2012

Can (and Should) an Insurance Defense Attorney Be Held Liable for Insurance Bad Faith?

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VIRGINIA LAW & BUSINESS REVIEW

VOLUME 7 | SPRING 2012 | NUMBER 1

CAN (AND SHOULD) AN INSURANCE DEFENSE ATTORNEY BE HELD LIABLE FOR INSURANCE BAD FAITH?

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"Sworn in by a fool and vouched for by a scoundrel. I'm a lawyer at last."[1]

I. INTRODUCTION

THE perilous pitfalls and treacherous traps of litigation practice can befall even the most diligent and conscientious of lawyers. The ethical lessons taught in Professional Responsibility courses at American law schools are numerous and varied. Some of the lessons are clearer and more straightforward than others. Some lessons are clear: never steal money from a client or misappropriate funds in a client's trust account;[2] never engage in a sexual relationship with a client that begins during the course of representation;[3] and maintain client confidentiality as required by law.[4] But the litigation world is also filled with other, less obvious pitfalls: for example, missing a statute of limitations deadline[5] or an appeal deadline can constitute malpractice.[6]

1 THE RAINMAKER (Paramount Pictures 1997).

2 7A C.J.S. Attorney & Client § 81 (2011) ("Improper dealings with funds of a client, such as by misappropriation with a fraudulent purpose, are grounds for suspension or disbarment. Disciplinary action against an attorney may be grounded on improper handling of, or dealings with, funds of a client.").

3 MODEL RULES OF PROF'L CONDUCT R. 1.8(j) (2006 ed.) ("A lawyer shall not have sexual relations with a client unless a consensual sexual relationship existed between them when the client-lawyer relationship commenced.").

4 MODEL RULES OF PROF'L CONDUCT R. 1.6(a) (2006 ed.) ("A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).").

5 *See, e.g.*, Boyle v. Welsh, 589 N.W.2d 118, 127 (Neb. 1999) (stating that "the failure to file *a suit that should otherwise be filed* within the time required by the statute of limitations is a deviation from the standard of care falling within the common knowledge exception" to the expert testimony requirement in legal malpractice cases).

6 *See, e.g.*, State of Neb. *ex. rel.* Counsel for Discipline of the Neb. Sup. Ct. v. Coe, 710 N.W.2d 863 (Neb. 2006) (disbarring an attorney who neglected several cases, including one in which the attorney missed an appeal deadline).

Insurance defense lawyers are faced with many practical and ethical challenges unique to their practice. On the practical operation and business side, insurance defense firms typically charge much lower rates than other commercial firms, since insurance companies typically are large consumers of legal services and request wholesale hourly rates for the firms with whom they work.[7] Insurance defense firms today also face steep competition to keep hourly rates low, as insurance companies can easily move work to other insurance defense firms or to national and regional firms.[8] In addition, many insurance companies now require insurance defense attorneys and insurance defense firms to comply with "Litigation Management Guidelines" and other billing and case management guidelines,[9] which require attorneys and firms to obtain approval from the insurance company before engaging in certain litigation practices[10] and to list required litigation reports.[11] Moreover,

7 Herbert Kritzer, *The Commodification of Insurance Defense Practice*, 59 VAND. L. REV. 2053, 2059 (2006) ("Insurance companies are large consumers of legal services. Given the quantity of such services they buy, these companies want what is akin to wholesale prices for these services unless they are confronting exceptional circumstances (i.e., the threat of a very large loss, probably eight figures or more). Because of this volume, insurance companies are able to secure hourly rates that are well below those that are paid by other commercial clients.").

8 *Id.* at 2059–60 (" Insurance companies are able to get these wholesale rates because they often have limited loyalty to their outside lawyers. Insurance defense lawyers can raise their rates only cautiously because insurance companies can easily move the work, either to competing firms or to in-house/captive offices. For much commercial work there is a cost to changing lawyers, in that the current lawyer will have a lot of working knowledge of the client's affairs that will take time to replicate in the new firm. The nature of insurance defense work, however, is such that there is little if any such cost involved. Insurance companies have in place detailed litigation policies that can be handed to the new firm, and in many cases the authority of local claims staff is so constrained that the personal relations that might exist between outside counsel and those staff persons, particularly when combined with litigation policies, has little impact on the handling of cases.").

9 Aviva Abramovsky, *The Enterprise Model of Managing Conflicts of Interest in the Tripartite Insurance Defense Relationship*, 27 CARDOZO L. REV. 193, 204 (2005) ("Insurance companies publish voluminous documents, which have become known by various names such as 'billing and practice rules,' 'Litigation Management Guidelines' and even 'Retention Policies.'").

10 *Id.* ("Specifically, the guidelines are used to indicate which practices are pre-approved for compensation by the insurance company in any given representation. Such practices typically include, among others, the 'selection and retention of investigators and experts; filings of motions; discovery [and] performance of computer research.' Moreover, the guidelines also serve to inform the defense counsel bar as to which factors are deemed to be important by the insurance company in their decision-making process of retention of these counsel in the future.").

although the attorneys may bill a certain number of hours, the insurance companies may not pay for every hour billed. In many cases, insurance companies define what counts as "billable" time[12] and perform audits of bills submitted by insurance defense law firms.[13]

In addition to these contemporary practical and business realities, insurance defense law firms and lawyers face unique ethical questions. For example, insurance defense lawyers must determine exactly whom they represent—the insurance company, the insured, or both? Much scholarly ink has been spilt regarding the "tripartite" insurance relationship between insurer, insured, and the insurance defense law firm.[14] Generally, the

11 Kritzer, *supra* note 7, at 2072 ("In addition to specifying what can be billed, the typical set of guidelines require the lawyer to provide a written report periodically to the insurer and to obtain approval for key steps in the litigation process (e.g., obtaining independent medical examinations, hiring experts, scheduling depositions, and the like). Some insurers require the lawyer to prepare a litigation budget for each file the insurer refers to the lawyer.").

12 *Id.* at 2071 ("Another way that insurance companies have sought to control outside counsel has been to define what counts as billable time. Insurers do this by establishing formal guidelines that specify procedures that defense counsel must follow and identify a list of things that the insurer will not pay for or will pay only at a reduced rate.").

13 *Id.* at 2070–71 ("Insurance companies have sought to develop systematic methods of monitoring the billing practices of the outside lawyers they employ. One aspect of this monitoring is the controversial use of outside auditing firms where the bills submitted by the law firm are reviewed and frequently reduced. . . . Even if outside auditors are not used, insurers may require lawyers to submit bills through an on-line system, either one provided by an outside vendor or one created and run by the insurer itself.").

14 *See, e.g.*, Abramovsky, *supra* note 9; Tom Baker, *Liability Insurance Conflicts and Defense Lawyers: From Triangles to Tetrahedrons*, 4 CONN. INS. L.J. 101 (1998); Amber Czarnecki, *Ethical Considerations Within the Tripartite Relationship—Who Is the Real Client?*, 74 DEF. COUNS. J. 172 (2007); Katherine E. Giddings & Stephen Zielezienski, *Insurance Defense in the Twenty-First Century: The Florida Bar's Proposed Statement of Insured Client's Rights—A Unique Approach to the Tripartite Relationship*, 28 FLA. ST. U. L. REV. 855 (2001); 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 (1996); Nancy J. Moore, *The Ethical Duties of Insurance Defense Lawyers: Are Special Solutions Required?*, 4 CONN. INS. L.J. 259 (1998); Thomas D. Morgan, *What Insurance Scholars Should Know About Professional Responsibility*, 4 CONN. INS. L.J. 1 (1998); Michael D. Morrison & James R. Old, Jr., *Economics, Exigencies and Ethics: Whose Choice? Emerging Trends and Issues in Insurance Defense Practice*, 53 BAYLOR L. REV. 349 (2001); Susan Randall, *Managed Litigation and the Professional Obligations of Insurance Defense Lawyers*, 51 SYRACUSE L. REV. 1 (2001); Douglas R. Richmond, *Lost in the Eternal Triangle of Insurance Defense Ethics*, 9 GEO. J. LEGAL ETHICS 475 (1996); Douglas R. Richmond, *Walking a Tightrope: The Tripartite Relationship Between Insurer, Insured, and Insurance Defense Counsel*, 73 NEB. L. REV. 265 (1994); Charles Silver, *Does Insurance Defense Counsel Represent the Company of the Insured?*, 72 TEX. L. REV. 1609 (1994); Charles Silver & Kent Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 DUKE L.J. 255 (1995); Tanya S. Bryant, Note, *Loyalty Divided? The Ethical*

insurance defense attorneys[15] only represent the insured policyholder on a limited basis insofar as the terms and conditions of a liability policy require.[16] Insurers can "control" the defense;[17] and insurance defense attorneys generally cannot give coverage advice or opinions concerning a dispute between the insured and the insurer.[18] Despite these rules, difficult ethical questions can arise during the course of litigation for the insurance defense attorney. What if coverage issues are inextricably linked with liability issues? What if a major dispute arises between the insured and insurer during the course of the litigation, while the insurance defense firm is representing the insured? These questions, which deserve their own separate scholarly treatment, are beyond the scope of this Article.

