LJN LAW JOURNAL NEWSLETTERS

The Insurance Coverage Law Bulletin®

An incisivemedia publication

Volume 7, Number 11 • December 2008

Using Staff Counsel to Defend Insureds

By Donald McMinn

The Texas Supreme Court recently declared that insurance companies do not commit the unauthorized practice of law when they use lawyers they employ to provide a defense to their insureds. *Unauthorized Practice of Law Comm. v. Am. Home Assurance Co.*, __ S.W.3d __, Case No. 04-0138, 2008 Tex. LEXIS 233 (Tex. Mar. 28, 2008).

The court's opinion demonstrates a pragmatic approach to a common situation and is interesting not so much for its direct result — as the court notes, most states to have considered the issue have allowed insurers to use staff attorneys — as it is for the implications of its rulings and the pragmatic grounds on which those rulings are based. Among other things, the opinion reinforces the ethical obligation of all defense counsel to their client, the insured. The opinion also suggests limits on the use of staff attorneys that could lead to a three-tier approach to defense counsel turning on the extent of congruence between the insured's and the insurer's interests. The court, however, provided little concrete guidance as to the situations in which the use of a staff attorney is not appropriate, placed on both insurers and their staff attorneys a burden of determining when such use is appropriate, and missed an opportunity to address the use of reservation-of-rights letters, which it admitted can often be "routine." The court also warned of potential knowledge-imputation pitfalls that could accompany the use of insurer employees to defend insureds.

Donald McMinn, a member of Spriggs & Hollingsworth in Washington, D.C., litigates a variety of insurance coverage issues for corporate insureds and their directors and officers.

The Opinion and Its Basis

The Texas Supreme Court considered whether a liability insurer using staff attorneys to defend claims against its insureds "is representing its own interests, which is permitted, or engaging in the unauthorized practice of law, which is not." *Id.* at *2. The minority and the majority fundamentally disagreed as to whose interest is at stake when an insurer provides a defense to its insured. The majority took a pragmatic approach focused on the underlying financial interest and declared the insurer was, in essence, defending itself such that its employees were not practicing law on behalf of others. By contrast, the minority took a more technical approach that recognized the legal distinction between the insured and the insurer, a distinction that meant staff attorneys would be working for an unrelated entity and thus engaging in the (unauthorized) practice of law. The differences in the approaches and their underlying assumptions have interesting implications for the future of the insurer-provided defense in Texas.

The Majority Opinion

In Texas, legal practice requires a license or special permission, *e.g.*, law students practicing in limited circumstances. *Id.* at *11 & n.18. Because Texas does not authorize corporations to engage in the practice of law, *Id.* at *21, the court had to determine whether an insurer engages in the practice of law when it employs the attorneys defending its insureds.

The court began with the proposition that a corporation or an organization is entitled to use staff attorneys to represent its own interest because a party's representation of itself does not involve the practice of law. *Id.* at *26 (citing, among other sources, Article 430a (rescinded) of Texas Penal Code, which stated that a person "attending to and caring for his or its own business" was not engaged in the practice of law). Looking at various ethics opinions, the court noted that the scope of self-representation includes the representation of related parties, such as corporate subsidiaries or parents, officers, directors, employees, and agents, provided the related party has no conflict of interest with the corporation providing the representation. *Id.* at 28-29. The expanded self-representation is not the practice of law because "'[t]here is obviously a common interest and there is *for all practical purposes* only one client involved.'" *Id.* at *29, quoting Comm. on Interpretation of the Cannons of Ethics, State Bar of Tex., Op. 343 (1968) (emphasis added). Drawing on these authorities, the court observed that the concept of legal practice implicitly "requires the rendering of legal services *for someone else*" such that the representation of "others with identical interests" is not the practice of law. *Id.* at *31. "Only when a corporation employs attorneys to represent the *unrelated* interests of others does it engage in the practice of law." *Id.* at *31 (emphasis added).

