



The Insurance Tripartite Relationship: “Who Is My Client Anyway?”

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Insurance-appointed counsel should be familiar with the “tripartite” relationship. Those who defend under a reservation of rights (“ROR”) especially should be aware of the potential conflicts that befall such representation. One commentator aptly described the ROR defense as “deeply and unavoidably vexing.”¹ The Supreme Court of Mississippi has recognized the “tripartite” relationship creates problems that would “tax Socrates.”²

The “tripartite” relationship refers to the relationship among an insurer, its insured and defense counsel retained by the insurer to defend the insured against third-party claims. This relationship can present actual or potential conflicts between the insurer and the insured, placing defense counsel in difficult, and often confusing, positions. This article examines the tripartite relationship in the context of an ROR defense, and some of the potential conflicts of interest defense counsel may face.

What is an ROR defense?

Liability policies typically require insurers to defend insureds against covered claims. The duty to defend usually is determined at the outset of litigation when coverage issues are still unresolved. Alabama law, like most jurisdictions, provides that the defense obligation in a duty-to-defend policy is triggered by comparing the policy language to the allegations of the complaint.³ If the complaint alleges an incident within the coverage of the policy, the insurer is obligated to defend, regardless of the insured’s ultimate liability.⁴ In Alabama, once the duty to defend is triggered, the insurer has an obligation to defend both covered and non-covered claims.⁵

An ROR defense allows the insurer to comply with its defense obligation without waiving its right to withdraw the

defense at a later date, nor waiving its right to refuse indemnity for non-covered claims. An ROR defense typically is employed when some, but not all, allegations in the complaint trigger the duty to defend, or when the complaint is so vague there is doubt as to whether the defense obligation has been triggered. The insurer's rights are preserved by issuing a letter to the insured (an ROR letter) reserving the insurer's right to later deny coverage, or withdraw its defense despite its initial agreement to defend. The purpose of an ROR letter is to place the insured on notice that even though the insurer is providing a defense in the lawsuit, certain claims ultimately may not be covered by the policy.

Who has the right to control an ROR defense?

Most insurance policies give the insurer the right to control the defense and settlement of claims against the insured. Notwithstanding these contractual rights, courts and legislatures often limit the insurer's control over the defense where conflicts of interest exist between the insurer and the insured.

Potential conflicts of interest are inherent in an ROR defense. Insureds sometimes argue defense counsel appointed by the insurer may attempt to steer the defense toward coverage results that are favorable to the insurer. For obvious reasons, insureds have vested interests in ensuring that the claims asserted remain covered. These interests of the insurer and insured may conflict. While most states have addressed the potential conflicts of interest created by an ROR defense, there is no clear consensus among them on how potential conflicts are to be resolved.

Some states, like California and Florida, have enacted legislation addressing how potential conflicts affect the insurer's defense obligation.⁶ According to Section 2860 of the *California Civil Code*, "when an insurer 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 the claim, a conflict of interest may exist." If a conflict exists, which is a factual determination, the statute requires the insurer to provide independent counsel to defend the insured at the insurer's expense, unless the insured waives, in writing, the right to independent counsel after disclosure of the conflict. This statute codifies to some extent the landmark ROR decision rendered in *San Diego Navy Federal Credit Union v. Cumis Insurance Society, Inc.*, 208 Cal. Rptr. 494 (Ct. App. 1984), which set the stage for future debate on this issue. Unlike the prior *Cumis* decision, the

California legislation stops short of presuming that a conflict of interest is present in every situation involving an ROR defense.

Florida, on the other hand, has enacted legislation that assumes a conflict of interest between the insurer and insured whenever the insurer asserts a coverage defense through an ROR letter. Section 627.426 of the Florida Claims Administration Statute requires the insurer either to: (1) obtain a non-waiver agreement from the insured after "full disclosure of the specific facts and policy provisions upon which the coverage defense is asserted and the duties, obligations, and liabilities of the insurer during and following the pendency of the subject litigation" or (2) retain independent counsel "which is mutually agreeable to the parties."⁷