Beyond these ethical questions concerning malpractice and the tripartite relationship, there looms the question of insurance bad faith: can (and should) an insurance defense attorney or insurance defense law firm ever be held liable for insurance bad faith? In many states, an insurer can be held liable for

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Considerations of the Tripartite Relationship in Insurance Defense Litigation, 29 OKLA. CITY. U. L. REV. 889 (2004).

15 Throughout this Article, references to "insurance defense attorneys" should also be understood as references to "insurance defense law firms."

16 Abramovsky, *supra* note 9, at 200–01 ("[T]he contractual relationship between defense counsel and the insured-policyholder within the tripartite relationship is that of lawyer-client for a specific, single representation. The defense counsel relationship with the insured-policyholder arises as a result of the insurance company's selection that he act on behalf of the insured-policyholder in a limited, contractually proscribed basis. Such representation occurs only when the terms of a liability insurance policy permit and require representation to be provided to the policyholder. The representation is therefore limited as a direct result of the nature of the retention. The attorney paid for by the insurance company represents the policyholder only insofar as the terms of the liability policy require"). *See also* ROWLAND H. LONG, MATTHEW BENDER'S THE LAW OF LIABILITY INSURANCE § 5.01 (2005) (stating that an insurance company's duty to defend arises from the terms and conditions of the insurance contract).

17 Abramovsky, *supra* note 9, at 201 ("[B]y virtue of their financial interest in the outcome of the litigation, insurance companies are generally granted the right to 'control' the defense."). *See also* Richmond, *Lost in the Eternal Triangle of Insurance Defense Ethics*, supra note 14, at 481 ("Because of their financial stake in effective claims resolution, insurers have a contractual right to control their insureds' defenses."); Randall, *supra* note 14, at 9–10 ("Some policies explicitly state that the insurance company has the right to choose counsel; that right is implicit in less specific policies. Liability policies generally provide that the insured, as a condition of coverage, must cooperate in the defense of the litigation.").

18 *Id.* ("Even if the policyholder wished to, she could not have her insurance-appointed attorney act outside the limited scope of representation for which he was retained. Such counsel are generally not permitted to give advice regarding coverage disputes between the policyholder and insurance company . . . .").

third-party bad faith for failure to settle within an insurance policy's limits.[19] Moreover, an insurer can be held liable in many states for *first*-party bad faith by not handling the claim of an insured policyholder in good faith.[20] Recently, bad faith liability has also been extended to hold an insurance company's employee claims adjuster *personally* liable for unfair claims settlement practices.[21] One noted insurance scholar has even argued that general agents, independent claims adjusters, and third party administrators—who are "downstream" intermediaries involved in the administration of insurance claims—should be subject to at least negligence claims and possibly also to bad faith claims in cases of "greater misconduct."[22]

With the increasing expanse of bad faith liability, insurance defense attorneys and law firms may be the next party included in the liability circle. This Article comprehensively examines the history and landmark cases involving insurance defense attorneys and insurance bad faith claims to date. As a general rule, insurance defense attorneys and law firms today are not *directly* liable to an insured or a third-party claimant for breach of the implied covenant of good faith and fair dealing,[23] and therefore cannot be directly

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19 *See, e.g.*, Braesch v. Union Ins. Co., 464 N.W.2d 769, 772 (Neb. 1991) ("This state recognizes a cause of action for an insurer's bad faith to settle a claim with a third party. . . . The rationale for the rule is that "[i]n the event the insurer elects to resist a claim of liability, or to effect a settlement thereof on such terms as it can get, there arises an implied agreement that it will exercise due care and good faith where the rights of an insured are concerned.").

20 *Id.* at 774. ("It has been argued that by creating a tort for a bad faith settlement of a first-party insurance claim, the floodgates will be opened for tort actions based upon a breach of any contract. . . . Because of the nature of first-party insurance contracts, that concern is unfounded. The public interest in insurance contracts, the nature of insurance contracts, and the inequity of the bargaining power between the insurer and the policyholder all serve to distinguish insurance contracts from other types of contracts.").

21 Taylor v. Nationwide Mutual Ins. Co., 589 S.E.2d 55, 57 (W. Va. 2003) (holding that an insurer's employee claims adjuster can be personally liable for unfair claims settlement practices under the West Virginia Unfair Trade Practices Act).

22 Jeffrey W. Stempel, *The "Other" Intermediaries: The Increasingly Anachronistic Immunity of Managing General Agents and Independent Claims Adjusters*, 15 CONN. INS. L.J. 599, 624 (2009).

23 *See, e.g.*, Gruenberg v. Aetna Ins. Co., 510 P.2d 1032, 1038–39 (Cal. 1973) ("With regard to the defendants other than the three insurance companies, we reach a different result. Plaintiff alleges that Brown, the insurance adjusting firm, and its employee, Busching, and Cummins, the law firm, and its employee, Ricketts, were the agents and employees of defendant insurers and of each other and were acting within the scope of that agency and employment when they committed the acts attributed to them. However, plaintiff contends that these non-insurer defendants breached only the duty of good faith and fair dealing; therefore, we need not consider the possibility that they may have committed another tort in their respective capacities as total strangers to the contracts of insurance. Obviously, the non-insurer defendants were not parties to the agreements for insurance;

liable for bad faith. However, the road to this doctrinal rule was not always historically clear with the development of insurance bad faith liability. In the 1980s, two courts reached an opposite conclusion before retreating. In 1983, the California First District Court of Appeals permitted a claim in *Wolfrich Corporation v. United Services Automobile Association* against attorneys by a third-party claimant through the California Unfair Practices Act based upon the insurer's failure to reasonably and timely settle a claim.[24] One year later, the Washington Court of Appeals also upheld a cause of action against attorneys based upon the Washington State Consumer Protection Act. [25] However, the holdings of both cases were eventually reversed,[26] and the doctrinal rule precluding *direct* insurance defense attorney bad faith liability stands today.

Although *direct* liability is not present today, exposure to *indirect* liability for insurance bad faith remains a risk for insurance defense firms. This Article also examines such *indirect* liability, which is alive and well today. The *indirect* liability may arise as in the following example: An insurer gives instructions for the insurance defense firm to settle an underlying claim, but the insurance defense firm negligently fails to do so. The insurer is then exposed to an excess judgment verdict, and the claimant then brings a claim against the insurer for a bad-faith refusal to settle within the policy limits. The insurer then files a third-party complaint against the insurance defense attorney for malpractice. Several cases, three of which are discussed at length in this article, have examined such *indirect* liability.[27]

With only *indirect* liability for attorneys in the insurance defense context, where does the law proceed next? After providing a historical and contemporary background of attorney liability for insurance bad faith, this

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therefore, they are not, as such, subject to an implied duty of good faith and fair dealing. Moreover, as agents and employees of defendant insurers, they cannot be held accountable on a theory of conspiracy.").

24 Wolfrich Corp. v. United Serv. Auto. Ass'n, 197 Cal. Rptr. 446 (Cal. Ct. App. 1983).

25 Gould v. Mutual Life Ins. Co. of N.Y., 683 P.2d 207 (Wash. Ct. App. 1984).

26 *Wolfrich* was disapproved of in The Doctors' Co. v. Superior Court, 775 P.2d 508 (Cal. 1989) and *Gould* was reversed in Haberman v. Washington Pub. Power Supply Sys., 744 P.2d 1032 (Wash. 1987).