Turning from general principles to the specific setting at hand, the court applied a three-rule test to evaluate whether an insurer is "practicing law or simply defending its own interest in discharging its contractual duty to the insureds and defeating claims it would be required to indemnify." *Id.* The court developed the three rules based on its analysis in *Hexter Title & Abstract Co. v. Grievance Committee*, 179 S.W.2d 946, 952 (Tex. 1944) (where a title company had staff attorneys prepare opinions for individuals purchasing property, it was practicing law because, among other things, opinions concerned rights of third parties rather than the rights of the corporation itself). First, the insurer's staff attorneys must be serving their employer's current rather than prospective interest;

here, to assist the insurer in satisfying its current contractual duty to defend. *See Unauthorized Practice of Law Comm.,* 2008 Tex. LEXIS 233 at *38. Second, the insurer must have "a direct, substantial financial interest in the matter for which it provides legal services," which the court determined insurers have as a result of their indemnification obligation. *Id.* (Apparently insurers will not be able to use their employee attorneys to defend insureds who have defense-only coverage, such as the coverage to be found in certain Director and Officer policies.) Third and "most important," the insurer's interest must be "aligned with that of the person to whom the company is providing legal services." *Id.* at *39. In ranking the third factor as the "most important," the court repeated its earlier citation of the 1968 ethics opinion finding that, in the context of the representation of one corporate affiliate by the attorney-employees of another, "'there is for all practical purposes only one client involved.'" *Id.*, quoting Comm. on Interpretation of the Cannons of Ethics, State Bar of Tex., Op. 343 (1968). The court further explained that where the insurer's and insured's interests are sufficiently "congruent," "a staff attorney's representation of the insured and insurer is indistinguishable." *Id.* at **39-40. By contrast, the third factor is not satisfied "when there are coverage questions or when the consequences of the manner in which the defense is rendered affect them differently." *Id.* at *39.

In considering the use of staff attorneys, the court observed that their use is a long-standing practice authorized in many jurisdictions and sanctioned by the American Bar Association. *Id.* at *10. While the mere fact that a practice is long-standing and widespread does not mean that the practice has a legal justification for it, longevity and popularity do suggest there are benefits to the practice (and that it warrants a careful examination). The court specifically identified insurers' assertions that staff attorneys are economical and have considerable expertise in particular areas of law, thereby allowing the insurers to reduce their expenses (and, arguably, premiums) while providing a defense equivalent or even superior to that provided by private practitioners. *Id.* at *4. Of course, staff attorneys also may prove economically advantageous to insurers because they are subject to direct control that could allow an insurer to limit the activity of counsel for reasons other than those related to the needs of the insureds' defenses; it is this possibility for mischief in the increased control by non-lawyers that critics of the practice disapprove of. *Id.* at *5 n.6, **40-41.

The Dissent

In contrast to the majority's focus on the pragmatic benefits of staff attorneys, the dissent focused on the nature of corporations to find that staff attorneys representing insureds practice law, a practice that is not authorized in Texas.

The dissent took what one commentator has suggested is a formalistic approach centered on the nature of the corporate entity and the consequences of the corporate form. *See* Michael S. Quinn, Insurance Counsel, 30 Insurance Litigation Reporter, May 15, 2008, at 289. The dissent joined the majority's view that the practice of law requires specific authorization and that an individual representing himself is not engaging in the practice of law because the practice of law implicitly involves the rendering of legal services for someone else. *Id.* at **68-69, 76. Similarly, because "[c]orporations are legal entities that function through the actions of people," a corporation's employment of staff attorneys to defend itself is not the practice of law. *Id.* at 77-78. *See also Id.* at 68 & 73 (noting earlier decisions in which the Texas Supreme Court determined that the actions of staff attorneys are those of the corporate employer). But, as the dissent observed, "[i]nsureds are, quite simply, legal entities completely separate from the insurance corporation." *Id.* at *80. Thus, "the insurance corporation is not representing itself when it represents its insureds." *Id.* Instead, "[t]he actions of staff attorneys in so defending insureds undeniably are the actions of the corporation," *Id.* at *78, and the insurance corporation is representing someone or something other than itself, which it is not authorized to do. *Id.* at *80.