Most states, including Alabama, address through case law the potential conflicts created by an ROR defense, and the duties of the insurer and defense counsel in that regard. For example, the Mississippi Supreme Court has taken an approach similar to California and Florida legislation requiring independent counsel. In Mississippi, a conflict of interest exists between the insurer and insured when (1) a defense is offered under an ROR and/or (2) only some of the claims asserted against the insured are covered. *Moeller v. American Guar. and Liability Ins. Co.*, 707 So.2d 1062, 1069 (Miss. 1996). According to *Moeller*, the insurer has an obligation to explicitly notify the insured of its right to select its own independent counsel when the insurer defends under an ROR, or when certain claims are not covered. If the insurer properly notifies the insured of its right to independent counsel, and the insurer only defends the covered claims, then the insured's independent counsel is retained at the insured's own expense. If the insurer elects to defend non-covered claims under an ROR, then the insurer must also pay the legal fees reasonably incurred by the insured's independent counsel.

The *Moeller* decision was elaborated on further in *Twin City Fire Ins. Co. v. City of Madison, Miss.*, 309 F.3d 901 (5th Cir. 2002). The *Twin City* court held "the insured should be immediately notified of a possible conflict of interest between his interests and the interest of his insurance company so as to enable him to give informed consideration to the retention of other counsel." If the insured is not timely advised of the possibility of a conflict of interest, and the right to independent counsel, the insurer may be estopped to deny coverage, even where valid coverage defenses exist.

Alabama allows the insurer to control the defense under an ROR if certain criteria are met

In Alabama, an ROR defense creates a potential conflict of interest between the insurer and insured. Like many states, however, Alabama allows the insurer to choose defense counsel when defending under an ROR. In other words, Alabama does not require the insurer to pay for separate independent counsel simply because a potential conflict of interest exists between the insurer and insured. However, because potential conflicts of interest exist in an ROR defense, the insurer has an enhanced



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duty of good faith.⁸ Under the enhanced duty of good faith set forth in the seminal Alabama case on the issue, *L&S Roofing*, the insurer must:

- Thoroughly investigate the claims asserted against its insured;
- Fully inform the insured of all developments relevant to policy coverage;
- Allow the insured to make the ultimate choice regarding settlement; and
- Pursue a course of action that is advantageous to the insured.⁹

The failure to satisfy the foregoing criteria can result in the insurer's loss of coverage defenses.

In *Shelby Steel Fabricators, Inc. v. United States Fidelity & Guaranty Co.*,¹⁰ insurance-appointed counsel defended the insured for more than two years under an ROR. During this time, defense counsel failed to keep the insured informed about the progress of its defense. Because defense counsel did not keep the insured informed, the court found that the insurer failed to meet its enhanced obligation of good faith. This breach estopped the insurer from denying coverage. The court reasoned that such a result would not unfairly burden insurers, stating that:

We point out that the obligation now placed on insurance companies is not an onerous one. It merely requires that if an insurer intends to defend a case pursuant to a . . . reservation of rights, then that insurer not only must provide notice to its

insured of that fact, but also must keep its insured informed of the status of the case.¹¹

The court concluded that enforcing a reporting requirement protects insureds and compels insurers to meet their acknowledged duties to insureds when coverage is at issue.

So, if you defend under an ROR, who is your client?

Under Alabama law, when the insurer retains counsel to defend the insured subject to an ROR, counsel represents the insured as well as the insurer in furthering the interests of each.¹² This is significant because, by virtue of the dual representation, the necessary privity for the attorney client relationship is established, so that defense counsel may be subject to malpractice claims both by the insured and the insurer.¹³ Hence, here is the cloud of confusion that hangs over the head of counsel defending under an ROR.

