

## LIABILITY OF INSURERS FOR DEFENSE COUNSEL MALPRACTICE

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Proposed section 12 of the American Law Institute's ("ALI") Restatement of the Law of Liability Insurance sets forth two alternative conditions under which a liability "insurer exercising the right to defend a claim is subject to liability for a breach of professional obligation by defense counsel and related service providers in relation to the claim."<sup>1</sup> The first condition is that the "[d]efense counsel is an employee of the [liability] insurer acting within the scope of employment."<sup>2</sup> The second condition is that "[t]he insurer negligently selects or supervises defense counsel, including by retaining a lawyer who carries inadequate liability insurance."<sup>3</sup> In a previous draft of the Restatement, the Reporters endorsed vicarious liability of liability insurers for all defense counsel malpractice.<sup>4</sup> In part based on an earlier draft of this Article, the current Restatement draft opts instead for vicarious liability only for "inside" defense counsel, and a direct liability standard with respect to "outside" defense counsel.<sup>5</sup> The question of the appropriate standard of liability for liability insurers with respect to defense counsel malpractice is an important one, which has split the courts in different jurisdictions, but which has not received sufficient academic attention.<sup>6</sup> I support the

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1. RESTATEMENT OF THE LAW OF LIAB. INS. § 12 (AM. LAW INST., Discussion Draft 2015).

2. *Id.* at 12(1).

3. *Id.* at 12(2).

4. PRINCIPLES OF THE LAW OF LIAB. INS. § 14 (AM. LAW INST., Tentative Draft No. 2, 2014).

5. RESTATEMENT OF THE LAW OF LIAB. INS. § 12 reporters' note a-b (AM. LAW INST., Discussion Draft 2015).

6. The primary exception is Douglas R. Richmond, *Liability Insurers' Right to Defend Their Insureds*, 35 CREIGHTON L. REV. 115 (2001), which is cited in the Reporters' Note to section 12. RESTATEMENT OF THE LAW OF LIAB. INS. § 12 reporters' note a (AM. LAW INST.,

current Restatement approach, and in this Article I will discuss the reasons I think the Reporters were correct to switch from a vicarious liability rule in all cases to a direct liability rule for non-employee defense counsel. By endorsing a negligence standard for outside defense counsel that expressly incorporates an assessment of the adequacy of defense counsel's malpractice insurance, the Restatement preserves the primary benefit of a vicarious liability rule while avoiding its costs.<sup>7</sup> Nevertheless, the Restatement approach raises a number of interpretive and practical issues that will need to be resolved by the courts.

I begin this Article with a discussion of the law of vicarious liability and its application to lawyers. I then examine Restatement section 12 and the cases on vicarious liability of insurers for defense counsel misconduct in light of this background law. Next, I turn to the law of direct liability and the discussion of this law in cases on insurer liability for lawyer misconduct. I then consider modern economic rationales for vicarious liability and apply these rationales to the context of insurer liability. Finally, I raise some questions about the limits of the scope of liability under section 12 if it is adopted by the ALI and subsequently by courts.

## I. VICARIOUS AND DIRECT LIABILITY UNDER AGENCY LAW

### A. *Vicarious Liability and Its Application to Lawyer Torts*

A brief review of vicarious liability doctrine and its ordinary application to lawyers will be helpful before evaluating the merits of vicarious liability of liability insurers for defense counsel misconduct. The basic source of vicarious liability is agency law. An agent is someone who acts on behalf of, subject to the control of, and with the consent of a principal.<sup>8</sup> Not all agents subject their principals to vicarious liability, however. Agents whose conduct does not generally result in vicarious liability are called "independent contractors,"<sup>9</sup> though that term is somewhat confusing because courts sometimes use it to refer to non-agent contractors.<sup>10</sup> Agents whose conduct results in vicarious liability are generally called "employees," or, in the older terminology,

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Discussion Draft 2015).

7. See RESTATEMENT OF THE LAW OF LIAB. INS. § 12 reporters' note a (AM. LAW INST., Discussion Draft 2015).

8. RESTATEMENT (THIRD) OF AGENCY § 1.01 (AM. LAW INST. 2006).

9. RESTATEMENT (SECOND) OF AGENCY § 2 cmt. b (AM. LAW INST. 1958).

10. *Id.*

“servants.”<sup>11</sup> The key difference between an employee-agent and an independent contractor-agent is that a principal controls the “manner and means” of the work of an employee, but not the work of an independent contractor.<sup>12</sup> An employer-employee relationship is not sufficient for vicarious liability under agency law.<sup>13</sup> An employee must also be acting within the “scope of employment.”<sup>14</sup>

Courts generally consider lawyers to be independent-contractor agents of their client principals because clients do not exercise control over the manner and means of their lawyers’ work. Thus, if a lawyer driving to the courthouse to represent his client in a case negligently runs over a pedestrian, the client would not be vicariously liable for the lawyer’s tort. Some lawyers, however, are employees. There are two main types of lawyer employees. The first type is a lawyer who is employed full-time by a client. The primary example is an in-house lawyer for a corporation. A corporation would be vicariously liable if its in-house corporate counsel negligently drives into another car while traveling to negotiate a merger deal during normal work hours, just as the corporate employer would be vicariously liable for the torts of its other employees in a similar circumstance. The second type of lawyer employee is a lawyer who is employed not by the client, but by a law firm. If a law firm associate negligently drives into another car on the way to the courthouse to represent a client, the law firm, but not the client, would be vicariously liable.<sup>15</sup> On the other hand, neither the corporate nor the law firm employer would be liable for an employee lawyer’s negligent car accident that occurs when the lawyer is driving to visit a friend over the weekend, because that would be outside the lawyer’s scope of employment.

If the tort the lawyer commits is malpractice rather than a car accident, agency law dictates that the results should be the same. A client is generally not vicariously liable for his lawyer’s malpractice. A client arguably exercises even less control over how a lawyer does his professional work than over how a lawyer does other tasks.<sup>16</sup> Even if a sophisticated client engages in extensive monitoring of a lawyer’s professional conduct, such as a corporate client’s monitoring of outside counsel through its in-house counsel, courts still consider the outside

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11. *Id.* § 2 cmt. a.

12. RESTATEMENT (THIRD) OF AGENCY § 7.07(3)(a) (AM. LAW INST. 2006).

13. *Id.* § 7.07(1)–(2).

14. *Id.*

15. *See, e.g.*, RESTATEMENT (SECOND) OF AGENCY § 250 cmt. a (AM. LAW INST. 1958) (stating that “an attorney employed as a subordinate in a law office . . . [is] within the master and servant relation with [his] employer”).

16. *See, e.g.*, *Lynn v. Superior Court*, 225 Cal. Rptr. 427, 428–29 (Cal. Ct. App. 1986); *Horwitz v. Holabird & Root*, 816 N.E.2d 272, 280–81 (Ill. 2004).

counsel to be an independent contractor for purposes of vicarious liability.<sup>17</sup>

One might wonder when the question of a client's vicarious liability for his lawyer's malpractice would even arise, since usually clients bring malpractice claims, which are direct liability claims. In some cases, non-clients may bring malpractice claims, but in these cases, the question of the client's vicarious liability for the lawyer's malpractice rarely arises. Generally the non-client sues the lawyer directly for malpractice because the client is judgment proof or otherwise unable to be sued.<sup>18</sup> If the non-client also sues the client, the claim is also likely to be direct liability rather than vicarious liability for the lawyer's malpractice. Another possible scenario in which the issue of client vicarious liability could arise outside of the insurance context is when a lawyer represents co-clients, and one of the co-clients alleges that the other co-client had greater control of the lawyer, and therefore should be liable for the lawyer's malpractice.<sup>19</sup> Courts do not generally hold one co-client vicariously liable to the other co-client for their joint lawyer's malpractice, however.<sup>20</sup>

On the other hand, if the lawyer is a full-time employee of the client, as in the in-house counsel situation, then under standard agency law, the employer client would be vicariously liable for the employee lawyer's malpractice, even though the non-lawyer managerial employees of the corporate employer may not substantially monitor the in-house counsel's legal work. All torts of a lawyer-employee committed within the scope of employment would result in vicarious liability, whether or not they involve breaches of a professional obligation. There is little law on the subject, however. Most malpractice claims against in-house counsel are brought as direct claims by the employer client, or more commonly, by a bankruptcy trustee standing in the shoes of the corporate client.<sup>21</sup> There are few situations in which a non-client could bring a malpractice claim against a corporation's in-house counsel where the non-client would also have a direct liability claim against the entity, thus making unnecessary a vicarious liability claim against the entity based on the in-house counsel's malpractice. It is true that the direct liability claim would in

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17. See, e.g., *Horwitz*, 816 N.E.2d at 281.

18. See, e.g., *Greycas, Inc. v. Proud*, 826 F.2d 1560, 1562, 1567 (7th Cir. 1987) (finding lawyer for debtor liable for negligent misrepresentation and malpractice based on false statements in an opinion letter that induced a creditor non-client to make a loan to the debtor client).

19. See *Baldassarre v. Butler*, 625 A.2d 458, 459 (N.J. 1993) (joint representation by lawyer of buyer and seller and claim of fraud against seller).

20. See, e.g., *id.* at 465.

21. See, e.g., *Fed. Deposit Ins. Co. v. O'Melveny & Myers*, 969 F.2d 744, 746-47 (9th Cir. 1992), *rev'd*, 512 U.S. 79 (1994).

reality be a vicarious liability claim against managerial agents of the corporation, but it would not be one based on legal malpractice. Moreover, although vicarious liability claims could arise if corporations use in-house lawyers to represent both the entity and employees (typically executives of the corporation), such joint representation is often done by outside counsel, not in-house counsel.<sup>22</sup>

By contrast, law firm vicarious liability is relatively common. A law firm is vicariously liable for the professional misconduct of its associate lawyers, who are employees of the firm, if the misconduct occurs within the scope of employment. A law firm is also vicariously liable for the professional misconduct of its partners under partnership law.<sup>23</sup> Law firm vicarious liability is not, however, based on a lawyer-client relationship.

Client vicarious liability for lawyer malpractice can also arise in cases involving a particular type of lawyer malpractice. Agency law recognizes a species of vicarious liability that is not grounded in the employer-employee relationship, and is applicable to independent-contractor agents as well as to employee agents.<sup>24</sup> A principal is subject to vicarious liability for fraud and related torts committed by any agent acting with apparent authority.<sup>25</sup> In the context of legal representation, under this principle a client would be vicariously liable for fraud committed against a third party by the client's lawyer who makes false statements acting with actual or apparent authority. Similarly, a client would be vicariously liable for malicious prosecution for a suit the client authorized the lawyer to bring.<sup>26</sup> As noted above, however, in many of these cases, a direct liability claim against the client would be available

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22. See William D. Anthony, Comment, *Vicarious Liability Concerns for Insurers Using In-House Insurance Defense Counsel*, 27 SW. U. L. REV. 125, 128-32 (1997).