While recognizing that insurers might "want the economic benefit of staff attorneys practicing law by defending insureds who are not corporate affiliates, subsidiaries, employees, officers, or agents," *Id.* at *65, the dissent defends its result against charges of absurdity (its word) by noting that the insurer's employees should be serving the goals of the corporation, which is to pursue profit. *Id.* at **81-82. Without accusing corporate executives of improper motives, the dissent observed that executives, unconstrained by the ethical obligations governing lawyers, would employ good management practices to reward those employees who increase profits and, at times, could be subject to pressure to impose "cost-cutting of some nature" during a downturn in a manner that could work at cross purposes to a lawyer's professional obligation. *Id.* at **82-86.

Ramifications

Between the Texas Supreme Court's decision itself and the justification for its decision, there are several important issues and some questions.

The Ethical Duty All Attorneys Owe Insureds

Unauthorized Practice of Law Committee v. American Home Assurance Company reiterates the prime obligation of defense counsel: to recall that the insured is the client of the attorney, whether that attorney be an independent counsel retained by the insured, a practitioner retained by the insurer, or an insurer's staff attorney. Insurer-affiliated defense counsel "'owes the insured the same type of unqualified loyalty as if he had been originally employed by the insured' and 'must at all times protect the interests of the insured if those interests would be compromised by the insurer's instructions.'" *Id.* at *3; *see also Id.* at *47, *49 (a "lawyer must represent the insured and protect his interests from compromise by the insurer"). The court expressly stated its "concern[ ] that the use of staff attorneys not diminish professionalism in insurance defense or harm the public." *Id.* at *51.

Because staff attorneys are members of and sworn to uphold the standards of the legal profession, they must stand ready to defy their employer if that employer requests an action inconsistent with their ethical duty to the insured. *Id.* at *47. The court noted critics' concern that the employment status of staff attorneys might make them more susceptible to insurer pressure than counsel retained by

the insurer, but responded that the record contained no empirical evidence to show that staff attorneys were any less able to comply with their ethical obligations. *Id.* at *41. In the absence of such evidence and in the face of contractual terms granting control of the defense to the insurer, *Id.* at **1, 2, the court expressly refused to presume that a staff attorney would be any more likely than retained counsel to fail to provide the requisite unqualified loyalty to the insured. *Id.* at **47-48. The court did not, however, acknowledge the difficulty of securing empirical evidence of staff attorneys' lack of zeal or qualified loyalty, matters of which staff attorneys may themselves be unaware, unwilling to commit to writing, or unwilling to admit to others.

Regardless of employment status, counsel provided by an insurer must, of course, be competent. *See, e.g., Am. Centennial Ins. Co. v. Canal Ins. Co.,* 843 S.W.2d 480, 485 (Tex. 1992).

A Three-Tier Approach?

Although the court stressed that all counsel have the same ethical obligation to the insureds they represent, the court's discussion of when an insurer should choose to retain counsel in place of using a staff attorney suggests that in Texas, insurer-paid representations now may fall into three distinct categories:

- Those cases where there is a sufficient identify of issues such that the matter can appropriately be defended by staff attorneys;
- Those cases where the insurer's and insured's interests are so divergent as to void the carrier's right to control the defense and entitle the insured to select counsel; and
- An intermediate ground, those cases where the insurer's and insured's interests are different, such that the insurer should select a private practitioner, but not so different as to entitle the insured to select counsel.

The court did not overtly state that it had established this new structure, but the situations in which it suggested an insurer should shy away from or would not be justified in using staff attorneys appear to encompass a broader range of situations than those justifying an insured's selection of independent counsel.