27 Smiley v. Manchester Ins. & Indem. Co. of St. Louis, 375 N.E.2d 118 (Ill. 1978); Commercial Union Ins. Co. v. Lewis and Roca, 902 P.2d 1354 (Ariz. Ct. App. 1995); Wolfpaw v. General Accident Ins. Co., 639 A.2d 338 (N.J. Super. Ct. App. Div. 1994); Calif. State Automobile Association Inter-Insurance Bureau v. Parichan, Renberg, Crossman & Harvey, 84 Cal. App. 4th 702 (Cal. Ct. App. 2000); California State Automobile Association Inter-Insurance Bureau v. Bales, 221 Cal. App. 3d 227 (Cal. Ct. App. 1990); Cooper v. Equity General Ins. Co., 219 Cal. App. 3d 1252 (Cal. Ct. App. 1990); Consolidated American Ins. Co. v. Hinton, 845 F. Supp. 1515 (M.D. Fla. 1994).

Article contends that the doctrinal rule of no *direct* liability should continue to stand. First-party and third-party bad faith liability should not be imposed on law firms and their attorneys, particularly since bad faith liability would create irreconcilable ethical conflicts between the interests of the insurer, the insured, and third-party claimants.

II. THE DEVELOPMENT AND GROWTH OF INSURANCE BAD FAITH LIABILITY

The cause of action for liability based upon insurance bad faith was born out of principles of contract law and the implied covenant of good faith and fair dealing which is found in every contract.[28] Insurance contracts are no exception to this rule because asymmetric bargaining power between insurance companies and their insureds could potentially lead "unscrupulous or predatory insurers to take advantage of their insureds' misfortunes in bargaining for the resolution or settlement of claims."[29] As the California Supreme Court took the lead in the development of the law of strict liability for products in the 1960s,[30] it also took the lead in the development of third-party liability for insurance bad faith[31] based upon an insurance company's failure to defend covered claims[32] and upon the wrongful refusal to settle claims within the limits of an insurance policy.[33]

Cases involving third-party bad faith liability ballooned during the 1970s.[34] In a world of unequal bargaining power between insurance

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28 Douglas R. Richmond, *Insured's Bad Faith as Shield or Sword: Litigation Relief for Insurers?*, 77 MARQ. L. REV. 41 (1993).

29 *Id.* at 42.

30 *See* Elmore v. American Motors Corp., 70 Cal. 2d 578 (Cal. 1969) (strict liability for product defects extended to apply to innocent bystanders in addition to direct consumers or users); Vandermark v. Ford Motor Co., 391 P.2d 168 (Cal. 1964) (extending liability under strict liability to not only manufacturers of products, but distributors and retailers of the product as well); Greenman v. Yuba Power Prods., Inc., 59 Cal. 2d 57 (Cal. 1963) (imposing strict liability upon a manufacturer who places a product into the market which is defective and causes injury).

31 Richmond, *supra* note 28, at 44. ("The earliest bad faith cases arose in the third-party insurance context.").

32 Comunale v. Traders & Gen. Ins. Co., 328 P.2d 198 (Cal. 1958).

33 Crisci v. Sec. Ins. Co., 426 P.2d 173 (Cal. 1967).

34 Kenneth S. Abraham, *The Natural History of the Insurer's Liability for Bad Faith*, 72 TEX. L. REV. 1295 (1994) ("As recently as ten years ago, an insurer's liability for bad faith was one of the legal growth stocks of that period. Having come into their own in the 1970s, both first-party and third-party bad faith claims were resulting in multi-million dollar judgments, treatises and law review articles exploring the contours of the law in these

companies and their insureds, third-party bad faith liability served as a check on the unscrupulous practices of insurers in resolving claims and ultimately protected insureds who were in difficult or precarious financial positions.[35] Elaborating on the insurer's duty to defend its insureds in third-party liability cases, courts, beginning with the California Supreme Court, soon began to apply bad faith liability in the first-party insurance context.

In 1973, the Supreme Court of California expanded the duty of an insurance company to act in good faith and with fair dealing in handling the claim of one of its insureds. The Court fully explained this duty in the following terms in the landmark *Gruenberg v. Aetna Insurance Company* decision:

> We [have] considered the duty of the insurer to act in good faith and fairly in handling the claims of third persons against the insured, described as a "duty to accept reasonable settlements"; in the case before us we consider the duty of an insurer to act in good faith and fairly in handling the claim of an insured, namely a duty not to withhold unreasonably payments due under a policy. These are merely two different aspects of the same duty. That responsibility is not the requirement mandated by the terms of the policy itself—to defend, settle, or pay. It is the obligation, deemed to be imposed by the law, under which the insurer must act fairly and in good faith in discharging its contractual responsibilities. Where in so doing, it fails to deal *fairly and in good faith* with its insured by refusing, without proper cause, to compensate its insured for a loss covered by the policy, such conduct may give rise to a cause of action in tort for breach of an implied covenant of good faith and fair dealing.[36]

Thus, liability for first-party bad faith gives the insured an additional remedy—a tort remedy—rather than limiting the insured to recovery of

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fields were being published, and—along with civil liability generally—the field seemed to be expanding without an end in sight.").

35 Richmond, *supra* note 28, at 42–43 ("Insurance contracts are more personal than commercial; that is, insureds purchase their policies for security and peace of mind, rather than entering into such contracts for financial gain. Moreover, insureds often need benefits and coverage when they are in dire or precarious financial straits, thus becoming vulnerable to oppressive tactics by their insurers. By recognizing tort duties, courts were able to overcome the inadequacy of contract remedies to compensate insureds and to deter insurer nonperformance in third-party cases.").

36 Gruenberg v. Aetna Ins. Co., 510 P.2d 1032, 1037 (Cal. 1973).

damages for breach of contract.[37] However, it is important to note that in the first-party context, the insured is not exposed to the potential of an excess judgment verdict as in the third-party context,[38] so the standards of proof for recovery in both contexts typically differ.[39] While a state-by-state analysis and analysis of standards for recovery is beyond the scope of this Article and has been addressed by two eminent commentators,[40] many states have adopted the tort of bad faith in first-party cases.[41] It should also be noted that some states, in particular Kansas,[42] have completely declined to adopt a cause of action for bad faith on the basis that adequate alternative remedies exist for insurer misconduct.

Despite the reticence of a few courts in adopting the cause of action for insurance bad faith, in the past several years bad faith liability has expanded in certain jurisdictions beyond its traditional application (i.e. against insurance companies) to apply against entities and even individuals related to the insurer. As noted earlier, insurance bad faith liability was recently extended by the Supreme Court of West Virginia in the case of *Taylor v. Nationwide Mutual Insurance Company* to hold an insurance company's employee claims adjuster *personally* liable for unfair claims settlement practices.[43] The *Taylor* case arose out of an insured's claim for underinsured motorist coverage on a Nationwide

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37 RANDY J. MANILOFF & JEFFREY W. STEMPEL, GENERAL LIABILITY INSURANCE COVERAGE: KEY ISSUES IN EVERY STATE 535 (Oxford University Press, 2d ed. 2012) ("In general, the significance of a court's adoption of a cause of action for first-part bad faith is the opening of the door to an insured's recovery of damages in tort, rather than its recovery being limited to damages for breach of contract.").

38 *Id.*

39 *Id.* ("Because first- and third-party bad faith address different risks for the insured, they are typically subject to different standards.").

40 *Id.*

41 *Id.* at 534–35.

42 Spencer v. Aetna Life & Casualty Ins. Co., 611 P.2d 149, 158 (Kan. 1980) ("We are of the opinion the legislature has intended to provide a remedy for an insured who has problems with his insurance company. He can maintain an action on the contract for his policy benefits, with costs, interest and attorneys' fees under arbitrary circumstances. He may also report the company to the Department of Insurance under the Uniform Trade Practices Act for improper handling of claims pursuant to K.S.A. 40-2404(9). The company's actions are reviewable by the department and punishable if found improper. The legislature has provided several remedies for an aggrieved insured and has dealt with the question of good faith first party claims. Statutory law does not indicate the legislature intended damages for emotional suffering to be recoverable by an aggrieved insured through a tort of bad faith. Where the legislature has provided such detailed and effective remedies, we find it undesirable for us to expand those remedies by judicial decree.").