23. See, e.g., UNIF. P'SHIP ACT § 305 (UNIF. LAW COMM'N 1997). Vicarious liability of the law firm applies even if the firm is organized as a limited liability company or limited liability partnership. *Id.* § 306(c). The vicarious liability precluded by the law governing those types of entities is vicarious liability of individual members or partners of the firm. *Id.*

24. See RESTATEMENT (THIRD) OF AGENCY § 7.08 (AM. LAW INST. 2006).

25. *Id.* Section 7.08 imposes vicarious liability not only for fraud, but for any "tort committed by an agent in dealing or communicating with a third party on or purportedly on behalf of the principal when actions taken by the agent with apparent authority constitute the tort or enable the agent to conceal its commission." *Id.* Fraud by an agent is nevertheless the most common application of this principle.

26. See RESTATEMENT (SECOND) OF AGENCY § 253 (AM. LAW INST. 1958) ("A principal who authorizes a servant or other agent to institute or conduct such legal proceedings as in his judgment are lawful and desirable for the protection of the principal's interests is subject to liability to a person against whom proceedings reasonably adapted to accomplish the principal's purposes are tortiously brought by the agent."); *SouthTrust Bank v. Jones, Morrison, Womack & Dearing, P.C.*, 939 So. 2d 885, 910 (Ala. Civ. App. 2005).

to the defrauded party, so the vicarious liability theory would not be necessary.

A final aspect of agency law relevant to vicarious liability is that vicarious liability of a principal is in addition to the personal liability of the agent.<sup>27</sup> A principal held vicariously liable for an agent's wrongdoing can seek indemnity from the agent.<sup>28</sup> The principal's ability to obtain indemnity from the agent assumes, however, that the principal is without fault. If, for example, the agent is without fault and acts with authority, and the principal is at fault, the agent can get indemnity from the principal for litigation expenses.<sup>29</sup> If both the principal and agent are at fault, there may be a division of liability.<sup>30</sup> Thus, in many cases, even if vicarious liability for a lawyer's malpractice is available outside of the law firm context, the lawyer may end up bearing some or all of the liability.

The general conclusion from this review of agency law is that vicarious liability for lawyer malpractice is relatively limited, whether for doctrinal or practical reasons.

*B. Vicarious Liability of Liability Insurers for Defense Counsel: Agency Law, the Courts, and the Restatement*

Proposed Restatement section 12 generally follows traditional agency law, as described in the previous section. It applies vicarious liability to a liability insurer for breach of a professional obligation by defense counsel if the lawyer is an employee of the insurer acting within the scope of employment,<sup>31</sup> but not if the lawyer is an outside counsel retained as an independent contractor.<sup>32</sup>

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27. See RESTATEMENT (THIRD) OF AGENCY § 8.14 reporter's note b (AM. LAW INST. 2006) ("A principal's duty to indemnify does not encompass losses that result from the agent's own fault.").

28. *Id.* § 8.08 cmt. b

29. *Id.* § 8.14 & cmt. d.

30. In the absence of vicarious liability for insurers, an insurer who is directly liable may be able to get contribution from the defense counsel whose malpractice was in part responsible for the liability. See *Walter & Shuffain, P.C. v. CPA Mut. Ins. Co.*, No. 06cv10163-NG, 2008 WL 885994, at \*7 (D. Mass. Mar. 28, 2008).

31. *Accord* *Young v. Nationwide Mut. Ins. Co.*, 801 N.Y.S.2d 827, 829 (App. Div. 2005) (holding that although insurers are not liable for the malpractice of independent contractor defense counsel in New York, the insured had alleged that the defense counsel, even though they were members of a law firm, were full-time employees of the insurer, which was sufficient to allow a vicarious liability claim against the insurer to go forward). *Young's* suggestion that lawyers in a law firm could be full-time employees of the insurer is surprising, but the holding that an insurer is vicariously liable for the malpractice of its employee lawyers is consistent with standard agency law as well as the Restatement position. In addition, several commentators endorse vicarious liability of insurers for staff

In declining to extend vicarious liability to insurers to the malpractice of outside defense counsel, the Restatement takes a position on a legal issue that has divided the courts. As the Reporters' Note to section 12 states, "[c]ourts disagree on the ability of the insured to sue their insurers under the theory that the insurer is vicariously liable for the actions of the defense attorney it hires."<sup>33</sup> The Reporters' Note then cites five cases supporting vicarious liability<sup>34</sup> and four cases rejecting it.<sup>35</sup> Although the Reporters' Note implies a relatively even split among the jurisdictions,<sup>36</sup> by my count, a majority of jurisdictions have rejected vicarious liability of liability insurers,<sup>37</sup> and to the extent that one can

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attorney malpractice. *See also* Anthony, *supra* note 22, at 126; Richmond, *supra* note 6, at 151; Charles Silver, *Flat Fees and Staff Attorneys: Unnecessary Casualties in the Continuing Battle over the Law Governing Insurance Defense Lawyers*, 4 CONN. INS. L.J. 205, 252 (1997).

32. RESTATEMENT OF THE LAW OF LIAB. INS. § 12 cmt. a (AM. LAW INST., Discussion Draft 2015).

33. *Id.* § 12 reporters' note a.

34. *Id.* (citing *Boyd Bros. Transp. Co., v. Fireman's Fund Ins. Cos.*, 729 F.2d 1407, 1409 (11th Cir. 1984); *Smoot v. State Farm Mut. Auto. Ins. Co.*, 299 F.2d 525, 530 (5th Cir. 1962); *Pac. Emp'rs Ins. Co. v. P.B. Hoidale Co.*, 789 F. Supp. 1117, 1122 (D. Kan. 1992); *Cont'l Ins. Co. v. Bayless & Roberts, Inc.*, 608 P.2d 281, 294 (Alaska 1980); *Stumpf v. Cont'l Cas. Co.*, 794 P.2d 1228, 1229 (Or. Ct. App. 1990)).

35. *Id.* (citing *Merritt v. Reserve Ins. Co.*, 110 Cal. Rptr. 511, 527 (Ct. App. 1973); *Aetna Cas. & Sur. Co. v. Protective Nat'l Ins. Co. of Omaha*, 631 So. 2d 305, 306 (Fla. Dist. Ct. App. 1993); *Feliberty v. Damon*, 527 N.E.2d 261 (N.Y. 1988); *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 627 (Tex. 1998)).

36. The Reporters' Note quotes Douglas Richmond, the one commentator who has written on the topic, as "concluding that 'it is presently impossible to state a majority rule' on vicarious liability." *Id.* (quoting Richmond, *supra* note 6, at 136).

37. By my count, twelve jurisdictions reject vicarious liability: Alabama, California, Florida, Georgia, Illinois, Massachusetts, New York, North Carolina, Ohio, Pennsylvania, Texas, and Washington. *See* *Ingersoll-Rand Equip. Corp. v. Transp. Ins. Co.*, 963 F. Supp. 452, 454 (M.D. Pa. 1997); *Lifestar Response of Ala., Inc. v. Admiral Ins. Co.*, 17 So. 3d 200, 218 (Ala. 2009); *Merritt*, 110 Cal. Rptr. at 527; *Aetna Cas. & Sur. Co.*, 631 So. 2d at 306; *Gibson v. Casto*, 504 S.E.2d 705, 708 (Ga. Ct. App. 1998); *Brocato v. Prairie State Farmers Ins. Ass'n*, 520 N.E.2d 1200, 1203 (Ill. App. Ct. 1988); *Herbert A. Sullivan, Inc. v. Utica Mut. Ins. Co.*, 788 N.E.2d 522, 540–41 (Mass. 2003); *Feliberty*, 527 N.E.2d at 265; *Brown v. Lumbermens Mut. Cas. Co.*, 369 S.E.2d 367, 371–72 (N.C. Ct. App. 1988); *Mentor Chiropractic Center Ctr., Inc. v. State Farm Fire & Cas. Co.*, 744 N.E.2d 207, 210–11 (Ohio Ct. App. 2000); *Traver*, 980 S.W.2d at 628; *Evans v. Steinberg*, 699 P.2d 797, 798–99 (Wash. Ct. App. 1985). Seven jurisdictions endorse vicarious liability: Alaska, Indiana, Kansas, Mississippi, Oregon, Tennessee, and Wisconsin. *See* *Cont'l Ins. Co.*, 608 P.2d at 294; *United Farm Bureau Mut. Ins. Co. v. Groen*, 486 N.E.2d 571, 573–74 (Ind. Ct. App. 1985); *Pac. Emp'rs Ins. Co.*, 789 F. Supp. at 1122–23; *Hartford Accident & Indem. Co. v. Foster*, 528 So. 2d 255, 285–86 (Miss. 1988); *Stumpf*, 794 P.2d at 1232; *Givens v. Mullikin*, 75 S.W.3d 383, 395 (Tenn. 2002); *Majorowicz v. Allied Mut. Ins. Co.*, 569 N.W.2d 472, 476–77 (Wis. Ct. App. 1997). Tennessee's position is somewhat unclear, however, because *Givens*, although it endorses what it calls "vicarious liability," in fact adopts what would under agency law be called "direct liability." 75 S.W.3d at 393–96; *see also* *infra* text accompanying notes 66–70.

identify a “trend” in the cases, almost all of the more recent cases,<sup>38</sup> as well as most cases decided by the larger jurisdictions, reject vicarious liability.

The cases cited in the Reporters’ Note as rejecting vicarious liability typically do so by a straightforward application of traditional agency law. According to the reasoning of these cases, defense counsel who are not employed full-time by liability insurers are independent contractors, and therefore do not subject the insurers who retain them to vicarious liability.<sup>39</sup> It is not hard to see why courts would be attracted to this position. If, as noted in the previous section, an ordinary client, no matter how sophisticated, is not deemed to control the “manner and means” of an “outside” lawyer’s professional work such that the lawyer becomes the client’s “employee,” then why should an insurer, which in some jurisdictions is not even deemed a “client” of defense counsel, be treated differently?<sup>40</sup> The independent-contractor rationale for denying vicarious liability enables the courts to sidestep not only the question of whether the insurer is a “client” of defense counsel,<sup>41</sup> but also the question of whether the insurer and defense counsel are in an agency relationship at all, since independent contractors can be either agents or non-agents.<sup>42</sup>

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38. No jurisdiction has endorsed vicarious liability since 1997. After 1997, with the questionable exception of Tennessee, all six jurisdictions to consider the issue rejected vicarious liability (Alabama, Georgia, Massachusetts, Ohio, Texas, and West Virginia). See, e.g., *Lifestar Response of Ala., Inc.*, 17 So. 3d at 218; *Gibson*, 504 S.E.2d at 708; *Herbert A. Sullivan, Inc.*, 788 N.E.2d at 540–41; *Mentor Chiropractic Ctr., Inc.*, 744 N.E.2d at 210–11; *Traver*, 980 S.W.2d at 628; *Rose ex rel. Rose v. St. Paul Fire & Marine Ins. Co.*, 599 S.E.2d 673, 674 (W. Va. 2004).

39. See *supra* note 35.

40. The question of whether a defense counsel retained by a liability insurer has only the insured for a client or also has the insurer as a second client is one that has generated extensive scholarly discussion. See generally Symposium, *Liability Insurance Conflicts and Professional Responsibility*, 4 CONN. INS. L.J. 1 (1997). For a recent article endorsing the one-client model, see Jean Fleming Powers, *Advantages of the One-Client Model in Insurance Defense*, 45 N.M. L. REV. 79 (2014).

