability of the Insured to block the settlement is limited. *Id.* ("As a practical matter. . . the insured may be powerless to prevent a settlement within the policy limits."). Because the policy often has a "no consent" clause, the adjuster may settle the plaintiff's claim without the consent of the Insured and circumvent the role of the Defense Counsel. *Id.*

¹⁴⁷*Id.*

¹⁴⁸ Sally Field, *Legal and Ethical Aspects of Outside Counsel Guidelines: The Professional and Liability Carrier's Perspective*, The University of Texas School of Law Insurance Law Institute at p. 5 (September 1996). Ms. Field argues that such Litigation Guidelines achieve these two values, both of which are important aspects of claims handling:

It is unrealistic to expect that an insurer's claims professional, even if highly qualified and well* informed about the facts and law of the case, can do a thorough investigation, evaluation and analysis of a claim without input from the professional hired to defend it. This input must include: initial and periodic status reports; assessments of liability; recommendations about strategy; evaluations of the credibility of the witnesses; including the insured; assessment of damages; and critical reviews of the alternatives for resolution, including settlement and trial. Unless the defense counsel is a master communicator, some general guidelines for transmitting this information is helpful, if not critical. It is further unrealistic to expect that the insurer will pay the fees and expenses pursuant to the policy without making an effort to contain the costs. The best way, unfortunately, to control the costs is to monitor the reasonableness and necessity of the tasks performed. One way to monitor the tasks, is to set out guidelines which indicate, in advance, the insurer's expectations.

Id.

¹⁴⁹ TEX. DISC. R. PROF. CONDUCT 1.08(e).

¹⁵⁰ RESTATEMENT (Third) OF THE LAW GOVERNING LAWYERS § 215 (2)

¹⁵¹ RESTATEMENT (Third) OF THE LAW GOVERNING LAWYERS § 215, cmt. f The Reporters to the Restatement, Charles Wolfram and Thomas Morgan offer the following in support of this conclusion:

May the insurer direct the defense, such as by identifying experts to be used, limiting the number of* depositions, and the like? Our answer is yes. The right of the *insurer* to direct the defense is, of course, in most liability policies. However expressed, whether the lawyer may accept such direction is not so readily answered... Relying primarily on the concept of the insured's implied consent following from relinquishment of* control of the defense in the policy, we say that the lawyer may accept direction from the insurer if "the direction is reasonable in scope and character, such as by reflecting obligations borne by the person directing the lawyer." One could propose other language, but we believe the quoted text is substantively correct and as clear as possible given the thousands of possible situations in which it might be applied.

Morgan and Wolfram, *supra* no. 126, p. 45.