43 Taylor v. Nationwide Mutual Ins. Co., 589 S.E.2d 55, 55 (W. Va. 2003).

Mutual Insurance Company automobile policy.[44] The insured claimed that Nationwide and a Nationwide claims adjuster violated the West Virginia Unfair Trade Practices Act in failing to afford him the opportunity to purchase optional levels of underinsured motorist insurance coverage as required by West Virginia law.[45]

The claims adjuster argued that because claims adjusters are not party to the contract and because the tort of bad faith emanates from a contractual relationship between the insured and the insurance company, a claims adjuster could not be held liable.[46] Despite this argument, the Court found that "any individual" could be held liable under the Unfair Trade Practices Act because the claims made against the adjuster arose out of a positive statutory duty and did not arise out of a contractual relationship or the common law.[47] Outside of the context of case law, one eminent insurance scholar has argued that individuals with functions similar to claims adjusters, such as independent claims adjusters and other individuals involved in the administration of claims, should potentially be subject to bad faith liability in cases of great misconduct.[48]

The *Taylor* case and the general expansion of personal and "downstream" insurance intermediary bad faith liability left open many questions. Among states that have recognized a cause of action for first-party insurance bad faith liability, some states have adopted a common law cause of action, while in other states, the cause of action is statutory in nature.[49] Since a claims adjuster can be held liable under an unfair trade practices statute, could a claims adjuster also be liable under a common-law bad faith action? And if a claims adjuster, who is not in direct privity of contract with the insured, can be held liable for insurance bad faith, what standards of proof should the court apply? Finally, if a claims adjuster can be held liable as an agent of the insurer, could an insurance defense attorney be held liable as an agent of the insurer as well? These questions concerning the *direct liability* of an insurance defense attorney for insurance bad faith have arisen and have been litigated in the era of expanding insurance bad faith liability.

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44 *Id.* at 57.
45 *Id.*
46 *Id.* at 61.
47 *Id.* at 61–62.
48 Stempel, *supra* note 22.
49 MANILOFF & STEMPEL, *supra* note 37, at 533–35.

III. DIRECT LIABILITY OF AN INSURANCE DEFENSE ATTORNEY FOR INSURANCE BAD FAITH: A CAUSE OF ACTION REJECTED

Gruenberg v. Aetna Insurance Company stands as one of the landmark cases that helped form the emerging cause of action for first-party insurance bad faith in the early 1970s. While *Gruenberg* is often remembered for its legacy in holding that a duty exists on the part of an insurer to act in good faith and to act fairly with respect to its insured,[50] one of its overlooked holdings directly addresses the question of the direct liability of an attorney for insurance bad faith.[51]

The underlying facts of *Gruenberg* involved a suspicious fire on November 9, 1969 at a cocktail lounge and restaurant in Los Angeles, California known as the Brass Rail.[52] Several days following the fire, the owner of the restaurant (Gruenberg) was placed under arrest and charged with arson and defrauding an insurer.[53] In the meantime, the business premises of the Brass Rail were insured against a fire loss by three separate insurers (Aetna Insurance Company, Yosemite Insurance Company, and American Home Assurance Company).[54]

Soon after the fire, the insurers retained a law firm to represent them concerning the plaintiff's claim for fire loss, and the attorney for the insurers demanded in writing on November 25, 1969 that Gruenberg appear for an examination under oath and produce certain documents on December 12, 1969.[55] The attorney for Gruenberg responded in writing to the attorney for the insurers that he advised his client not to make any statements until the criminal investigation was complete and requested a waiver of the requirement of an examination until the criminal charges were concluded.[56] The attorney for the insurers declined the request, and when Gruenberg did not appear for the examination under oath, the insurers denied liability under the policies based on the insured's failure to submit to the examination and to produce the requested documents.[57]The insured (Gruenberg) filed an

50 Gruenberg v. Aetna Ins. Co., 510 P.2d 1032, 1037 (Cal. 1973).
51 *Id.* at 1039.
52 *Id.* at 1034.
53 *Id.*
54 *Id.*
55 *Id.* at 1034–35.
56 *Id.*
57 *Id.* at 1035.

insurance bad faith claim against the insurers and also asserted a bad faith claim against the law firm that represented the insurers, claiming they were also liable as the agents and employees of the insurers.[58]

The Supreme Court of California found that the law firm could not breach the duty of good faith and fair dealing and could not be held liable for bad faith, since it was not a party to the contractual agreements for insurance.[59] The Court did not address the issue of whether the law firm committed another tort in its capacity as the firm representing the insurers, since no other allegations were made against it other than a breach of the contractual duty of good faith and fair dealing.[60]

However, the *Gruenberg* Court's rejection of direct liability of an attorney for insurance bad faith in a first-party insurance context did not completely close the door on the issue of direct liability, particularly in the third-party context. Just six years after the *Gruenberg* decision, the California Supreme Court once again took another step toward expanding bad faith liability in the *Royal Globe Insurance Company v. Superior Court* decision.[61] In *Royal Globe*, the Supreme Court of California recognized a cause of action for a *third-party claimant* based on a single instance of misconduct that constituted violations of the duty to settle promptly and reasonably under the California Unfair Practices Act.[62] For approximately nine years, from 1979 to 1988, this decision stood as the law of the land in California; however, *Royal Globe* was eventually overruled by *Moradi-Shalal v. Fireman's Fund Insurance Companies*.[63]

The holding of *Royal Globe* perhaps represented the high point in the development of insurance bad faith liability. It did not take long for the ramifications of this holding to reach insurance defense law firms and attorneys. Just four years after the *Royal Globe* decision, the owners of an automobile damaged by the actions of an insured brought a third-party claim against the insurer, as well as against the attorneys working for the insurer, based upon a statutory violation of failing to act in good faith to settle an insurance claim under the California Unfair Practices Act.[64]

58 *Id.*
59 *Id.* at 1038–39.
60 *Id.*
61 Royal Globe Ins. Co. v. Superior Court, 592 P.2d 329 (Cal. 1979).
62 *Id.*
63 Moradi-Shalal v. Fireman's Fund Ins. Cos., 758 P.2d 58 (Cal. 1988) (holding that the insurance statute prohibiting insurance companies from engaging in unfair practices, such as not making a good-faith effort to reach prompt and fair settlement of claims, did not create any private cause of action in favor of an insured or a third-party claimant).
64 Wolfrich Corp. v. United Serv. Auto. Ass'n, 197 Cal. Rptr. 446 (Cal. Ct. App. 1983).

This case, *Wolfrich Corporation v. United Services Automobile Association*, opened the door for direct liability against an attorney by a third-party claimant based upon a statutory violation. The third-party claimants in *Wolfrich* alleged that the attorneys conspired with the insurer to violate the California Unfair Practices Act.[65] The Court distinguished the *Gruenberg* case, which held there was no direct liability for an attorney for insurance bad faith, by explaining that attorneys are immune from charges of conspiracy based upon advice given to clients who are accused of breaching a contract—a situation that did not occur in *Wolfrich*.[66] In *Wolfrich*, the allegations against the attorneys did not concern the contractual breach of the duty of good faith and fair dealing, but instead related to tort liability, and the Court reasoned that "[a]ttorneys may be liable for participation in tortious acts with their clients, and such liability may rest on a conspiracy."[67]

The *Wolfrich* Court recognized that attorneys should have the freedom to exercise independent judgment and render advice without the threat of liability resulting from discharging their professional obligations.[68] Nevertheless, the Court found that the third-party claimants alleged the necessary facts in their complaint to plead a cause of action based on conspiracy between the insurance company and its attorneys.[69]

The fires the *Wolfrich* decision ignited regarding attorney personal liability were not contained to the state of California. Within one year of the *Wolfrich* decision, the Washington Court of Appeals followed *Wolfrich's* lead in *Gould v. Mutual Life Insurance Company of New York*, holding that personal liability could be imposed on attorneys pursuant to the state Consumer Protection Act.[70] In *Gould*, the sole beneficiary of an accidental death insurance policy issued on the life of the beneficiary's deceased husband filed a bad faith claim against both the insurance company (Mutual Life) and the attorneys who advised Mutual Life to deny the beneficiary's claim for the death benefits.[71]

The plaintiff in *Gould* alleged that the attorneys who represented Mutual

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65 *Id.* at 448.
66 *Id.* at 449.
67 *Id.*
68 *Id.* ("[A]ttorneys must be free to fully advise and represent their clients without fear of subjecting themselves to liability as a result of the proper discharge of their professional obligations. Any rule to the contrary would constitute a serious impairment to the attorney-client relationship, and a resulting deleterious effect on the administration of justice.").
69 *Id.* at 450.
70 Gould v. Mutual Life Ins. Co. of N.Y., 683 P.2d 207, 209 (Wash. Ct. App. 1984).
71 *Id.* at 208.