41. See *Traver*, 980 S.W.2d at 627 (“However, even assuming that the insurer possesses a level of control comparable to that of a client, this does not meet the requisite for vicarious liability.”). But see Richmond, *supra* note 6, at 144–45 (arguing that determining whether an attorney-client relationship exists between the insurer and defense counsel is an important first step in determining whether the insurer should be held vicariously liable for defense counsel malpractice). Several courts rejecting vicarious liability nevertheless state that the defense counsel was not a client of the insurer. See *Ingersoll-Rand Equip. Corp.*, 963 F. Supp. at 454; *Aetna Cas. & Sur. Co.*, 631 So. 2d at 306; *Feliberty*, 527 N.E.2d at 265; *Brown*, 369 S.E.2d at 372; *Traver*, 980 S.W.2d at 627. One court rejects vicarious liability despite finding that the insurer is generally a co-client with the insured. *Lifestar Response of Ala., Inc.*, 17 So. 3d at 216, 218. On the other hand, most of the courts allowing vicarious liability claims against insurers do not discuss whether the insurer is a client. One exception is *Foster*. 528 So. 2d at 268.

42. *Gibson* in particular rejects vicarious liability and specifically states there is no

By contrast, the cases cited in the Reporters' Note as supporting vicarious liability ignore or discard standard agency law without providing any reason for doing so. The first case cited is *Smoot v. State Farm Mutual Automobile Insurance Co.*, one of the earliest and most cited cases supporting vicarious liability.<sup>43</sup> *Smoot's* rationale, which is quoted in the Reporters' Note and other cases, is simply: "Those whom the Insurer selects to execute its promises, whether attorneys, physicians, no less than company-employed adjusters, are its agents for whom it has the customary legal liability."<sup>44</sup> But as we have seen, the "customary legal liability" of agents who are also independent contractors, such as lawyers, does not include vicarious liability for their principals.<sup>45</sup> The second case cited, *Boyd Brothers Transportation Co. v. Fireman's Fund Insurance Cos.*, simply relies on *Smoot's* reasoning.<sup>46</sup> Moreover, *Smoot* and *Boyd Brothers* are both of questionable legal validity because they are federal court diversity cases and since the decisions in those cases, the states whose law the courts were applying have rejected vicarious liability.<sup>47</sup>

The rationales of the other two cases cited in support of vicarious liability in the Reporters' Note are not much more satisfying. The third case, *Pacific Employers Insurance Co. v. P.B. Hoidale Co.*, found that defense counsel acts as an agent of the insurer as well as of the insured and that the principal is responsible for the agent's negligence if the

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agency relationship between the defense counsel and insurer, though that case involved a failure to raise a counterclaim on behalf of the insured, so it is not clear whether the courts would find that a defense counsel retained by an insurer is not an agent of the insurer for any purpose. 504 S.E.2d at 708. It would seem difficult to reach the conclusion that defense counsel is not an agent of the insurer when the insurer is exercising its right to defend, as is required for liability under Restatement section 12.

43. 299 F.2d 525 (5th Cir. 1962).

44. *Id.* at 530.

45. *See id.*

46. 729 F.2d 1407, 1409–11 (11th Cir. 1984).

47. *Smoot* purports to apply Georgia law as it existed in 1962. 299 F.2d at 529. In 1998, the Georgia Court of Appeals, without mentioning *Smoot*, rejected vicarious liability in *Gibson*, on the ground that the defense counsel retained by the insurer did not act as the insurer's agent with respect to the pursuit of a counterclaim on behalf of the insured. 504 S.E.2d at 708. Ten years later, a federal court sitting in diversity and applying Georgia law endorsed *Gibson* and rejected *Smoot*. *Whiteside v. Infinity Cas. Ins. Co.*, No. 4:07-CV-87 (CDL), 2008 WL 3456508, at \*13–14 (M.D. Ga. Aug. 8, 2008). *Boyd Brothers* determined New York law to be applicable, but finding no relevant New York case as of 1984, turned to Alabama law as the next most relevant jurisdiction, but again found no relevant case. 729 F.2d at 1410–11. The court then applied the vicarious liability rule of *Smoot* on the ground that Georgia was a neighboring state to Alabama. *Id.* Both New York and Alabama subsequently rejected vicarious liability. *See Lifestar Response of Ala., Inc. v. Admiral Ins. Co.*, 17 So. 3d 200, 213–18 (Ala. 2009) (discussing the questionable validity of *Boyd Bros*); *Feliberty v. Damon*, 527 N.E.2d 261, 265 (N.Y. 1988).

principal has the right to control and direct the agent's activities.<sup>48</sup> The court then stated that the lawyer "reported to and received directions from" the insurer.<sup>49</sup> Again, that kind of "control" is generally not sufficient for vicarious liability under agency law, unless the "directions" include directions about the manner in which the lawyer must do his or her work. The "directions" that clients give to their lawyers are generally not sufficient to result in vicarious liability. Finally, in *Continental Insurance Co. v. Bayless & Roberts, Inc.*, the court based its finding of vicarious liability on the fact that the defense counsel "believed that his first loyalty was to [the insurer], and that throughout the course of the litigation he acted for and on behalf of the insurance company."<sup>50</sup> Once more, that statement just states one of the characteristics of an agent (acting on behalf of another) and one of the consequences of agency (fiduciary duties), even though not all agents subject their principals to vicarious liability, and lawyers generally fall into that category.

The cases cited in the Reporters' Note as endorsing vicarious liability for liability insurers<sup>51</sup> appear to be in tension with the standard agency law of vicarious liability in a second way. None of the cases adopting vicarious liability of an insurer for defense counsel malpractice suggest that the insurer would be vicariously liable for lawyer torts other than breaches of professional obligations. For example, a liability insurer would not, under the apparent reasoning of these cases, be vicariously liable to a victim of a car accident caused by the negligent driving of its retained counsel heading to court to argue the case for which the lawyer was retained. The cases thus seem to take a much narrower view of either the employment relationship or scope of employment than agency law in general does. Of course, courts can adjust common law principles to take account of particular circumstances in a given industry, but none of the five cases cited in the Reporters' Note discuss why vicarious liability for malpractice only makes sense in terms of broader rationales for vicarious liability, or justify departing from the general rules of vicarious liability because of the special situation created by liability insurance and insurance defense.

Finally, none of the cases cited in the Reporters' Note, nor any of the other cases on vicarious liability, make any reference to the special agency law rule on vicarious liability for fraud, under which a principal can be vicariously liable for misrepresentations by an agent acting with

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48. 789 F. Supp. 1117, 1122 (D. Kan. 1992) (quoting *Brinkley v. Farmers Elevator Mut. Ins. Co.*, 485 F.2d 1283, 1286 (10th Cir. 1973)).

49. *Id.*

50. 608 P.2d 281, 294 (Alaska 1980).

51. *See supra* note 34.

apparent authority, even if the agent is an independent contractor.<sup>52</sup> Section 12 and its Comments are silent on the possibility of vicarious liability for lawyer fraud as well. Not all insurance defense counsel misconduct involves fraud, but some does. For example, defense counsel could make a misrepresentation to the insured during settlement negotiations. Moreover, unlike ordinary malpractice claims, misrepresentation claims against defense counsel could be made by plaintiffs in the underlying case as well as by insured defendants. Interestingly, and in my view, incorrectly, several recent cases, in jurisdictions that reject vicarious liability of insurers based on the independent contractor rule, also reject the alternative of vicarious liability for defense counsel fraud based on apparent authority.<sup>53</sup> Section 12 is not limited to malpractice, but encompasses any “breach of professional obligation by defense counsel.”<sup>54</sup> Because fraud and related torts violate professional obligations of lawyers,<sup>55</sup> section 12 should, in my view, acknowledge and endorse traditional vicarious liability principles in these cases.

### C. Direct Liability

In addition to vicarious liability, agency law recognizes the direct liability of a principal whose agent engages in conduct that harms a third party.<sup>56</sup> The key difference between the two forms of liability is that vicarious liability is strict with respect to the principal, though it is not pure strict liability in that it requires a negligent or intentionally wrongful act on the part of the agent.<sup>57</sup> Direct liability, by contrast,

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52. RESTATEMENT (THIRD) OF AGENCY § 7.08 (AM. LAW INST. 2006).

53. See *Kahama VI, LLC v. HJH, LLC*, No. 8:11-cv-2029-T-30TBM, 2013 WL 6511731, at \*3 (M.D. Fla. Dec. 12, 2013) (holding that because Florida rejects vicarious liability for malpractice, there cannot be vicarious liability for misrepresentations); *Sandman v. Quincy Mut. Fire Ins. Co.*, 961 N.E.2d 135, 138–40 (Mass. App. Ct. 2012) (holding that a lawyer retained by insurer to pursue insured’s subrogation claim against a company for pollution cleanup misrepresented to insured that he would pursue a separate claim for her against the company for property damage, which was excluded by insurance policy, when he failed to do so and statute of limitations ran).

54. RESTATEMENT OF THE LAW OF LIAB. INS. § 12 (AM. LAW INST., Discussion Draft 2015).

55. See, e.g., MODEL RULES OF PROF’L CONDUCT rr. 4.1, 8.4(c) (AM. BAR ASS’N 2014).

56. See RESTATEMENT (THIRD) OF AGENCY § 7.03(1) (AM. LAW INST. 2006).

57. In *Remodeling Dimensions, Inc. v. Integrity Mutual Insurance Co.*, the Supreme Court of Minnesota declined to rule on whether insurers are vicariously liable for defense counsel’s malpractice because the court found that the lawyer did not violate the duty of care, and so it was not necessary to reach the vicarious liability question. 819 N.W.2d 602, 615-16 (Minn. 2012). This case thus serves as an example of how vicarious liability is not pure strict liability.

generally requires a showing of fault on the part of the principal,<sup>58</sup> though it may or may not involve agent misconduct.<sup>59</sup> Another difference is that although direct liability applies to principals who retain and act through agents, an agency relationship is not always required to find one person directly liable for harm caused by that person through another.<sup>60</sup>

A number of potential direct liability claims could be available to insureds seeking to hold their insurers responsible for the professional misconduct of defense counsel. One species of direct liability is a claim for negligence by the principal in selecting, training, retaining, supervising, or controlling the agent.<sup>61</sup> This type of direct liability is the one expressly recognized in Restatement section 12. Agency law recognizes several other types of direct liability claims, however. A second type of direct liability involves a principal authorizing an agent to engage in tortious conduct.<sup>62</sup> Related to that type of claim is one for collusion or conspiracy between the principal and the agent to engage jointly in tortious conduct.<sup>63</sup> A third type is ratification by the principal of an agent's tort.<sup>64</sup>

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58. RESTATEMENT (THIRD) OF AGENCY § 7.03 cmt. b (AM. LAW INST. 2006) (“In most cases, direct liability requires fault on the part of the principal whereas vicarious liability does not require that the principal be at fault.”).

59. *See id.* § 7.04 cmt. c (“A person may be subject to tort liability because of an actor’s conduct although the actor is not subject to liability.”).