With respect to the insured, defense counsel's duties include providing the insured with competent representation, and disclosing any and all information relevant to the insured's case. Defense counsel has the obligation to act loyally to the insured in compliance with Rule 5.4(c) of the *Model Rules of Professional Conduct*. That rule prohibits an attorney, employed by a party to represent a

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third party, from allowing the employer to influence his or her professional judgment. Defense counsel also has a duty of confidentiality to the insured. Rule 1.8(f)(3) of the *Model Rules of Professional Conduct* states that a lawyer shall not accept compensation from the insurer unless information relating to the representation of the insured may be adequately protected as required by Rule 1.6. Rule 1.6 provides that, "A lawyer shall not reveal information relating to the representation of a client unless the client consents after consultation." Finally, defense counsel must disclose all settlement offers to the insured as those offers are presented.¹⁴

Defense counsel also owes certain duties to the insurer, on behalf of the insured, many of which are outlined in the insurance policy. These duties include cooperating with the insurer in its investigation of the claims asserted against the insured, reporting developments to the insurer and disclosing any settlement offers to the insurer. Defense counsel's failure to comply with the conditions outlined in the insured's policy could adversely affect the insured's rights under the policy. Therefore, it is necessary for defense counsel to be familiar with the insured's obligations under the policy, and comply with those obligations after consultation with the insured, to the extent those obligations do not conflict with rules 5.4(c), 1.8(f)(3), and 1.6 of the *Model Rules of Professional Conduct*.

Although defense counsel owes duties both to the insured and the insurer, the Disciplinary Commission of the Alabama State Bar has addressed in several opinions the conflict of interest issues raised by dual representation of the insured and the insurer. In one opinion, the commission describes defense counsel's obligations as follows:

Although you were retained to represent the insured by the insurance company and are paid by the company, your fiduciary duty of loyalty to the insured is the same as if he had directly engaged your services himself ... Since the interests of the two clients, the insurance company and the insured do not fully coincide, the attorney's duty is first and primarily to the insured.¹⁵

It is of utmost importance that counsel defending under an ROR keeps these obligations in mind when the interests of the insurer and the insured potentially conflict.

The pitfalls existing for Alabama attorneys defending insureds under an ROR were delineated by the Honorable Judge Guin in a 1994 federal opinion from the Northern District of Alabama. In *Carrier Express, Inc. v. Home Indemnity Company*,¹⁶ Judge Guin elaborated extensively on the obligations of defense counsel defending under an ROR. In *Carrier*, a trucking company filed suit against its liability insurer alleging bad faith in failing to settle several wrongful death and personal injury lawsuits. The lawsuits arose from an accident resulting in five deaths and two serious personal injuries. The insurer defended the insured under an ROR, and retained defense counsel. A copy of the ROR was sent to defense counsel.

During the course of the defense, deposition testimony was elicited indicating the claims against the insured were not covered. Defense counsel sent a letter to the insurer summarizing this deposition testimony; however, a copy of that letter was never sent to the insured. The insured subsequently requested the insurer tender its policy limits to settle the cases. The insurer responded that on advice of counsel it did not want to enter into settlement negotiations until the insured's summary judgment motion was addressed by the court.

The plaintiffs later made a written settlement demand that was to remain open until the date set for oral argument on the insured's summary judgment motion. At the time of the demand, most of the other defendants (not insured by Home Indemnity) had tendered their limits. The insured made multiple demands on its insurer and defense counsel to tender policy limits to plaintiffs' counsel. On several occasions, the insured expressed its concern over exposure to a judgment in excess of policy limits. In one letter to defense counsel, the insured explicitly stated, "We are your client. The insurance company is not."¹⁷ The insurer's file notes indicated defense counsel consistently advised it to wait until the insured's summary judgment motion was decided before considering whether to tender its limits, despite the insured's requests to the contrary.

The insured's summary judgment motion was denied. Plaintiffs' demand then increased substantially above the policy limits. The insured attempted to terminate the insurer-appointed defense counsel. However, the insurer would not agree and continued to allow defense counsel to represent the insured's interests. The insured



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nevertheless retained separate counsel, and reached a settlement with the plaintiffs that required the insured to pay sums in excess of its policy limits.

The insured filed suit against the insurer alleging negligent or bad faith refusal to settle. The case went to trial, and the jury awarded the insured compensatory and punitive damages against the insurer. On a post-trial motion by the insurer, the court stated the “award was well supported by the record and frankly, [it] would have been astounded by a lesser result.”¹⁸ The court found that defense counsel assisted the insurer in gambling with the insured’s welfare by making recommendations that were in the insurer’s best interests, and by failing to communicate crucial information to the insured. The court concluded that defense counsel was rendering legal advice to the insurer at the expense of the insured.