Life acted in bad faith:

> That the acts and conduct of defendants Robert L. Israel and C. William Bailey [(the attorneys who represented and advised Mutual Life)] were not limited to services of attorneys, but included participation in and managing the wrongful and bad faith conduct as agents of Mutual Life Insurance Company of New York, including, but not limited to, making command decisions to wrongfully and in bad faith deny plaintiff's claim, initiating and approving conduct designed solely to HARASS [*sic*] and humiliate plaintiff and cause her mental distress[.][72]

These allegations are significant not only in that they relate to the typical functions of an attorney, such as representation, advice, and counsel,[73] but also in that they suggest that the attorneys managed the bad faith conduct in the case. In essence, the attorneys were alleged to have acted as "de facto" corporate officers.[74] The Court summarily stated, without weighing the policy considerations behind its holding, that the attorneys were not shielded from liability simply because they were attorneys.[75] *Gould* stood as the law in Washington for several years, along with *Royal Globe* and *Wolfrich* in California, before the expanse of bad faith liability and attorney liability came to a halt.

For several years during the 1980s, at least in Washington and California, insurance defense attorneys and law firms were open to direct liability exposure for insurance bad faith. But *Royal Globe*, which allowed third-party claimants to sue insurers for violations of an unfair practices statute, eventually came under heavy criticism. One scholar criticized the decision on the basis that it tended to encourage frivolous and unrealistic settlement demands by third-party claimants and that it would force insurers to accept overvalued settlements to avoid excess exposure and bad faith liability.[76]

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72 *Id.* at 209 (first bracket added by author; other brackets in original).

73 MODEL RULES OF PROF'L CONDUCT R. 2.1 (2006 ed.) ("In representing a client, a lawyer shall exercise independent professional judgment and render candid advice. In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation.").

74 *Gould*, 683 P.2d at 209.

75 *Id.*

76 Joan Marion Price, *Royal Globe Insurance Co. v. Superior Court: Right to Direct Suit Against an Insurer by a Third Party Claimant*, 31 HASTINGS L.J. 1161, 1186 (1980) ("One result of this decision is that every time a demand is now made to settle a lawsuit, an additional demand is likely to be forthcoming to coerce higher settlements. The demand now carries the

Another commentator criticized the decision on the grounds that direct actions by third-party claimants would increase insurance costs to the general public.[77]

In light of this criticism, which pointed out the "undesirable social and economic effects of the [*Royal Globe*] decision,"[78] the California Supreme Court overruled *Royal Globe* in *Moradi-Shalal v. Fireman's Fund Insurance Companies* in 1988.[79] Soon thereafter, direct liability of an insurance defense attorney for insurance bad faith suddenly stopped. Similarly, the Washington Supreme Court overruled *Gould* in *Haberman v. Washington Public Power Supply System* in 1987.[80] And the California Supreme Court reversed *Wolfrich* six years later in *Doctors' Company v. Superior Court*, holding that an attorney could not be held liable under the Unfair Practices Act either directly or as a conspirator.[81]

The issue in California, however, did not end with pronouncements from the judicial branch. Instead, the issue moved to the California legislature. A year after the *Doctors' Company* case held that an attorney could not be liable under the Unfair Practices Act, the California legislature codified this by permitting a civil action against an attorney only if there is a "reasonable probability" that the cause of action will be successful.[82] The effect of this action by the California legislature was essentially to eliminate direct actions by third-party claimants against insurance defense attorneys, except in the most egregious cases. With *Haberman* and *Doctors' Company* still the law of the land, the era of *direct* liability against an insurance defense attorney essentially ended in the late 1980s.

Since the late 1980s, attempts have been made to reverse the current

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threat that, unless settlement is immediate, a separate suit will be filed for violation of the Unfair Practices Act. The public ultimately will be affected by the additional drain on judicial resources. Moreover, the public will indeed suffer from escalating costs of insurance coverage, a certain result of inflated settlements and costly litigation.").

77 Glenn L. Allen, *Insurance Bad Faith Law: The Need for Legislative Intervention*, 13 PAC. L.J. 833, 851 (1982).

78 Moradi-Shalal v. Fireman's Fund Ins. Cos., 758 P.2d 58, 64 (Cal. 1988).

79 *Id.* at 68.

80 Haberman v. Wash. Pub. Power Supply Sys., 744 P.2d 1032 (Wash. 1987).

81 Doctors' Co. v. Superior Court, 775 P.2d 508, 509 (Cal. 1989).

82 CAL. CIV. CODE § 1714.10 (West 2008). The statute states: "No cause of action against an attorney for a civil conspiracy with his or her client arising from any attempt to contest or compromise a claim or dispute, and which is based upon the attorney's representation of the client, shall be included in a complaint or other pleading unless the court enters an order allowing the pleading that includes the claim for civil conspiracy to be filed after the court determines that the party seeking to file the pleading has established that there is a reasonable probability that the party will prevail in the action."

doctrinal rule, but even cases with egregious and somewhat disturbing facts have not shifted the rule. For example, in the Connecticut case *Scribner v. AIU Insurance Company*,[83] the plaintiff held an uninsured motorist claim with AIU Insurance Company ("AIU") and offered to settle the claim for the policy limit of $150,000 in August 1989, but the offer was refused.[84] Over two years later, in September 1991, the court ordered AIU to proceed with arbitration.[85] Due to the "defendants' delaying tactics," however, the arbitration did not occur until September 1992, *three years* after the plaintiff's initial policy limit demand.[86]

AIU had retained a law firm with regard to the uninsured motorist claim. The court described the egregious actions of the attorney and firm as follows:

> During these three years, the defendants, at the behest of Duborg [the attorney], undertook an excessive investigation of the plaintiff that included following him in his daily affairs, conducting surveillance of him and of his home, photographing and videotaping him, interviewing and harassing his friends and invading his privacy. Prior to the arbitration, the defendants made false and misleading statements to others defaming the plaintiff's character and integrity.[87]

Despite all this, the court still found that the plaintiff did not make out a *prima facie* case against the attorney on the implied covenant of good faith and fair dealing claim or for insurance bad faith. The court concluded that such claims could only be made against an *insurer*.[88]

In fact, attempts to overturn the doctrinal rule insulating insurance defense attorneys from bad faith liability have not only been rejected soundly by the courts, but in 2003, the Washington Court of Appeals went even further by imposing attorney fees on a litigant who pursued an insurance bad

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83 Scribner v. AIU Ins. Co., 647 A.2d 48 (Conn. Super. Ct. 1994).

84 *Id.* at 49.

85 *Id.*

86 *Id.*

87 *Id.*

88 *Id.* at 51 ("Although Connecticut recognizes a common law duty of an insurer to act in good faith in the settlement of the claims of its insured, a cause of action for breach of that duty may be asserted only against an insurer. . . . An action for bad faith, therefore, does not lie against a person who is not a party to the contract of insurance, including an attorney.").

faith claim against a law firm as a third party.[89] The court considered the lawsuit to be a "frivolous" lawsuit in nature because the possibility of a private cause of action against an attorney had been rejected earlier in *Haberman*.[90]

Although *direct* liability of an insurance defense attorney is an idea that has faded, the possibility of *indirect* liability for insurance defense litigators still looms over the insurance defense bar as an ominous and ever-present cloud.