60. *Id.* § 7.05 cmt. a (“Although the rules stated in this section apply to principals who deploy employees or other agents to act on their behalf, the general principles are applicable regardless of whether a person conducts an activity through an employee or other agent.”); *id.* § 7.05 cmt. b (“The rules stated in this section stem from general doctrines of tort law not limited in their applicability to relationships of agency as defined in § 1.01. . . . It is not a defense to liability under this rule that the actor whose conduct harms a third party does not have a relationship of agency as defined in § 1.01 with the person who conducted an activity through the actor.”).

61. *Id.* § 7.05(1). A number of cases rejecting vicarious liability of liability insurers for defense counsel conduct recognize the possibility of these types of direct liability claims, although both of these cases reject the direct liability claims on the facts presented. *See Brown v. Lumbermens Mut. Cas. Co.*, 369 S.E.2d 367, 372 (N.C. Ct. App. 1988) (recognizing potential claim of negligence in selecting defense counsel); *Evans v. Steinberg*, 699 P.2d 797, 799 (Wash. Ct. App. 1985) (same). On the other hand, several cases rejecting vicarious liability hold that an insurer cannot be held liable for negligent supervision of defense counsel because insurers have no duty to supervise them. *See Lifestar Response of Ala., Inc. v. Admiral Ins. Co.*, 17 So. 3d 200, 219 (Ala. 2009); *Brocato v. Prairie State Farmers Ins. Ass’n*, 520 N.E.2d 1200, 1203 (Ill. App. Ct. 1988).

62. RESTATEMENT (THIRD) OF AGENCY § 7.04 & cmt. b (AM. LAW INST. 2006) (“Under general tort-law principles, a person who orders or induces an actor’s tortious conduct is subject to liability for harm resulting to a third person when the person ‘knows or should know of circumstances that would make the conduct tortious if it were his own . . . .’”) (alteration in original).

63. For a case adopting this theory in the insurance defense context, see *Barney v. Aetna Casualty & Surety Co.*, 230 Cal. Rptr. 215, 224 (Ct. App. 1986).

64. RESTATEMENT (THIRD) OF AGENCY §§ 4.01, 7.04 (AM. LAW INST. 2006). Ratification

Finally, the principal may be liable because of a nondelegable duty it owes to a third party.<sup>65</sup> Although Restatement section 12 could be read implicitly to endorse these alternative theories of direct liability, based on the citations to the Restatement (Third) of Agency provisions on these topics in the Reporters' Note, in my view section 12 or its Comments should expressly acknowledge these alternative theories to help clarify the scope of the rule.

One reason for doing so is that in considering the liability of an insurer for the conduct of defense counsel, courts have not always recognized or acknowledged the distinction between vicarious and direct liability. In *Givens v. Mullikin*, the Tennessee Supreme Court stated that generally defense counsel retained by an insurer is an independent contractor for whose torts the insurer is not vicariously liable.<sup>66</sup> Nevertheless, the court acknowledged that the independent contractor rule is subject to many exceptions, including "when an independent contractor acts pursuant to the orders or directions of the employer."<sup>67</sup> The court then held "that an insurer can be held *vicariously* liable for the acts or omissions of an attorney hired to represent an insured when those acts or omissions were directed, commanded, or knowingly authorized by the insurer."<sup>68</sup> The court thus conflates direct and vicarious liability. The confusion is perhaps understandable because direct liability in the situations identified by the court does involve liability of a principal for the torts committed by its agent. But as already discussed, the key difference is that vicarious liability is strict, whereas direct liability is based on fault of the principal. Having articulated a direct liability standard, however, *Givens* then seems to slide into something more like true vicarious liability in the immediately following passage:

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requires that the principal have knowledge of material facts, though knowledge can be found if a principal knows of facts that would lead a reasonable person to investigate but chooses not to. *Id.* § 4.06 & cmt. d.

65. *Id.* § 7.06 ("A principal required by contract or otherwise by law to protect another cannot avoid liability by delegating performance of the duty, whether or not the delegate is an agent."). The classic case on nondelegable duty involving lawyers is *Kleeman v. Rheingold*, 614 N.E.2d 712 (N.Y. 1993). In that case, the court held that the lawyer could not avoid liability to the client for missing a statute of limitations deadline on the grounds that the lawyer had retained an independent contractor process server, who botched the service of process. *Id.* at 717. The situation here, of course, is the opposite: whether an insurer that oversees a lawyer has a nondelegable duty to the client insured, not whether the lawyer who oversees an independent contractor has a nondelegable duty to the client.

66. 75 S.W.3d 383, 393–94 (Tenn. 2002).

67. *Id.* at 394.

68. *Id.* at 395 (emphasis added).

This having been said, we suspect that cases in which an insurer may be held liable under an agency theory will be rare indeed. We do not hold today that an insurer may be held vicariously liable for the acts or omissions of its hired attorney based merely upon the existence of the employment relationship alone. Nor do we hold that an insurer may be held liable for any acts or omissions resulting solely from the exercise of that attorney's independent professional judgment, and in all cases, a plaintiff must show that the attorney's tortious actions were taken partly at the insurer's direction or with its knowing authorization. Nevertheless, when the insurer does undertake to *exercise actual control over the actions of the insured's attorney*, then it may be held vicariously liable for any harm to a plaintiff proximately caused thereby.<sup>69</sup>

Liability for merely exercising actual control over the actions of the lawyer seems broader than liability for directing, commanding, or authorizing a particular tortious act by that attorney, though it may be that Tennessee courts will read the Tennessee Supreme Court's statement about exercising actual control more narrowly based on the fuller context of the opinion.<sup>70</sup>

Another theory of direct liability that courts sometimes conflate with vicarious liability is nondelegable duty. The difference between liability based on a nondelegable duty and vicarious liability is less clear than the difference between other forms of direct liability and vicarious liability, however. If the principal's nondelegable duty is itself a strict liability duty (as many contractual and statutory duties are), then the two theories are essentially equivalent. In the context of liability insurance, the question is whether an insurer's duty to defend is a strict liability duty or one governed by a fault standard. Section 14 of the Restatement defines the insurer's duty to defend to "include[] the obligation to provide a defense of the claim that" meets professional standards.<sup>71</sup> If the insurer's duty to defend is understood as a strict liability contractual duty, that is, one that guarantees a particular result (malpractice-free defense), then finding that duty to be nondelegable is the equivalent of

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69. *Id.* at 395–96 (emphasis added).

70. That is the approach the Sixth Circuit took in *Matthews v. Storgion*, 174 F. App'x 980, 985 (6th Cir. 2006) (rejecting claim of "vicarious liability" under *Givens* because the court held that "actual control" under *Givens* means "invidious' actual control").

71. See RESTATEMENT OF THE LAW OF LIAB. INS. § 14 (AM. LAW INST., Discussion Draft 2015).

vicarious liability. I doubt that is what the Reporters have in mind in section 14, however.

The Reporters' Note to section 12 cites to the Restatement (Third) of Agency section 7.06, which is that Restatement's version of the nondelegable duty rule, for the proposition that the nondelegable duty rule is an exception to the independent contractor rule, but the Restatement of the Law of Liability Insurance takes no position on the application of the nondelegable duty exception to liability insurers. Many of the cases rejecting vicarious liability of insurers for defense counsel malpractice in fact specifically reject the idea that the insurer's duty to defend is a nondelegable duty.<sup>72</sup> To the contrary, they find the insurer's duty to defend is, and must be, delegable because insurers cannot practice law.<sup>73</sup> On the other hand, one case endorsing vicarious liability cites the nondelegable duty rule and finds that the insurer's nondelegable duty to defend, combined with the fact that the insurer exercised control over the defense, is sufficient to support vicarious liability.<sup>74</sup> These views are not necessarily inconsistent, as one court has recognized. *Majorowicz v. Allied Mutual Insurance Co.* holds that although insurers can delegate aspects of the duty to defend to defense counsel, an insurer cannot delegate its contractual duty to act in good faith, which is part of its duty to defend.<sup>75</sup> Under this more limited view of the insurer's nondelegable duty, if a finding of insurer bad faith depends on the insurer's own wrongful conduct, as it seemed to in *Majorowicz*,<sup>76</sup> then the liability is really direct rather than vicarious. This approach seems more consistent with what the Reporters have in mind.

The relationship between the nondelegable duty theory and insurer bad faith leads to an important point. In the context of legal malpractice by insurance defense counsel, the gap between direct and vicarious liability may be small. To the extent the defense counsel's malpractice is related to a conflict of interest between the insurer and the insured, the insured will typically have a direct liability claim, such as bad faith, against the insurer. In addition, to the extent the malpractice involves

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72. See, e.g., *Merritt v. Reserve Ins. Co.*, 110 Cal. Rptr. 511, 526 (Ct. App. 1973); *Aetna Cas. & Sur. Co. v. Protective Nat'l Ins. Co. of Omaha*, 631 So. 2d 305, 306 (Fla. Dist. Ct. App. 1993); *Herbert A. Sullivan, Inc. v. Utica Mut. Ins. Co.*, 788 N.E.2d 522, 540 (Mass. 2003); *Feliberty v. Damon*, 527 N.E.2d 261, 264 (N.Y. 1988).

73. See, e.g., *Merritt*, 110 Cal. Rptr. at 526; *Aetna Cas. & Sur. Co.*, 631 So. 2d at 306; *Herbert A. Sullivan, Inc.*, 788 N.E.2d at 540; *Feliberty*, 527 N.E.2d at 265.

74. *Stumpf v. Cont'l Cas. Co.*, 794 P.2d 1228, 1232 (Or. Ct. App. 1990).

75. 569 N.W.2d 472, 477 (Wis. Ct. App. 1997); see also *Richmond*, *supra* note 6, at 149–50 (arguing that an insurer's duty of good faith should be deemed nondelegable).

76. 569 N.W.2d at 477 (finding that the insurer "failed to properly investigate and evaluate" the insured's claim).

tasks that the insurer could perform on its own without having to “practice law,” such as claim investigation, evaluation, and assessment, as well as decisions whether or not to settle, again direct liability claims may often be available against the insurer, based on its nondelegable duty to defend, if the insurer performs those tasks poorly. Section 12 itself helps narrow the gap between direct and vicarious liability by interpreting negligent selection to include whether defense counsel carried adequate malpractice insurance. Although there is not much case law on the contours of negligent selection of defense counsel, the Restatement position is in my view consistent with general agency law.<sup>77</sup>

The smaller the gap between direct and vicarious liability, the less the debate over vicarious liability matters. The proponents of vicarious liability could argue that given courts’ expansive view of direct liability, vicarious liability is more or less already present. On the other hand, opponents of vicarious liability could argue that there is no need to recognize a new form of vicarious liability since direct liability already handles the problems adequately.