Judge Guin’s opinion in *Carrier* demonstrates that defense counsel was confused as to his role in defending under an ROR. During the trial, defense counsel testified he was employed by the insurer. He later stated his “first duty” was to the insured. When asked how he justified not telling the insurer to settle in the face of a demand by the insured to do so, defense counsel stated he was being paid by the insurer, although he recognized that the insured was his client. Judge Guin ultimately concluded the insurer’s ROR charged defense counsel with certain duties. These duties included giving the insured the ultimate choice regarding settlement.

The *Carrier* case highlights the importance of defense counsel understanding his or her role when defending under an ROR. Defense counsel’s confusion in *Carrier* clearly contributed to both the insurer’s and the insured’s overall liability exposure.

Other Ethical Dilemmas Faced by Counsel Defending under an ROR

The Restatement (Third) of the Law Governing Lawyers says a conflict of interest exists “if there is a substantial risk that the lawyer’s representation of the client would be materially and adversely affected by the lawyer’s own interests or by the lawyer’s duties to ... a third person.”¹⁹ A host of situations may pose actual or potential conflicts between the interests of the insurer and its insured, which raise ethical dilemmas for defense counsel.

1. Can defense counsel move for summary judgment if the result would be that only non-covered claims remain?

Assume a claim is asserted against the insured that involves both covered and non-covered claims. In Alabama, the insurer owes a duty to defend all claims as long as there remain potentially covered claims. However, if covered claims are later dismissed, the insurer may withdraw from the insured’s defense if it has reserved its right to do so.²⁰ One question to ponder is how should defense counsel proceed if summary judgment is appropriate only as to covered claims? The answer depends on the facts of each case. A summary judgment, while benefiting



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the insured as to liability, would also leave it without a defense to the remaining claims. Considering the potential ramifications, defense counsel should fully disclose to the insured the coverage risks associated with a summary judgment motion under these circumstances. In some cases, it could be more beneficial to the insured not to file a summary judgment motion if a positive ruling leaves the insured without a defense from the insurer. In other cases, it could be more beneficial to proceed with a summary judgment motion in spite of coverage ramifications. The key for defense counsel defending under an ROR is that it is a decision that can be made only by the insured after consultation. Defense counsel faced with this dilemma might also consider approaching the insurer with a proposal whereby the insurer agrees not to withdraw its defense of non-covered claims in the event the covered claims successfully are dismissed on summary judgment.

2. Can defense counsel disclose information to the insurer that provides a basis to deny coverage?

How should defense counsel proceed when he or she discovers information that affects coverage, or provides the insurer with a basis to deny coverage? Defense counsel's options include: (1) disclosing that information to the insurer; (2) withholding that information from the insurer; or (3) analyzing whether that information is protected by the attorney-client privilege before disclosing it to the insurer. The Disciplinary Commission of the Alabama State Bar cautions attorneys to err on the side of non-disclosure to the insurer if, in the exercise of defense counsel's professional judgment, there is a reasonable possibility that waiver of the attorney-client privilege could result.²¹ In other words, if defense counsel has *any* reasonable basis to believe that disclosure could result in waiver of client confidentiality, then defense counsel should decline to disclose that information to the insurer.

3. What if the insured has a large deductible or SIR and the insurer wants to settle with the insured's lawyer?

Another ethical dilemma arises where the insured has a large deductible or self-insured retention. A potential conflict of interest exists because the insurer presumably would prefer to settle the

case for an amount within, or close to, the deductible while the insured presumably would prefer to try the case in the hope of avoiding liability altogether. In most jurisdictions, the insurer has authority to settle claims or lawsuits without the insured's consent absent policy wording to the contrary. In Alabama, however, the insured must be given the ultimate choice regarding settlement when there is an ROR defense. Otherwise, the enhanced duty of good faith owed to an insured has not been satisfied. From defense counsel's perspective, it is important he or she keep the insured apprised of all settlement discussions, and seek the insured's consent before agreeing to any settlement.