IV. THE CURRENT STATE OF INDIRECT LIABILITY OF AN INSURANCE DEFENSE ATTORNEY FOR INSURANCE BAD FATIH

In an age when the liability exposure for insurance bad faith has generally expanded, the *indirect* liability of an insurance defense attorney for insurance bad faith has remained as solvent as ever and must be mentioned in any discussion concerning insurance bad faith liability. The typical *indirect* liability case occurs when an insurance defense attorney allegedly falls below the attorney's professional standard of care in the representation of an insured or an insurer, and the insurance company becomes exposed to an excess judgment or a bad faith verdict. When this occurs, the insurance company then typically files suit against the attorneys for malpractice or indemnity. Three cases in particular demonstrate a variety of scenarios of *indirect* bad faith liability.

First, *Smiley v. Manchester Insurance and Indemnity Company of St. Louis* illustrates the importance of an insurance defense attorney having a clear and open line of communication with the insurance company, as well as the importance of prompt reporting to the insurance company of all material information and developments concerning a fast-moving case.[91] In *Smiley*, the insurance defense attorney, Mr. Knight, represented the estate of an insured who was killed in an accident when his car crossed the centerline and collided with another vehicle.[92] Several claims existed against the estate of the insured; namely, there were two claims by passengers of the vehicle driven by the

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89 Manteufel v. Safeco Ins. Co. of Am., No. 28653-0-II, 2003 WL 1986333, at *4 (Wash. Ct. App. Apr. 23, 2003).

90 *Id.* ("Had Manteufel [plaintiff] carefully reconstructed the facts, he would have known that SAFECO retained counsel only after adjusting his claim and paying him for his loss in 1999. SAFECO did not hire Wathen's law firm until much later in the process, namely in October 2000. Thus, it was frivolous for Manteufel to argue that Wathen had adjusted Manteufel's claim when that was factually impossible.").

91 Smiley v. Manchester Ins. & Indem. Co. of St. Louis, 375 N.E.2d 118, 121–22 (Ill. 1978).

92 *Id.* at 119.

insured, and two claims by passengers of the other vehicle.[93] The estate of the insured had few assets except the Manchester Insurance policy, which had limits of $10,000 per person and $20,000 per accident.[94]

Six days before trial, the claims supervisor for Manchester Insurance instructed Knight to use the entire policy limit to resolve all claims—$3,000 to the two passengers in the vehicle of the insured and $17,000 to the two passengers in the other vehicle.[95] The attorney for the two passengers of the other vehicle renewed an earlier demand for settlement at $10,000 per claimant.[96] Significantly, Knight did not make any type of counteroffer.[97]

At trial, it became apparent that the exchange between the claims supervisor and Knight had been a miscommunication. The claims supervisor recalled authorizing Knight to settle the claims of the two passengers of the other vehicle for the policy limits of $20,000 to avoid a verdict against Manchester, but Knight recalled the claims supervisor telling him to "try the case, go all the way," asserting that he never received authority to settle the two claims for the maximum amount under the policy limits.[98]

This miscommunication was costly not only for the insurance company, but also for its attorney. The miscommunication led to verdicts entered at trial for $25,000 and $30,000 for the two claimants in the other vehicle.[99] This occurred despite the fact that the claims supervisor sent Knight a memorandum while the jury was deliberating that authorized Knight to settle the two claims for $20,000.[100] The two claimants then brought a bad faith claim against Manchester for refusal to settle within the policy limits, resulting in a $35,000 excess judgment, plus interest.[101] The next step in the litigation was no surprise—Manchester brought a third-party claim against Knight, alleging negligence in allowing the excess verdict based upon bad faith to occur.[102]

Knight won the trial on the third-party complaint, but lost in the Court of Appeals.[103] During the trial, perhaps the most damaging testimony against

93 *Id.*
94 *Id.*
95 *Id.* at 120.
96 *Id.*
97 *Id.*
98 *Id.*
99 *Id.* at 121.
100 *Id.*
101 *Id.*
102 *Id.*
103 *Id.* at 122.

Knight was expert testimony concerning Knight's failure to notify the plaintiff's attorney, the court, or his own client of receipt of the memorandum received during jury deliberations.[104] The Supreme Court of Illinois found that a verdict against Knight "could never stand," and ruled in the attorney's favor.[105]

Just as an omission may lead to indirect liability, an attorney's oversight may give rise to indirect liability as well. *Commercial Union Insurance Company v. Lewis and Roca* provides an example.[106] In *Commercial Union*, an insurer retained an insurance defense law firm to provide a coverage opinion concerning a policy exclusion to determine whether an insured was entitled to liability coverage in the defense of a suit that alleged negligence and breach of contract concerning the construction of certain townhouses in Pima County, Arizona.[107] The insurer relied on the policy exclusion in denying coverage to its insured.[108] However, the advice the law firm gave to the insurer did not include the fact that the policy exclusion had recently been ruled unenforceable by the Arizona Supreme Court.[109] Not surprisingly, with the legal advice the insurer received, it denied liability coverage to its insured.[110] The case proceeded to trial, and the insured offered to settle for the $100,000 policy limits.[111] Unfortunately for the insurer and insured, the case did not settle and the jury returned an $880,700 verdict, more than eight times the policy limits.[112] After the return of the jury verdict, the insured filed a coverage case against the insurer with claims not only for breach of contract, but also for bad faith refusal to settle the claim within the policy limits of $100,000.[113] The coverage case eventually settled for $500,000.[114] As a result, the law firm that provided the coverage opinion faced a legal malpractice

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104 *Id.* at 121.

105 *Id.* at 124 ("It was Knight's complete failure to make any offer or to attempt any negotiations that firmly established the excess liability case against Manchester. On the facts of this case we must hold as a matter of law that the evidence viewed most favorably to Knight so overwhelmingly favors Manchester that a verdict for Knight could never stand.").

106 Commercial Union Ins. Co. v. Lewis and Roca, 902 P.2d 1354 (Ariz. Ct. App. 1995).

107 *Id.* at 1357.

108 *Id.*

109 *Id.* at 1356.

110 *Id.* at 1357.

111 *Id.*

112 *Id.*

113 *Id.*

114 *Id.* at 1358.

claim by the insurer.[115]

As seen in the *Smiley* and *Commercial Union Insurance Company* decisions, attorney omissions and oversight can lead to *indirect* liability for insurance bad faith. Additionally, an insurance defense attorney could be held *indirectly* liable for insurance bad faith through fraud and collusion. Insurance fraud is certainly not a new development in the insurance industry.[116] Unfortunately, attorneys are not immune to being willing and able participants in fraud.

Participation by insurance defense attorneys in collusion and fraud with an insured can also lead to indirect liability for insurance bad faith. A great example appears in *Consolidated American Insurance Company v. Hinton*.[117] In *Consolidated American*, the plaintiff ingested a pesticide chemical after a lawn service company sprayed the chemical on a lawn in a residential community.[118] The insurer for the lawn service company, Consolidated American, denied liability coverage on the basis of an "absolute pollution exclusion" clause contained in the Consolidated American liability insurance policy.[119]

After the insurer refused coverage, the lawn service company retained an attorney to represent it in the underlying action.[120] The parties then entered into a stipulation to settle the claim for $1.2 million, and then under the settlement, agreed that enforcement of the judgment would only be sought against the insurer.[121] After entering into the settlement, the insured filed suit against Consolidated American to enforce the applicable liability policy and sought bad faith damages for the wrongful denial of coverage and for the refusal to defend.[122]

Consolidated American filed a subsequent action against all of the parties, arguing that there was no coverage for the spraying incident and that all the parties owed it a duty to act in good faith in reaching the settlement.[123] Significantly, Consolidated American also brought a claim against the attorney

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115 *Id.* at 1356.

116 *See, e.g.*, Robert W. Emerson, *Insurance Claims Fraud Problems and Remedies*, 46 U. MIAMI L. REV. 907, 918 (1992) ("Fraud occurs in all areas of automobile insurance, particularly through falsified insurance applications, legitimate but fraudulently inflated claims, and phony claims.").