To say that the gap between direct and vicarious liability is small, however, is not to say that it does not exist at all. There are certainly cases of defense counsel malpractice for which insureds would not be able to make out a direct liability claim against the insurer under the standard proposed by the Restatement. Some of these types of claims were made in the cases where courts rejected vicarious liability.<sup>78</sup> These

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77. I have found no cases addressing the issue of whether a liability insurer can be liable for negligent selection of defense counsel if the insurer fails to require that the defense counsel maintain liability insurance. In an ongoing securities fraud class action against Bank of America, a class representative recently sued class counsel for negligent hiring of a claims administrator who did not carry adequate liability insurance, but the case was dismissed for lack of standing and is pending appeal. *Oetting v. Green Jacobson, P.C.*, No. 4:13-CV-1148 (CEJ), 2014 WL 942952, at \*2–3 (E.D. Mo. Mar. 11, 2014). In the context of medical malpractice, two California appellate court cases reached opposite conclusions on whether a hospital can be held liable for negligent selection of doctors because the hospital did not ensure that staff doctors had malpractice insurance. *Compare* *Brown v. Superior Court*, 214 Cal. Rptr. 266, 275 (Ct. App. 1985) (“In a suit based on hospital’s negligence in screening and evaluating a physician, it is relevant to discover whether Hospital enforced its own by-law requiring malpractice coverage. The physician’s poor record of malpractice claims may be the cause of lack of coverage. Failure of Hospital to inquire as to malpractice coverage, . . . demonstrates a willingness to ignore that the physician is not coverable for reasons that may go to the physician’s medical competency.”), *with* *Snell v. Superior Court*, 204 Cal. Rptr. 200, 204 (Ct. App. 1984) (“The duty of care owed to patients is to admit and screen doctors in a non-negligent fashion, and to provide for ongoing evaluation procedures. That has palpably little to do with whether insurance is required as a condition of being a hospital staff physician or acquiring hospital privileges, a fact implicitly recognized by the Legislature; it has determined that whether a hospital should require malpractice insurance as a condition of medical staff membership is an entirely discretionary decision.”).

78. *See, e.g.,* *Ingersoll-Rand Equip. Corp. v. Transp. Ins. Co.*, 963 F. Supp. 452, 453, 454

cases involve issues of pure legal judgment, such as defective legal research, failure to raise claims or defenses, inadequate response to discovery, or errors during depositions or trial. For example, several of the cases rejecting vicarious liability involve a lawyer botching a statute of limitations issue, either in failing to raise it as a defense<sup>79</sup> or in failing to file a timely counterclaim.<sup>80</sup> At least for these types of cases, the availability or not of vicarious liability claims against insurers matters. In deciding whether to expand the general law of vicarious liability, however, one should consider whether doing so would further the purposes of vicarious liability. The next section considers that question.

## II. ECONOMIC ANALYSIS OF INSURER LIABILITY FOR DEFENSE COUNSEL MISCONDUCT

Having looked at the question of insurer liability for defense counsel misconduct from the perspective of agency law doctrine and extant case law, in this section, I consider whether the modern economic arguments for vicarious liability<sup>81</sup> support vicarious liability of insurers. I conclude that the Restatement approach adequately addresses the concerns that underlie the economic justifications for vicarious liability; thus, in my view there is no need to expand vicarious liability in this context.

### A. *Judgment-Proof Agents*

The primary economic justification for vicarious liability of employer principals for the torts of their employee agents is the problem of judgment-proof agents.<sup>82</sup> Many employees do not have sufficient assets to cover work-related accidents that they cause.<sup>83</sup> If an agent working for a principal can cause harms whose costs exceed the agent's assets, the agent will not have sufficient incentives to take precautions against those

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(M.D. Pa. 1997); *Aetna Cas. & Sur. Co.*, 631 So. 2d at 306; *Gibson v. Casto*, 504 S.E.2d 705, 707, 708 (Ga. Ct. App. 1998); *Brown v. Lumbermens Mut. Cas. Co.*, 369 S.E.2d 367, 369, 371–72 (N.C. Ct. App. 1988).

79. See, e.g., *Ingersoll-Rand Equip. Corp.*, 963 F. Supp. at 453; *Aetna Cas. & Sur. Co.*, 631 So. 2d at 305.

80. See, e.g., *Gibson*, 504 S.E.2d at 707 (failure to file counterclaim within the statute of limitations period).

81. The classic article is Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231 (1984). See also WILLIAM M. LANDES & RICHARD A. POSNER, *THE ECONOMIC STRUCTURE OF TORT LAW* 120–21 (1987); STEVEN SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* 170–75 (1987).

82. See Sykes, *supra* note 81, at 1246.

83. *Id.* at 1241.

harms.<sup>84</sup> Even if some agents are not judgment-proof, absent vicarious liability, judgment-proof agents would be more attractive to principals because principals would not need to pay them wages sufficient to cover their expected accident costs; rather, these costs would be shifted to the accident victims, who would not be able to recover their full losses from either the judgment-proof agents or the non-liable principals. Principals would therefore have incentives to hire too many insolvent agents, who would in turn have insufficient incentives to take cost-effective precautions. Moreover, if principals were not vicariously liable for their judgment-proof agents, they would have insufficient incentives to monitor those agents and induce them to take cost-effective precautions to reduce the likelihood and severity of work-related accidents. Vicarious liability reduces the principal's incentive to hire judgment-proof agents, and encourages the principal to monitor its agents' behavior and to induce them to take cost-effective precautions.

One could argue that the judgment-proof problem justifies vicarious liability for liability insurers, though the courts endorsing vicarious liability have not relied on this rationale. The argument would be that unless insurers face the prospect of vicarious liability for the malpractice of defense counsel, they would be too tempted to hire defense counsel who are judgment-proof and who lack adequate malpractice insurance, and therefore would cost the insurer less. Restatement section 12, however, addresses the judgment-proof problem without endorsing vicarious liability by explicitly making the inadequacy of a lawyer's malpractice liability insurance grounds for a direct negligent retention claim against the insurer.<sup>85</sup> The question then is whether the judgment-proof problem is significant enough to justify the Restatement's rule on negligent retention in this context.

The independent contractor rule, discussed above, is based on a rough assessment that independent contractors, including independent-contractor agents, are less likely to be judgment-proof than employees. Many of the factors courts use to distinguish independent contractors from employees are correlated to some degree with the likelihood of assets against which a plaintiff could potentially recover.<sup>86</sup> As is the case for most legal rules, the presumptions on which the independent-contractor rule is based are not invariably true. Courts have nevertheless tolerated and refined the distinction between independent contractors and employees over an extended period of time. And under our current

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84. See SHAVELL, *supra* note 81, at 174; Sykes, *supra* note 81, at 1241–42;

85. RESTATEMENT OF THE LAW OF LIAB. INS. § 12(2) & cmt. b (AM. LAW INST., Discussion Draft 2015).

86. See Sykes, *supra* note 81, at 1261–63.

regime, if a person hires an independent contractor to do a job, the law generally does not impose vicarious liability even if the hiring person is “in the best position to select and monitor” the independent contractor.<sup>87</sup> Nor have courts generally interpreted negligent selection to incorporate underinsurance. Is the risk of insurers hiring judgment-proof independent contractors greater than the risk of parties in general hiring judgment-proof independent contractors?

There are some reasons to think that the judgment-proof problem in the liability insurance context might not be a significant enough problem on which to base a liability rule. Most importantly, insurers have a greater incentive than many other principals not to hire judgment-proof defense counsel. The reason is that liability insurers have a significant economic stake in the performance of the defense counsel they retain. If a defense lawyer commits malpractice that harms the insured, that will generally cost the insurer money because the insurer will have to make good on its promise to indemnify the insured under the liability insurance policy up to the policy limits for the insured’s liability-related losses (less any applicable deductible or co-payment). The insurer’s indemnity liability is a contractual promise to the insured that is governed by strict liability principles. If the insurer suffers losses as a result of defense counsel’s malpractice, then because it has to make a payment to the insured that it would not have had to make in the absence of the malpractice, the insurer will generally be able to bring a claim against the defense counsel to recoup that payment, regardless of whether the insurer is considered a “client” of the defense counsel.<sup>88</sup> To protect its own interests, therefore, the insurer will generally want to hire defense counsel with malpractice insurance.<sup>89</sup>

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87. PRINCIPLES OF THE LAW OF LIAB. INS. § 14 cmt. a–b (AM. LAW INST., Tentative Draft No. 2, 2014) (explaining why some courts have adopted a special vicarious liability rule for insurers).

88. “Because and to the extent that the insurer is directly concerned in the matter financially, the insurer should be accorded standing to assert a claim for appropriate relief from the lawyer for financial loss proximately caused by professional negligence or other wrongful act of the lawyer.” *Paradigm Ins. Co. v. Langerman Law Offices, P.A.*, 24 P.3d 593, 600 (Ariz. 2001) (en banc) (quoting RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 14 cmt. f (AM. LAW INST. 2000)); accord RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 51 cmt. g (AM. LAW INST. 2000) (“[A] lawyer designated by an insurer to defend an insured owes a duty of care to the insurer with respect to matters as to which the interests of the insurer and insured are not in conflict, whether or not the insurer is held to be a co-client of the lawyer.” (citation omitted)); Powers, *supra* note 40, at 107–08 (endorsing *Paradigm* analysis); David A. Grossbaum, *Legal Malpractice by Insurance Defense Counsel: Who Can Be Sued, Who Can Sue, and for What*, COUNTY B. UPDATE (May 2002), [http://www.lacba.org/show\\_page.cfm?pageid=2104](http://www.lacba.org/show_page.cfm?pageid=2104).

89. See, e.g., Tom Baker, *Liability Insurance as Tort Regulation: Six Ways that Liability Insurance Shapes Tort Law in Action*, 12 CONN. INS. L.J. 1, 4–5 (2005) (stating that

One response to this argument would be that the insurer's incentive might be limited to hiring lawyers who carry malpractice insurance with policy limits that correspond only to the insurer's stake in the case in order to pay less for defense counsel. However, given the potential exposure of the insurer to bad faith and other claims in excess of the policy limits, it is not so clear that insurers would have an incentive to hire defense counsel with only enough malpractice insurance to cover the insurer's stake, as defined by the policy limits in its contract with the insured. In any case, it is also not so clear that insurers would be able to implement this strategy even if they wanted to because of what might be called "bundling" problems. Lawyers will generally have secured their malpractice insurance policy before being retained by the insurer, and insurers may not be able to find lawyers whose malpractice policy limits precisely match the limits in their liability policies, or to negotiate individually with lawyers to tailor their malpractice policy limits. Moreover, insurers will often want to retain defense counsel who have a good track record with them, which could mean those lawyers may be handling cases with a variety of policy limits. Would insurers really keep switching the defense counsel malpractice liability limits each time they retain the lawyer, even if they could do so? If anything, the repeated use of defense counsel by liability insurers might make the insurers pay more attention to the adequacy of those lawyers' malpractice insurance, because they would want to make sure that both per claim policy limits and their aggregate limits are adequate.

In addition, the victims of defense counsel malpractice are generally the insureds, who are in a contractual relationship with their insurers. Insureds could in theory demand that insurance contracts include a requirement that retained counsel have a certain amount of malpractice insurance. Even if insurers are not willing to put such a requirement in their standard contracts, and insureds are not able to bargain for such a requirement, one might argue that insureds could instead choose to increase the policy limits in the liability insurance policies to reduce the likelihood of potential conflicts between insurers and defense counsel that often lead to malpractice claims. If we allow people to choose their liability insurance policy limits (subject to statutorily mandated minimums), why not allow them to decide whether or not to pay higher premiums to their liability insurers for either a legal malpractice policy with higher policy limits, or higher policy limits on the liability insurance policy itself? After all, when people hire lawyers on their own, we

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"liability insurance is the only asset that plaintiffs can count on collecting," and that generally "people without liability insurance will not be subject to tort liability").

generally let them decide whether to hire lawyers who carry malpractice insurance and how much malpractice insurance they deem to be sufficient protection.