4. What about consent to settle provisions and hammer clauses?

Many liability policies contain provisions requiring the insured's consent to settle. Other policies expressly provide the insured's consent is not necessary. An interesting dilemma is presented where counsel is defending under an ROR, and the policy provides the insurer may settle without the insured's consent. Remember, Alabama courts have said in an ROR defense, "It is the insured who must make the ultimate choice regarding settlement."²² Does that mean *L&S Roofing* trumps the contractual policy language allowing the insurer to settle, when the insured does not consent? It seems the rationale behind the *L&S Roofing* ruling was to give the insured the ultimate choice where it has the greatest exposure, not the other way around.

Another interesting twist to this dilemma arises when liability policies (particularly professional liability policies) contain "hammer" or "suicide" clauses. These clauses shift financial responsibility from the insurer to the insured for a judgment in excess of an amount the insurer is prepared to settle for when the insured refuses to settle. Very little has been written about the enforceability of "hammer" clauses, and Alabama courts have not addressed them.²³ That said, defense counsel should be cautious not to be perceived by the insured as acting on behalf of the insurer in recommending a settlement in the event the insurer decides to "bring down the hammer." On the other hand, if the policy contains a "hammer" clause, defense counsel should advise the insured of the potential repercussions associated with refusing to settle when the insurer is prepared to do so. The key for defense counsel is to give the insured enough information so that it can make an informed decision regarding potential settlements.

5. "Scorched Earth" defense versus cost-effective defense

The interests of the insurer and insured also may conflict when the insured expects the best (and sometimes most expensive) possible defense and the insurer expects a cost-effective defense. Under this scenario, extreme cost constraints potentially expose defense counsel to malpractice liability for inadequate defense preparation. The Alabama State Bar Office of General Counsel has made it clear that defense counsel may not permit an insurer to influence his or her exercise of professional judgment in rendering legal services to the insured.²⁴ This view is in accord with the Restatement (Third) of the Law Governing Lawyers as well as the ABA *Model Rules of Professional Conduct*. Both of those authorities prohibit a third-party, such as

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an insurer, from interfering with defense counsel's independent professional judgment, irrespective of the tripartite relationship. The best way to resolve this potential dilemma is through open communication with the insurer. By keeping the insurer apprised of the status of the litigation, along with the steps necessary to protect the insured's interests, defense counsel reduces the risk of the insurer imposing significant cost restraints on his or her litigation plan.

6. Damages in excess of policy limits

Cases in which potential damages exceed available insurance coverage may also create conflicts of interest between the insurer and the insured. As discussed in the *Carrier* case, a conflict arises when the insured demands that an insurer tender policy limits to avoid a judgment in excess of policy limits. As soon as this demand is made by the insured, or a demand within policy limits is made by a plaintiff, the insurer's interests and those of the insured diverge. The insured wants to avoid excess exposure and potential financial ruin. However, a policy-limits settlement is not always in the insurer's best interests, particularly where significant coverage issues are involved. To avoid this problem, the Alabama Supreme Court has held that an insurer must allow an insured to make the ultimate choice regarding settlement as part of its enhanced duty of good faith. Defense counsel must assist the insurer in fulfilling this obligation.

Recommendations for Defending under a Reservation of Rights

There are several steps defense counsel can take to minimize the ethical dilemmas faced in the context of an ROR defense. One, defense counsel should be familiar with the insurer's coverage position. Defense counsel should always remember that he or she is never an advocate for the insurer's coverage position. Nevertheless, defense counsel may unwittingly lead the defense toward a path of non-coverage if he or she is not aware of coverage issues. The insured's policy, as well as any reservation of rights letters, should be reviewed. Two, defense counsel must be careful about obtaining information from the insured and passing it along to the insurer with recommendations. Defense counsel owes a duty of confidentiality to the insured, regardless of the tripartite relationship with the insurer. Three, if the insured has questions concerning coverage under the policy, defense counsel should refer the insured to the insurer. Four, defense counsel should keep the insured and the insurer informed of any settlement discussions. Failure to do so could result in ramifications for both parties. Finally, if there is the possibility for damages in excess of policy limits, defense counsel should advise the insured

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of this danger and suggest the insured retain counsel at its expense to advise on the issue.

The foregoing is by no means an exhaustive list of precautions defense counsel should take when defending under an ROR. Each case must be examined on an individual basis to ensure that defense counsel is carrying out his or her duties to the insurer and, most importantly, the insured.