117 Consolidated American Ins. Co. v. Hinton, 845 F. Supp. 1515 (M.D. Fla. 1994).

118 *Id.* at 1516.

119 *Id.*

120 *Id.* at 1516–17.

121 *Id.* at 1517.

122 *Id.*

123 *Id.*

for the insured, alleging it was involved in facilitating a "bad faith and collusive settlement."[124] The United States District Court for the Middle District of Florida held that the insurer's complaint did in fact state a cause of action against the attorney for the collusive settlement.[125]

As these cases demonstrate, the actions of an insurance defense attorney can lead to *indirect* liability for insurance bad faith for several reasons. Although *indirect* liability is a cloud that hovers over insurance defense attorneys and law firms, *direct* liability for bad faith has not been recognized for some time. And as discussed below, to impose such direct liability would create irreconcilable ethical conflicts between the interests of the insurer, the insured, and third-party claimants.

V. Direct Liability of an Insurance Defense Attorney for Insurance Bad Faith Should Not Be Adopted in an Era of Expanding Bad Faith Liability

Judicial imposition of *direct liability* upon an insurance defense attorney for insurance bad faith would impair and undermine the sanctity of the attorney-client relationship. As a general rule, an attorney may not represent a client if the representation of that client would involve a concurrent conflict of interest.[126] The American Bar Association's Model Rules of Professional Conduct state that there is a concurrent conflict of interest if "there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer."[127] The imposition of *direct* liability on attorneys to third-party claimants for insurance bad faith would impose on attorneys a responsibility toward third-party claimants of upholding a covenant of good faith and fair dealing—a responsibility that attorneys currently owe only to their clients. An understanding of the differences between the first-party and third-party contexts is crucial to understanding these duties in more detail.

A. Attorney Duties: First-Party Insurance Context and Third-Party

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124 *Id.* at 1519.

125 *Id.*

126 MODEL RULES OF PROF'L CONDUCT R. 1.7(a) (2006 ed.) ("Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest.").

127 *Id.*

Insurance Context

Standards for liability for insurance bad faith in the first-party and third-party insurance context vary widely. There is greater cause for concern relating to insurance bad faith in the third-party context than in the first-party context. Professor Jeffrey Stempel and Randy Maniloff, renowned experts in insurance law, have remarked that in the third-party context, the insurer has the responsibility of defending a claim for the insured and, by its actions or inactions, can subject the insured to a judgment in excess of the policy limits if settlement within the insurance policy limits is refused.[128] However, in the first-party context, the insurer cannot injure the insured by virtue of its control over the defense of the case.[129]

This rationale extends to the contour of the duties of an insurance defense attorney in the first-party and third-party insurance situations. With regard to first-party insurance cases, two major authorities on legal malpractice, Ronald Mallen and Jeffrey Smith, note that the general rule is that attorneys owe duties to only the insurer in a first-party case and are not liable for negligent errors to an insured in litigation.[130]

In a time when liability for insurance bad faith is expanding, courts have recognized the importance of avoiding the concurrent conflict of interest that would exist if direct liability for insurance bad faith were imposed upon an insurance defense attorney. In particular, the Michigan Court of Appeals recognized this in the first-party context in *Casey v. Auto Owners Insurance Company*.[131] The plaintiff, a first-party claimant in the case, attempted to add a bad faith claim against the attorneys for Auto Owners Insurance Company.[132] The court rejected the third-party claimant's attempt to add a bad faith claim.[133] In reaching its decision, the Michigan Court of Appeals noted not only that imposing direct liability would pose additional burdens on attorneys,[134] but also that it would create an "unacceptable" conflict of

128 MALINOFF & STEMPEL, *supra* note 37, at 532.
129 *Id.*
130 4 RONALD E. MALLEN & JEFFREY M. SMITH, LEGAL MALPRACTICE § 30:11, at 245 (2011 ed.).
131 Casey v. Auto Owners Ins. Co., 729 N.W.2d 277 (Mich. Ct. App. 2006).
132 *Id.* at 287.
133 *Id.*
134 *Id.* ("Recognition of an attorney's duty an adverse party would . . . impose additional burdens on the attorney. The conflict of interest which would result cannot be resolved . . . simply by allowing the attorney to resolve all doubts in favor of the client, for the existence or reasonableness of the doubts might themselves become jury questions which

interest that would jeopardize the attorney's representation of his client.[135] In addition, direct liability would "detrimentally interfere" with the attorney-client relationship since the attorney would be concerned with being sued for negligence.[136]

The same concern of interference in the attorney-client relationship arises to an even greater degree in the third-party insurance context. Generally an attorney owes no duties to the client's adversary, absent fraud or an intentional tort.[137] The possibility of liability in cases of fraud and intentional tort becomes problematic, however, when considering a potential cause of action against attorneys based upon insurance bad faith.

Slotkin v. Citizens Casualty Co. of New York provides a useful example.[138] The underlying case involved a medical malpractice action in which a newborn child sustained brain damage after a hospital negligently failed to properly administer insulin to the child's mother during childbirth.[139] The plaintiffs settled the case during trial on the belief that only $200,000 in insurance coverage was available.[140] Attorneys for the hospital made this representation both to the plaintiffs and to the court.[141] In fact, $1 million dollars in excess coverage was available.[142]

As a result of the misrepresentations, plaintiffs filed suit on the basis of fraud, naming the attorneys for the hospital's liability insurer in the complaint.[143] The Second Circuit Court of Appeals found that the plaintiffs stated a valid cause of action as to fraud, particularly given the fact that the plaintiffs never had an opportunity to avoid injury and were injured by the dismissal of the jury during trial prior to settlement and discovery of the fraud.[144] Significantly, the Second Circuit Court of Appeals found that it was a

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would defy principled resolution." (quoting Friedman v. Dozorc, 312 N.W.2d 585, 592 (Mich. 1981))).

135 *Id.* ("In short, creation of a duty in favor of an adversary of the attorney's client would create an unacceptable conflict of interest which would seriously hamper an attorney's effectiveness as counsel for his client." (quoting *Friedman*, 312 N.W.2d at 591)).

136 *Id.* ("Not only would the adversary's interests interfere with the client's interests, the attorney's justifiable concern with being sued for negligence would detrimentally interfere with the attorney-client relationship." (quoting *Friedman*, 312 N.W.2d at 592)).

137 MALLEN & SMITH, *supra* note 130, at 245.

138 Slotkin v. Citizens Casualty Co. of N.Y., 614 F.2d 301 (2d Cir. 1979).

139 *Id.* at 305.

140 *Id.* at 307.

141 *Id.*

142 *Id.* at 308.

143 *Id.* at 310.

144 *Id.* at 313.

question of fact as to whether the attorney retained by the hospital's liability insurer engaged in fraudulent conduct because the attorney held documents in his possession that indicated the amount of available insurance coverage was much higher. With this information, the attorney could be liable under the New York definition of scienter for claiming that only $200,000 was available.[145]

If other courts followed *Slotkin*, a misrepresentation by an insurance defense attorney to a litigation adversary concerning the amounts of available insurance coverage could constitute bad faith and render that insurance defense attorney directly liable. As noted by Mallen and Smith, in cases of fraud or intentional torts, an attorney can be liable to a litigation adversary and, by extension, to a third-party insurance claimant. Since insurance bad faith is considered generally to be a tort,[146] then if Mallen and Smith's conception of the law is correct, a cause of action brought by a third-party claimant against an attorney based upon intentional insurance bad faith could be permitted. This would open the floodgates to a new era of insurance bad faith litigation.

In response to this possibility, an exception to attorney liability in "fraud and intentional tort" cases should be adopted in cases concerning insurance bad faith. As a general public policy, insurance bad faith has been imposed upon insurers as a means to maintain public trust in insurance companies, to ensure that insurers live up to their contractual obligations, and to protect insureds during times in which they are vulnerable.[147] While there certainly is a public policy that clients should trust their attorneys,[148] the public policy

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145 *Id.* at 314.