Despite these objections, I agree with the rule endorsed by the Restatement Reporters for several reasons. First, liability insurance is a special contract. That is why a whole body of law, both statutory and case law, is built up around it, and that is why a Restatement is being prepared on the subject. Assuming that insureds would be able to bargain for, or choose, insurance policies based on whether they contain provisions guaranteeing that any retained counsel will have a certain level of malpractice insurance coverage would be inconsistent with the assumptions generally underlying insurance law. In particular, many insureds are not parties who are experts in assessing low-probability, high-loss risk events. They rely on insurers, subject to both competition and regulation, to make the proper risk assessments and provide fair policies, including the duty to defend, at reasonable premiums. In effect, the insurer acts as the insured's agent in retaining counsel to represent the insured. The insured relies on the insurer's expertise to make appropriate choices and to monitor the defense lawyer's conduct on behalf of the insured.

Second, as with all agency relationships, the interests of the insurer agent and the insured principal are not completely aligned. Although, as noted above, insurers do have some incentive to retain lawyers with adequate malpractice insurance, their self-interest in doing so is not the same as the interests of risk-averse insureds, who seek protection against high-risk events and are willing to pay a premium to achieve peace of mind.<sup>90</sup> Agency law imposes fiduciary duties despite the fact that, in general, agents act to further their principal's interests, because in some cases, the interests do diverge, and agents not bound by fiduciary duties would be too tempted to favor their own interests at the expense of the interests of their principals in those cases.<sup>91</sup> The insurer's duty of good faith serves some of the same purposes of aligning the interests of insurer and insured.<sup>92</sup> The standard endorsed by the Restatement would deter those insurers whose self-interest calculus leads them in some cases to retain uninsured or underinsured defense counsel.

The fact that cases exist in which insureds bring vicarious liability claims against liability insurers for defense counsel malpractice provides some evidence that the defense counsel underinsurance problem is real.

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90. See RESTATEMENT OF THE LAW OF LIAB. INS. § 10 reporters' note a (AM. LAW INST., Discussion Draft 2015).

91. See *id.* § 10 cmt. c.

92. *Id.*

Of course, it is always risky to infer too much about the world from reported cases since they are such a small, and often unrepresentative, sample relative to all the claims brought and settled. And the number of published cases on the issue is relatively small. On the other hand, the small number of cases could be attributed to the fact that insurers have already incorporated the risk of vicarious liability or liability for negligent selection (despite the absence of cases supporting the Restatement position that underinsurance is a relevant factor) into their decisions about which defense counsel to hire. That is, the proposed Restatement rule may merely confirm an existing (though implicit) feature of insurer liability that already serves to some extent as an effective deterrent. Nevertheless, if that were true, one might have thought that at least one court rejecting vicarious liability would have considered negligent retention based on inadequate malpractice liability insurance as a possibility.

Direct liability of insurers for negligent retention, as endorsed by Restatement section 12, is not the only possible solution to the judgment-proof problem. For example, legislatures could mandate that all lawyers maintain a certain minimum amount of malpractice insurance.<sup>93</sup> Though this solution may not be politically feasible,<sup>94</sup> it has the advantage of not discriminating between clients who have lawyers provided to them by their liability insurers, and who therefore get the protection of section 12, and clients who retain lawyers on their own, and who therefore do not get such protection. Nonetheless, the Restatement Reporters can fairly take the position that they are dealing with an apparently real underinsurance problem by adopting a rule that is at least feasible, consistent with existing law, and beneficial to some client victims, and that is better than doing nothing.

### B. *Control and Precaution-Taking*

Apart from the judgment-proof problem, or really complementary to it, both traditional and economic theories of vicarious liability focus on the degree of control that principals can and do exercise over their

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93. It is interesting that Oregon, the only state currently requiring mandatory minimum malpractice insurance for all lawyers, has nevertheless endorsed vicarious liability of insurers for defense counsel malpractice. *Stumpf v. Cont'l Cas. Co.*, 794 P.2d 1228, 1232 (Or. Ct. App. 1990).

94. Kyle D. Logue, *Encouraging Insurers to Regulate: The Role (If Any) for Tort Law*, U.C. IRVINE L. REV. (forthcoming 2015) (manuscript at 27), <http://ssrn.com/abstract=2547358> (noting that “[m]any scholars have suggested mandatory liability insurance as a response to the judgment proof problem . . . [but arguing that] expanding the use of legislative insurance mandates is likely to be politically unpopular”).

agents. From an economic perspective, unless the principal can monitor the agent's conduct and induce the agent to take proper precautions, there is little justification for imposing vicarious liability on the principal. Again, the independent contractor rule focuses on this goal to the extent that an employee is defined as someone whose "manner and means" of work is controlled by someone else.<sup>95</sup> Independent contractors, by contrast, not only have sufficient assets to undertake precautions, but they also have the expertise and ability to do so.

Applying this criterion to lawyers, as well as to other professionals, naturally leads to the conclusion that lawyers should typically be considered independent contractors, whose professional misconduct does not result in liability for anyone else.<sup>96</sup> Not only are they highly trained, they are governed by professional norms and rules of ethics that include duties to exercise judgment independent of any outside influence.<sup>97</sup> Clients, even sophisticated ones, do not generally have the right to exercise control over how lawyers do their jobs.<sup>98</sup>

The exceptions to the independent contractor rule as applied to lawyers also make sense under the control criterion. The easiest exception to justify is vicarious liability of law firms for the professional misconduct of their lawyers.<sup>99</sup> Law firms are made up of lawyers, who are themselves professionals with their own ethical obligations, including duties of partners and lawyers in managerial positions to supervise other lawyers in the firm. It is also relatively easy to justify the vicarious liability of non-lawyer employers, such as corporations, for the non-

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95. RESTATEMENT (THIRD) OF AGENCY § 7.07(3)(a) (AM. LAW INST. 2006).

96. See Joseph Eliot Magnet, *Vicarious Liability and the Professional Employee*, 6 CANADIAN CASES ON LAW TORTS 208, 225 (2015) (arguing that vicarious liability for torts committed by professionals cannot be explained under a control theory).

97. See MODEL RULES OF PROF'L CONDUCT r. 1.8(f)(2) (AM. BAR ASS'N 2015) (requiring a lawyer who accepts compensation for representing a client from someone other than the client to ensure that "there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship"); *id.* r. 5.4(c) ("A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services."). Several cases rejected vicarious liability citing to these rules or their predecessors in support of their holdings. *Ingersoll-Rand Equip. Corp. v. Transp. Ins. Co.*, 963 F. Supp. 452, 454–55 (M.D. Pa. 1997); *Lifestar Response of Ala., Inc. v. Admiral Ins. Co.*, 17 So. 3d 200, 216–218 (Ala. 2009); *Brocato v. Prairie State Farmers Ins. Ass'n*, 520 N.E.2d 1200, 1203 (Ill. App. Ct. 1988); *Herbert A. Sullivan, Inc. v. Utica Mut. Ins. Co.*, 788 N.E.2d 522, 538–41 (Mass. 2003); *Feliberty v. Damon*, 527 N.E.2d 261, 265 (N.Y. 1988).

98. See MODEL RULES OF PROF'L CONDUCT r. 1.2(a) (AM. BAR ASS'N 2015) (requiring a lawyer to "abide by a client's decisions concerning the objectives of representation," but only to "consult with the client as to the means by which they are to be pursued"); *id.* r. 2.1 (requiring a lawyer "[i]n representing a client . . . [t]o exercise independent . . . judgment").

99. See *id.* r. 5.1(c).

professional torts committed by their lawyer employees, namely in-house counsel.<sup>100</sup> As with other employer-employee relationships, the non-lawyer employer exercises a great deal of control over the lawyer's activities, including what tasks the lawyer must perform, when, and under what circumstances.<sup>101</sup> An in-house lawyer has but one client, and this exclusivity gives the employer-client control over the lawyer that other clients generally do not have over their lawyers.

The harder question is whether vicarious liability of a non-lawyer employer is justified under the control theory when a lawyer employee commits malpractice or a similar professional misconduct tort. As noted in Part I, the question does not arise if the non-lawyer employer-client is the injured party, but only if the in-house lawyer's professional misconduct injures someone else, such as a co-client of the employer-client.<sup>102</sup> Agency law in general opts for a uniform rule of vicarious liability for all employees acting within the scope of their employment, regardless of the nature of the tort.<sup>103</sup> The control theory justification for this approach is that although the employer does not exercise control over every type of precaution that a professional employee might take, the control that an employer has the right to, and does, exercise can affect the risk of even an employee's professional misconduct.<sup>104</sup> For example, the employer controls how much training the professional gets and how much supervision by other employed professionals the employer will provide. Moreover, because an employee generally works exclusively for an employer, who generally has the right to terminate employment at will, the pressures on even professional employees to conform to the wishes of their employers, even at the expense of violating professional duties, is arguably greater than for independent contractor professionals. Treating a professional employee like other employees for vicarious liability purposes also relieves an injured party from the burden of proving that the degree of control the employer actually exercised, or should have exercised, was a substantial cause of his injury. Rather, courts presume control from the relationship. In applying vicarious liability to insurers who use their own lawyer employees as defense counsel, Restatement section 12 adopts this traditional approach.

When it comes to an insurer's retention of outside counsel, however, the control theory does not suggest any departure from the traditional

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100. *Id.* r. 1.2.

101. *See id.*

102. *See supra* Part I.A.

103. *See supra* Part I.A.

104. *See* SHAVELL, *supra* note 81, at 170-75.

independent contractor rule.<sup>105</sup> Although there is no doubt that insurers can and do exercise significant control over their retained defense counsel, it is not the kind of control that an employer typically exercises, and therefore, is not the kind of control that justifies vicarious liability. Whether the insurer exercises more control over the lawyer than the insured client does is not the relevant question. The question is whether the insurer exercises any greater control than, say, the control that a corporation's in-house counsel exercises over outside counsel retained by the corporation, which does not result in vicarious liability of the corporation for the malpractice of outside counsel. The control an insurer generally exercises over defense counsel is not meaningfully different from the control that a sophisticated entity client exercises over outside counsel. In both cases, the control exercised focuses primarily on cost as well as the quality of the service ultimately provided. If insurers go further than is appropriate in exercising control over defense counsel, they open themselves up to direct liability claims, whether for bad faith or, as Restatement section 12 recognizes, for negligent supervision.

### C. Activity Level Control

Insurers can and do, however, exercise a potentially important form of control over defense counsel, one that is relevant to the economic theory of vicarious liability. That control involves control over what economists have termed the "activity level."<sup>106</sup> As noted in the last subsection, employers control not only how tasks are performed by their employees, but also how often, when, and under what circumstances.<sup>107</sup> The negligence standard, however, may not include factors related to these activity level concerns. As a result, if employers are subject only to direct liability and not strict vicarious liability, they may induce their employees to engage in levels of activity that exceed the social optimum, and result in excessive rates of accidents. A classic example of this effect is driving. Even if employers do not exercise meaningful control over how employees drive when doing work-related tasks, they do decide whether and how often driving tasks need to be performed, at what times, and by what routes. Those factors do not generally show up in a negligence analysis, however. (They could if, for example, the employer insists that the employee drive in the wee hours of the morning, when the employer has reason to know that the employee would be tired, because that choice

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105. RESTATEMENT (THIRD) OF AGENCY § 1.01 (AM. LAW INST. 2006); see SHAVELL, *supra* note 81, at 170–75.