Conclusion

One author describes the tripartite relationship as an “‘ethically sanctioned’ duality of representation.”²⁵ Another author notes that “the Restatement’s analysis of the relationship was ‘conceptually impoverished.’”²⁶ The bottom line is that conflicts of interest are inevitable when an insurer appoints defense counsel to defend an insured under an ROR. In order to avoid breaching obligations both to the insurer and the insured, defense counsel must keep all parties informed, while being mindful of the confidential relationship he or she has with the insured.

Ultimately, when an ROR defense is provided, all parties involved must be careful to segregate the handling of coverage matters from the defense of the lawsuit against the insured. Otherwise, any assistance given by defense counsel to the insurer may expose defense counsel to a malpractice claim by the insured, and result in a waiver of the insurer’s coverage defenses. ▲▼▲

Endnotes

1. See, Charles Silver, *Does Insurance Defense Counsel Represent the Company or the Insured?*, 72 Tex. L. Rev. 1583, 1587 (1996).

2. *Hartford Acc. & Indem. Co. v. Foster*, 528 So.2d 255, 273 (Miss. 1988).
3. *USF&G v. Armstrong*, 479 So.2d 1164 (Ala. 1985).
4. *Ladner & Co. v. Southern Guaranty Ins. Co.*, 347 So.2d 100 (Ala. 1977).
5. *Universal Underwriters Ins. Co. v. East Central Ala. Ford Mercury, Inc.*, 574 So.2d 716 (Ala. 1990).
6. See, Laura A. Foggan and Elizabeth Eastwood, *Assessing Conflicts of Interest in the Tripartite Relationship* (October 1, 1997), for a thorough discussion of the way in which various states have treated potential conflicts of interest created by a reservation of rights defense.
7. Alaska and Guam also have statutes that address an insured’s right to independent counsel in the context of a reservation of rights defense.
8. *Twin City Fire Ins. Co. v. Colonial Life & Acc. Ins. Co.*, 839 So.2d 614 (Ala. 2002).
9. *L&S Roofing Supply Co., Inc. v. St. Paul Fire & Marine Ins. Co.*, 521 So.2d 1298 (Ala. 1987).
10. 569 So.2d 309 (Ala. 1990).
11. *Id.* at 313.
12. *Mitchum v. Hudgens*, 533 So.2d 194 (Ala. 1988).
13. See, Amber M. Czarniecki, *Ethical Considerations within the Tripartite Relationship of Insurance Law—Who is the Real Client?*, *Defense Counsel Journal* (April 2007) for a thorough discussion of this issue.
14. *L&S Roofing Supply Co., Inc.*, 521 So.2d at 1303 (Ala. 1987).
15. RO-98-02. (internal citations omitted).
16. 860 F.Supp. 1465 (N.D. Ala. 1994).
17. *Id.* at 1471.
18. *Id.* at 1480.
19. Restatement (Third) of the Law Governing Lawyers 121 (1998).
20. *Tapscott v. Allstate Ins. Co.*, 526 So.2d 570 (Ala. 1988) (Alabama law is clear that an insurer’s withdrawal may not prejudice an insured’s case).
21. RO-98-02.
22. *L&S Roofing Supply Co., Inc.*, 521 So.2d at 1303 (Ala. 1987).
23. See, Daniel J. Pope, *Hammered by the Hammer Clause: Does It Mean What It Says?* 68 Def. Couns. J. 236 (April 2001) for a discussion on “hammer” clauses.
24. RO-98-02.
25. See, Amber M. Czarniecki, *Ethical Considerations within the Tripartite Relationship of Insurance Law—Who is the Real Client?*, *Defense Counsel Journal* (April 2007) (quoting Michael J. Brady and Heather A. McKee, *Ethics in Insurance Defense Context: Isn’t Cumis Counsel Unnecessary?*, 58 Def. Couns. J. 230 (1991)).
26. *Id.* (quoting Charles Silver and Michael Sean Quinn, *Are Liability Carriers Second-Class Clients?*) *Coverage* (Vol. 6, No. 1, Jan.-Feb. 1996).

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