146 *See* John H. Bauman, *Emotional Distress Damages and the Tort of Insurance Bad Faith*, 46 DRAKE L. REV. 717, 732 (1998) ("The 'tort' of insurance bad faith essentially involves nothing more than the breach by the insurance company of its obligations under an insurance policy."). However, it should be noted that the issue of whether insurance bad faith was a "willful tort" was addressed recently by the Florida District Court of Appeal. *See* Citizens Property Insurance Corp. v. Garfinkel, 25 So. 3d 62, 68–69 (Fla. Dist. Ct. App. 2009) (holding that first-party insurance bad faith was not a "willful tort" for the purpose of Florida Statutes § 627.351(6)(r)1.a, which provides a willful-tort exception to the general state sovereign immunity of Citizens Property Insurance Corporation, a Florida state insurer providing insurance in the property insurance residual market).

147 Larry Garrett, Note, *Comparative Fault in Legal Malpractice and Insurance Bad Faith: An Argument for Symmetry*, 21 REV. LITIG. 663, 694 (2002).

148 *Id.* ("Tort liability for attorney malpractice is predicated on the public trust nature of legal representation. It is stating the obvious to point out that people hire attorneys to protect them and advise them when they are helpless. The public is not expected to understand the substance or procedure of the legal system; the public should be able to rely on legal practitioners to carry out the processes of the legal system with skill and integrity. The

concerning the imposition of insurance bad faith relates only to the conduct of insurance companies, agents, brokers, and arguably "downstream" intermediaries.[149] Insurance bad faith arises out of the contractual cause of action for a breach of the implied covenant of good faith and fair dealing.[150] Insurance defense attorneys are not in privity of contract with a third-party claimant,[151] and the public policy rationale concerning the imposition of insurance bad faith does not apply. To impose a distinct duty of care on an insurance defense attorney toward a third-party claimant would fundamentally disrupt and interfere with the attorney-client relationship and with the duties of an attorney toward a client currently in place. In addition, as discussed below, the system of professional regulation of attorneys arguably provides an adequate alternative remedy in situations where an insurance defense attorney acts with intentional or reckless misconduct.

B. Professional Regulation of Attorneys as an Adequate Alternative Remedy

It is also beneficial to view this issue from the lens of the professional

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proper and efficient functioning of civil society necessitates public faith in the integrity of the legal system. The trust that people place in attorneys to act in a competent and loyal manner is so vital to society that there is an expansive system of lawyer regulation.").

149 *See* Stempel, *supra* note 22, at 629 (arguing intermediaries' bad faith liability is premised on the idea that "intermediaries have assumed the traditional functions of an insurer to a sufficient degree that for most practical purposes, the actions of the intermediary are the actions of the insurer.").

150 Marc S. Mayerson, *"First Party" Insurance Bad Faith Claims: Mooring Procedure to Substance,* 38 TORT TRIAL & INS. PRAC. L.J. 861, 864 (2010) ("However clothed, the first party bad faith doctrine rests fundamentally on the principle that an insurance company has a separately enforceable duty not to withhold benefits unreasonably and that the rubric for imposing that duty is the contractually derived covenant of good faith and fair dealing"); Douglas R. Richmond, *Bad Insurance Bad Faith Law*, 39 TORT TRIAL & INS. PRAC. L.J. 1, 3–4 (2003) ("A duty of good faith and fair dealing is implied in every insurance policy. The implied duty of good faith and fair dealing fundamentally requires that the insurer do nothing to injure the insured's right to receive benefits due under its policy. In most jurisdictions an insurer that breaches its duty of good faith and fair dealing commits the tort of bad faith. Bad faith is actionable as a tort only in the realm of insurance.").

151 *See* Johnny Parker, *The Expansion of Defense Counsel Liability to Include Malpractice Claims by Insurance Companies: How the West Was Won,* 46 TORT TRIAL & INS. PRAC. L.J. 33, 41 (2010). In addition, in some jurisdictions, in order to recover on a bad faith claim, the plaintiff must first prove an underlying breach of contract. *See, e.g.*, State Farm Fire & Casualty Co. v. Slade, 747 So. 2d 293 (Ala. 1999) (holding that for an insured to prevail on a bad faith failure to investigate claim against an insurer, the insured must first show the insurer breached the insurance contract).

regulation of attorney misconduct. Stempel and Maniloff remark that in some states, first-party bad faith is not recognized on the theory that alternative remedies exist to address an insurer's improper behavior.[152] The system of professional regulation of attorneys works as a silent regulator and deterrent of intentional or reckless misconduct, even apart from a cause of action against an insurance defense attorney on the basis of bad faith arising out of a first-party or third-party insurance situation.

In cases where a third-party claimant believes he has been harmed by the misconduct of an insurance defense attorney, the injured party has the option of filing a complaint with a state attorney disciplinary board, which then typically institutes an investigation that may result in the imposition of sanctions.[153] In addition, attorneys today also generally have a duty to report the misconduct of other attorneys.[154] Many insurance defense firms have more than one attorney who practices within the firm. If one insurance defense attorney within the firm observes another attorney engaging in fraudulent conduct, such as acting in collusion against the interests of an insurer, the observing lawyer has a duty to report the fraudulent behavior. Courts have even disciplined attorneys who fail to report the misconduct of other attorneys.[155] The specter of professional discipline is a powerful incentive for attorneys to report certain misconduct—like the attorney's behavior in *Consolidated American Insurance Company*—that can lead to indirect liability for insurance bad faith.

Finally, and arguably most significantly, *indirect* liability plays a significant

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152 MANILOFF & STEMPEL, *supra* note 37, at 534–35; *see also* Marquis v. Farm Family Mut. Ins. Co., 628 A.2d 644, 652 (Me. 1993) ("[I]n view of the broad range of compensatory damages available in a contract action and in view of the statutorily provided remedies of interest on the judgment and attorney fees, we believe sufficient motivation presently exists to stifle an insurer's bad faith tendencies without the further imposition of the specter of punitive damages under an independent tort cause of action.") (brackets omitted) (quoting McCullough v. Golden Rule Ins. Co., 789 P.2d 855, 859 (Wyo. 1990)).

153 *See generally* Debra Moss Curtis, *Attorney Discipline Nationwide: A Comparative Analysis of Process and Statistics*, 35 J. LEGAL PROF. 209 (2011) (providing a state-by-state survey of the process, procedures, and sanctions concerning the filing of a disciplinary complaint against an attorney).

154 MODEL RULES OF PROF'L CONDUCT R. 8.3(a) (2006 ed.) ("A lawyer who knows that another lawyer has committed a violation of the Rules of Professional Conduct that raises a substantial question as to that lawyer's honesty, trustworthiness or fitness as a lawyer in other respects, shall inform the appropriate professional authority.").

155 *See In re* Himmel, 533 N.E.2d 790, 790 (Ill. 1989) (holding that an attorney's failure to report misconduct on part of attorney who has formerly represented client and who converted a client's settlement, in violation of an Illinois professional conduct rule, warranted a one-year suspension).

role in deterring egregious conduct. The mere threat of an insurer pursuing an indemnity claim for attorney omissions, oversights, misconduct, or fraudulent collusion is enough to persuade attorneys to act with care and integrity. The professional regulation of attorneys may serve as an adequate alternative to address allegations of any bad faith conduct of an insurance defense attorney. *Direct* liability for insurance bad faith, either in the first-party or third-party context, need not be added as a deterrent to attorney misdeeds and misconduct.

VI. CONCLUSION

While courts are still finding that insurance defense attorneys may be *indirectly* liable for insurance bad faith, typically through an insurer's indemnity suit against a law firm, the decisions of the courts in the *Haberman* and *The Doctor's Companies* cases have stood since the late 1980s. The doctrinal rule still stands today that an insured or a third-party claimant may not *directly* recover from an insurance defense attorney for breach of the implied covenant of good faith and fair dealing or for insurance bad faith.

In an era of expanding insurance bad faith liability, the doctrinal rule concerning *direct* liability should remain intact. The *direct* liability of an insurance defense attorney for insurance bad faith should not be a solution to attorney error and misconduct because it unduly interferes with the attorney-client relationship. Direct liability of an insurance defense attorney has been rightly rejected by the courts and should forever remain a relic of the past.