106. SHAVELL, *supra* note 81, at 12.

107. See MODEL RULES OF PROF'L CONDUCT r. 1.2 (AM. BAR ASS'N 2015).

would likely increase the risk of an accident.) Negligence analysis tends to focus on what the driver was doing at the time of the accident, not how often the driver drives. Imposing strict vicarious liability on employers encourages them to take into account activity level decisions that they control, and that affect the riskiness of various work-related tasks.

One could make an activity level argument in favor of vicarious liability for insurers. The argument would in some sense be the opposite of the one made in cases like car driving, where the concern is that a higher level of the activity (driving) increases the expected accident costs. If the analogous activity for defense counsel is “litigation,” one might think that more activity by that lawyer would actually be *better* because it gives the lawyer more experience, and a more experienced lawyer is less likely to commit malpractice.<sup>108</sup> The concern, however, might be that the activity level for insurance defense counsel would in fact be too *low* in the absence of vicarious liability. The paradigmatic example would be depositions, or perhaps legal research. If the insurer puts a limit on the number of depositions defense counsel can take or the number of hours of legal research the lawyer can perform in order to contain costs, the insurer makes a kind of activity level decision. Vicarious liability would encourage insurers to consider whether such limitations create an undue risk of malpractice for the lawyer.

It is not clear, however, that the standard of care for direct liability that applies to insurers retaining defense counsel inadequately takes into account this kind of “activity level” problem. The negligence standard of care for malpractice takes into account the “kind *and extent* of effort” appropriate under the circumstances.<sup>109</sup> In some cases, representation within a limited budget can be reasonable.<sup>110</sup> On the other hand, if the insurer insists on limitations that the lawyer believes are not reasonable under the circumstances, such as prohibiting the lawyer from deposing a person the lawyer believes to be a key witness, the lawyer has an ethical obligation to resist.<sup>111</sup> If the lawyer succumbs, the insurer could, under

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108. The same of course is true to some extent with driving. See Nuno Garoupa & Thomas S. Ulen, *The Economics of Activity Levels in Tort Liability and Regulation*, in RESEARCH HANDBOOK ON ECONOMIC MODELS OF LAW 37 (Thomas J. Miceli & Matthew J. Baker eds., 2013).

109. RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 52 cmt. c (AM. LAW INST. 2000) (emphasis added).

110. *Id.* § 52 cmt. d (stating that “a properly informed client and lawyer can agree that the lawyer will provide services only within an agreed-upon budget or according to an agreed-upon timetable”); see also MODEL RULES OF PROF'L CONDUCT r. 1.2(c) (AM. BAR ASS'N 2015) (“A lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent.”); ABA Comm'n on Ethics & Prof'l Responsibility, Formal Op. 96-403 (1996).

111. ABA Comm'n on Ethics & Prof'l Responsibility, Formal Op. 01-421 (2001) (“[T]he

Restatement section 12, be subject to a direct liability suit for wrongfully interfering with the lawyer's independent professional judgment. Thus, direct liability as endorsed by the Restatement should be sufficient to handle activity level concerns in this context.

*D. Least Cost Insurer*

Another economic theory of vicarious liability is grounded in insurance itself. Even if an employer may not be able to take precautions against employee misconduct, the employer may be in a better position than its employees to insure against the torts that do occur, either through self-insurance or market insurance. Like an insurer, an employer may have superior information about accident risks related to employment with that employer, and so may be in a better position to insure against those risks. A related point is that in some cases, employers may have economies of scale advantages over employees in investing in precaution-taking technology. Under this theory, an efficient agency contract would have the employer provide liability insurance to its employees. Vicarious liability simply presumes that such a contract exists without the parties having to contract for the insurance explicitly.<sup>112</sup>

Of course, liability insurers are already in the insurance business, so one might think that the least cost insurer argument applies *a fortiori* to them when they act to retain defense counsel. In fact, although the courts adopting vicarious liability for liability insurers do not expressly rely on this justification, they may be influenced by the view that “insurers are in a much better position than insureds to shift or spread the risk of those losses that do occur.”<sup>113</sup> But the question is “much better position” relative to whom? If defense counsel is adequately protected by malpractice liability insurance, why is the defense counsel's malpractice insurer not the superior insurer? Not only can legal malpractice insurers spread risk as well as liability insurers can, but in addition, legal malpractice insurers are well-positioned to provide loss-prevention services in many cases.<sup>114</sup> Recognizing this point, comment b to section 12 states that so long as defense counsel has adequate malpractice liability

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rules of professional conduct—and not the liability insurance contract—govern the lawyer's ethical obligations to her client, whether the client is the insured, the insurer, or both.”)

112. Sykes, *supra* note 81, at 1236.

113. RESTATEMENT OF THE LAW OF LIAB. INS. § 12 cmt. b (AM. LAW INST., Discussion Draft 2015).

114. George M. Cohen, *Legal Malpractice Insurance and Loss Prevention: A Comparative Analysis of Economic Institutions*, 4 CONN. INS. L.J. 305, 332–38 (1997).

insurance, then “[a]s between [liability] insurers and defense counsel, . . . defense counsel [ordinarily] is in just as good a position to spread the risk of those losses that do occur.”<sup>115</sup>

The least cost insurer rationale in the insurance defense context does raise an interesting question. Suppose liability insurers are actually superior insurers, for example, because they are “closer to the action” in a particular case and so are in a better position to monitor defense counsel than the legal malpractice insurers of defense counsel. Moreover, like employers, liability insurers who repeatedly hire the same defense counsel effectively have a “bonding mechanism” for controlling those lawyers in the sense of promising (explicitly or implicitly) future work conditional on competent performance. Why then do liability insurers not simply hire lawyers whom they themselves insure against malpractice? I have no empirical evidence on whether or how often they do, but some anecdotal evidence that generally they do not. Insurers may be willing to hire lawyers they insure, but they apparently do not go out of their way to do so. Why not? Some liability insurers may not provide malpractice insurance. In addition, perhaps liability insurers worry about the internal conflict of interest problems between the two departments of the same insurer. Alternatively, insureds may fear that a liability insurer who hires a lawyer whom it insures would be too likely to favor the insurer’s interests over the insured’s interests. Or perhaps it is more important to the liability insurer to diversify its risks by shifting the malpractice liability risk of its defense counsel to a different insurer, achieving a kind of reinsurance. I wonder, then, whether vicarious liability would encourage more liability insurers to retain as defense counsel those to whom they provide malpractice insurance, and whether that would be a good or bad thing.

In fact, it may be that when insurers use their own staff lawyers as defense counsel, they do provide internal malpractice insurance to those lawyers, perhaps without even a formal policy. If so, that may be another reason why vicarious liability makes sense for in-house defense counsel, but not for outside defense counsel with independent malpractice insurance. With respect to separately insured outside counsel, an insurer that is held vicariously liable would likely seek indemnity from the lawyer’s malpractice insurer, so the liability would end up with the malpractice insurer, assuming that the defense counsel’s insurance was adequate to cover the claim. With internally insured staff counsel, however, the liability would likely remain on the liability insurer, who

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115. RESTATEMENT OF THE LAW OF LIAB. INS. § 12 cmt. b (AM. LAW INST., Discussion Draft 2015).

would be unlikely to seek indemnity from the personal assets of its employee lawyers.

*E. Agency Costs*

A final, less well-known theory of vicarious liability is that employers actually welcome vicarious liability because it enables them to deal with what economists call an “agency cost” problem with their employees.<sup>116</sup> If employees are personally liable for torts they incur in the course of employment and employers are not vicariously liable, employees might take *too many* precautions from the point of view of the employer, because they would have an incentive to use the employer’s own assets to protect themselves.<sup>117</sup> For example, absent vicarious liability an employee on a salary who does not care whether his work time is spent efficiently might drive *too slowly* to ensure he does not have any accidents for which he will be personally responsible. Unlike the traditional theory emphasizing control, the idea here is that the employer lacks sufficient means to control the employee’s self-interested behavior that runs counter to the employer’s interests, creating a classic moral hazard problem. By making the employer responsible, vicarious liability actually benefits employers because the employer-provided insurance counter-intuitively reduces the moral hazard of the employee, at least to the extent that employers do not seek indemnity for the vicarious liability from their employee, which in general they do not.<sup>118</sup>

This theory, too, does not seem to justify vicarious liability of liability insurers for the professional misconduct of outside defense counsel. Liability insurers seem to be very hawkish on how defense lawyers spend their time, so it is not clear that there is really an agency problem that we need vicarious liability to solve. Moreover, if defense counsel has adequate malpractice insurance, that insurance mitigates the temptation of defense counsel to engage in “overcompliance.”<sup>119</sup> To the extent that an agency problem with defense counsel remains, the natural solution might be the one suggested above, namely that liability insurers should retain lawyers whom they insure for malpractice purposes. Alternatively,

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116. Bruce Chapman, *Corporate Tort Liability and the Problem of Overcompliance*, 69 S. CAL. L. REV. 1679, 1678–88 (1996).

117. *Id.* at 1688–89.

118. Gary T. Schwartz, *The Hidden and Fundamental Issue of Employer Vicarious Liability*, 69 S. CAL. L. REV. 1739, 1764–67 (1996) (offering several explanations for why employers do not generally seek indemnity from employees).

119. Chapman, *supra* note 116, at 1689.

insurers could use staff counsel to conduct the defense and accept the vicarious liability that goes along with that choice.

The agency cost theory does raise an interesting possibility, however. Perhaps liability insurers favor vicarious liability<sup>120</sup> because they believe that in its absence, defense counsel are not sufficiently attentive to insurer interests, but instead tend to favor the interests of insureds. In fact, the courts that adopt vicarious liability tend to envision a strong role for the insurer in controlling the defense, whereas courts that reject vicarious liability tend to worry more about preserving the independence of defense counsel and supporting their ethical obligations to the insured.<sup>121</sup> Insurers may be willing to eat the extra costs of vicarious liability from occasional defense counsel malpractice as quid pro quo for enjoying a greater ability to control defense counsel costs and make defense counsel err more on the side of protecting the insurer than the insured. Of course, as already noted, if the insurer goes too far in that direction, it risks direct liability and bad faith claims; what is an “agency cost” problem to an insurer may be bad faith to an insured. Moreover, lawyers who unduly favor the interests of insurers may risk disciplinary sanctions, though disciplinary rules are notoriously under-enforced. But insurers may be willing to make the tradeoff nonetheless.

### III. THE SCOPE OF INSURER LIABILITY UNDER RESTATEMENT SECTION 12

Thus far, I have argued that the basic approach of proposed Restatement section 12 is consistent with general agency law, the majority of cases addressing the issue of insurer liability, and economic theories of vicarious liability. Nevertheless, if the ALI adopts section 12 in its current form, important interpretive questions remain concerning the scope of insurer liability. This section briefly discusses several of these questions.

#### A. *The Insurer’s Right to Defend as the Trigger for Liability*

An insurer’s liability under Restatement section 12 requires that the insurer be “exercising the right to defend a claim.”<sup>122</sup> The right to defend underlies insurer responsibility for defense counsel malpractice because

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120. I do not know if they do, and if they do, it may simply be because they think the incremental liability over existing direct liability is not a big deal.

121. See MODEL RULES OF PROF’L CONDUCT rr. 1.8(f), 5.4(c) (AM. BAR ASS’N 2015).

122. RESTATEMENT OF THE LAW OF LIAB. INS. § 12 (AM. LAW INST., Discussion Draft 2015).

it gives the insurer the right to select counsel and control the defense.<sup>123</sup> By the same token, the right to defend trigger imposes important limits on the scope of the insurer's liability. If defense counsel for the insured breaches a professional obligation at a time when the insurer is not exercising its right to defend a claim, the insurer will not be liable for that lawyer's conduct. This limitation can occur in several scenarios.

First, the insurer may be obligated to provide an "independent defense" for the insured when a potential conflict between the insurer and the insured arises.<sup>124</sup> Under the Restatement, the insurer is not liable for the conduct of that independent counsel.<sup>125</sup> This limitation is consistent with case law. No cases impose vicarious or direct liability on an insurer when the insured is represented by independent counsel. The exception is also consistent with the main rationale for insurer liability, since the insured has the right to select the independent counsel<sup>126</sup> and the whole point of independent counsel is that the insurer will not exercise any control over that counsel. Moreover, one might surmise that if the insured chooses the independent counsel, vicarious or direct liability would not be necessary because the insured would have an incentive to choose a lawyer who carried adequate malpractice insurance. On the other hand, unsophisticated insureds may not think to hire lawyers with malpractice insurance or may not know how much insurance would be adequate to protect their interests.<sup>127</sup> Perhaps insurers, acting to protect their own interests against defense counsel malpractice, will encourage insureds to retain lawyers with adequate malpractice liability insurance,<sup>128</sup> but that assumption is in some tension with the assumptions underlying Restatement section 12.<sup>129</sup>

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123. Richmond, *supra* note 6, at 115, 144 ("If an insurer does not have the right to control its insured's defense it cannot be vicariously liable for a defense attorney's malpractice.").

124. RESTATEMENT OF THE LAW OF LIAB. INS. § 15-16 (AM. LAW INST., Discussion Draft 2015). Section 16 says that the insurer must provide an independent defense for the insured if the insurer provides "notice of a ground for contesting coverage under [section] 15 and there are common facts at issue in the claim and the coverage defense such that the claim could be defended in a manner that would benefit the insurer at the expense of the insured." *Id.* § 16. Section 15 details the steps an insurer must take to reserve its rights to contest coverage. *Id.* § 15.

125. *Id.* §§ 12, 17. Section 17(1) states that "[w]hen an independent defense is required under [section] 16 . . . [t]he insurer does not have the right to defend the claim." *Id.* § 17(1).

126. *Id.* § 17(2).

127. *Cf. id.* § 12 cmt. b ("[A]s long as the insurer makes sure that defense counsel has adequate liability insurance to cover the consequences of malpractice, the ordinary vicarious and direct liability rules provide adequate protection to insureds . . .").

128. Somewhat surprisingly, comment a to section 17 suggests that the insurer should have the right, as a condition of paying independent counsel's fees, to "insist that counsel maintain professional liability insurance that is adequate to protect the insured (and

The “right to defend” trigger of insurer liability may create interpretive difficulties. Suppose the insurer does not give the insured notice of a ground for contested coverage until after the litigation has started, perhaps because the insurer does not uncover relevant facts before discovery. If defense counsel malpractice occurs, there may be a question of whether the relevant malpractice occurred before or after the trigger of the “independent defense.” Perhaps, however, because the relief from liability under Restatement section 12 in the absence of an insurer’s right to defend lowers the expected cost to insurers of providing independent counsel, the liability limitation will also give insurers an incentive to provide the notice that triggers an independent defense as soon as possible and in close cases, which could reduce uncertainty and redound to the benefit of insureds overall. It is possible that the exception could give insureds an offsetting incentive to allow the insurer to proceed with the defense despite the conflict so as to preserve the possibility of liability against the insurer in the event of defense counsel malpractice, but it seems unlikely that insureds would make that calculation in most cases.

A second scenario in which interpretive issues might arise involves termination of an insurer’s duty to defend a claim.<sup>130</sup> Under Restatement section 12, an insurer’s liability is triggered by the insurer’s *right* to defend a claim.<sup>131</sup> Does the end of the insurer’s *duty* to defend also end the insurer’s right to defend, and therefore the liability of the insurer for defense counsel misconduct? It seems that the right to defend would end when the duty to defend ends, since the right includes “[t]he authority to direct all the activities of the defense of any claim that the insurer has the duty to defend.”<sup>132</sup> That rule suggests that the insurer’s liability ends when the duty to defend ends, at least for lawyer conduct occurring after the duty to defend ends. But what if a lawyer’s post-duty-to-defend conduct is related to the lawyer’s conduct when the insurer had a duty to defend? Similarly, does the exhaustion of the policy limits, which also

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indirectly the insurer) from the financial consequences of incompetence.” *Id.* § 17 cmt. a. This comment, unlike the comment quoted in the previous footnote, seems to contemplate that an insured would intentionally resist retaining a lawyer who carried adequate malpractice insurance rather than an insured who hires an uninsured or underinsured lawyer out of ignorance.

129. Those assumptions are that the insureds will not pay sufficient attention to the malpractice insurance carried by defense counsel and that insurers, absent liability, will not have sufficient incentive to care about defense counsel’s malpractice insurance.

130. *Id.* § 18.

131. *Id.* § 12.

132. *Id.* § 10(1).

terminates the insurer's duty to defend,<sup>133</sup> also end the insurer's liability under Restatement section 12? That would seem strange, because insurer liability for defense counsel malpractice, when it applies, is not generally limited by the liability insurance policy limits. Again, the idea may be that the exhaustion of policy limits ends any malpractice occurring after that time but not before. Finally, does termination by final adjudication<sup>134</sup> preclude insurer liability for defense counsel malpractice in connection with the distribution of funds to the insured?

Third, an insurer who breaches its duty to defend "loses the right to assert any control over the defense or settlement of the claim and the right to contest coverage for the claim."<sup>135</sup> The duty to defend trigger of Restatement section 12, suggests that the insurer would not be liable for any malpractice of defense counsel after the time that an insurer breaches its duty to defend. If, however, the insurer's breach of its duty to defend contributes to the defense counsel's malpractice, then presumably the insurer could still face direct liability.

Fourth, some insurance policies do not include a duty to defend at all, but simply promise to reimburse the insured for defense costs incurred by the insured.<sup>136</sup> Again, the duty to defend trigger in Restatement section 12 suggests that there would be no insurer liability for defense counsel malpractice under that provision, though there could be liability under the policy itself depending on how "defense costs" are interpreted.

Finally, in some cases, the duty to defend may be shared among multiple insurers.<sup>137</sup> In that case, the Restatement provides that "[t]he duty to defend is jointly and severally owed to the insured."<sup>138</sup> But the insured has the right to select any of the insurers to defend the claim.<sup>139</sup> If the insured picks one insurer to defend the claim, is that chosen insurer the only one who would be subject to liability under Restatement section 12? The Restatement states that the selected insurer may seek contribution from any nonselected insurer for the costs of defense and any judgment rendered, or settlement entered into, with respect to the claim.<sup>140</sup> Does that right of contribution include vicarious liability claims, effectively making the non-selected insurers "jointly and severally liable" on these claims as well?

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133. *Id.* § 18(6).

134. *Id.* § 18(2).

135. *Id.* § 19(1).

136. *Id.* § 22(1).

137. *Id.* § 20.

138. *Id.* § 20(5)(a).

139. *Id.* § 20(1).

140. *Id.* § 20(4)(b).

*B. Adequate Malpractice Liability Insurance*

Apart from the limitations imposed by the “right to defend” trigger, a second interpretive issue under section 12 is what counts as “inadequate” liability insurance.<sup>141</sup> Presumably, the mere fact that malpractice insurance is not sufficient to cover a particular claim of defense counsel malpractice *ex post* would not be sufficient to render that insurance inadequate. As with all reasonableness standards, courts will need to find an appropriate and reasonable benchmark against which to measure adequacy. Possible benchmarks include the average level of malpractice insurance carried by large law firms, or by corporations for their in-house counsel in the relevant jurisdiction, but these averages may not be readily available. Alternatively, these benchmarks may be unreasonable either because the types of claims faced by these lawyers may not be sufficiently analogous to the claims made against insurance defense counsel, or because underinsurance may be a problem in these other contexts as well.

*C. Suits by Parties Other than the Insured*

Section 12 is not clear whether parties other than the insured, most notably the plaintiff in the underlying lawsuit, can sue the defendant’s insurer if the defense counsel commits a professional wrong that injures the plaintiff. Although the text of section 12 does not expressly limit insurer liability to only insureds, comment b to section 12 could be read to suggest that only an insured will be able to sue the insurer because only the insured is in the kind of “special relationship” with the insurer that makes the professional wrong committed by defense counsel a foreseeable harm.<sup>142</sup> In my view, it would be unwise to read section 12 to preclude liability of insurers to third parties. Several of the cases discussing vicarious liability for insurers involve claims by a party other than the insured.<sup>143</sup> Moreover, one could argue that to the extent insurers have an incentive to hire underinsured defense counsel, there is an even stronger case for allowing parties other than the insured to recover against the insurer. Those third parties, not being in a contractual

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141. *Id.* § 12(2).

142. *Id.* § 12 cmt. b.

143. See *United Farm Bureau Mut. Ins. Co. v. Groen*, 486 N.E.2d 571, 572 (Ind. Ct. App. 1985) (negligence and abuse of process claim made by tort victim); *Givens v. Mullikin*, 75 S.W.3d 383, 390–91 (Tenn. 2002) (abuse of process claim made by tort victim); *Rose ex rel. Rose v. St. Paul Fire & Marine Ins. Co.*, 599 S.E.2d 673, 675 (W. Va. 2004) (violation of Unfair Trade Practices Act claim made by tort victim).

relationship with the insurer, would have less chance to protect themselves than insureds would. True, third parties may have their own counsel, but that may not be sufficient to protect them against defense counsel misconduct.

#### IV. CONCLUSION

Restatement section 12 adopts a workable and sensible rule that, if adopted by courts, would bring welcomed clarity to the question of insurer liability for the professional misconduct of retained defense counsel. Applying traditional agency law principles, section 12 adopts vicarious liability for in-house defense counsel, who are employees of the insurer, and direct liability for outside defense counsel, who are independent contractors. Adding the provision that insurers can be liable for negligent hiring if the outside counsel they hire lacks adequate malpractice insurance addresses the primary economic justification for vicarious liability on outside defense counsel, thus rendering vicarious liability unnecessary in this context. Section 12 or its comments should, however, clarify that under traditional agency principles, vicarious liability of insurers for fraud by defense counsel acting with actual or apparent authority is an alternative possible theory, as are several other forms of direct liability, including nondelegable duty for insurer breaches of the duty of good faith or other aspects of the duty to defend. Although a number of interpretive questions under Restatement section 12 remain, courts can resolve these issues as they arise in future cases.