In Texas, an insured is entitled to hire independent counsel where the claim against the insured could be sustained on several grounds, at least one of which would result in an indemnified liability and others of which would not. *E.g., N. County Mut. Ins. Co. v. Davalos,* 140 S.W.3d 685, 688-89 (Tex. 2004); *Britt v. Cambridge Mut. Fire Ins. Co.*, 717 S.W.2d 476, 481, 483 (Tex. Ct. App. 1986). *See also Rhodes v. Chicago Ins. Co.,* 719 F.2d 116, 120-21, 1983 (5th Cir. 1983); *Housing Auth. of Dallas, Tex. v. Northland Ins. Co.,* 333 F. Supp. 2d 595, 600-01 (N.D. Tex. 2004). For example, in an action for bodily injury, an insurer would have no indemnification obligation either if there were a defense verdict or if the insured were found to have intended the injury, while the insured would prefer either a defense verdict or a loss predicated on negligence, which would be within the insurer's indemnification obligation. The justification for independent counsel is that the insured should not to be concerned that the insurer remains in control of the defense counsel and could try to steer the litigation toward a liability result based on findings that would leave the loss uncovered. *See, e.g., Golden Eagle Ins. Co. v. Foremost Ins. Co.,* 25 Cal. Rptr. 2d 242, 256-57 (Ct. App. 1993). Not all coverage disputes, however, present a coverage-determinative conflict of interest. There are disputed issues which would, depending on the resolution, leave the insured without coverage but which would not be determined in the defense of the underlying tort action. In such instances, it could not be said that the insurer and insured had identical interests, but neither would Texas law entitle the insured to select independent counsel. *N. County,* 140 S.W.3d at 689.

By contrast, the court's discussion of the use of staff attorneys indicates that insurers should avoid their use in situations in which the litigated interest is not their own. *Unauthorized Practice of Law Comm.*, 2008 Tex. LEXIS 233 at **39-40 (interest of insurer and insured should be congruent such that "a staff attorney's representation of the insured and insurer is indistinguishable"). In other words, staff counsel are inappropriate for situations in which an insurer denies coverage on any ground, not just a ground indicative of a conflict the resolution of which has implications for the conduct of the defense. *See Id.*

In fact, staff counsel *may* be inappropriate even when there is no denial. The court's opinion varies in its language concerning the requisite identity of interests necessary to support an insurer's use of staff attorneys for the defense of its insureds. While the court's reference to "identical interests" would seem to require great congruence before staff attorneys could defend an insured, discussions noting the problems arising when the interests are "unrelated" suggest that staff attorneys could be used where interests are related, though not identical. Compare *Id.* at *21 and *31. Given the basis for the decision — that the staff attorney is for all practical purposes defending the insurer when it defends the insured — it would seem a considerable, if not complete, identity of interests would be required, and the court did caution that while it would not prohibit the use of staff attorneys altogether in the case of merely "routine" reservation-of-rights letters, "[d]eclining representation is the safer course to avoid conflicts that destroy the congruence of interest between the insurer and the insured that allows for the use of staff attorneys." *Id.* at *44. Such situations would arise where a staff attorney might learn confidential information that could, for instance, relate to whether a policy should be canceled or not renewed, *Id.* at *45, a situation that would not, in the case of an insurer-selected outside counsel, trigger the insured's right to select independent counsel because there would be no impact on the potential for coverage under the existing policy.

As an aside, the court acknowledged that many reservation-of-rights letters are "routine" and "issued liberally, as a prophylactic measure" even in the absence of "any specific intent to pursue a coverage issue." *Id.* at **43-44. Given that the insured who receives a reservation-of-rights letter cannot seek advice concerning that letter from counsel provided by the insurer and thus must hire separate counsel to determine if the reservation of rights is appropriate, relevant, and a threat to coverage, the fact that insurers "routinely" issue such letters without any

actual intent to assert the defenses should have been cause for negative comment by the court.

Saving Defense Costs: At What Risk?

The court's approval of staff attorneys frees insurers to reap asserted savings, but the court's opinion makes clear that the use of staff counsel carries risk. For that reason, caution would suggest limiting the use of staff counsel to the situations least likely to carry risk: claims the insurer has accepted without reservation beyond the application of a limits provision.

The court notes, for instance, that it would not be "unusual" for a staff attorney to learn an insured's confidential information during the course of the defense. If this confidential information relates to coverage or underwriting issues, counsel may need to withdraw from the representation. *Id.* at *45. If the need for withdrawal were to arise well into the proceedings, the insurer's cost savings could be eaten up by the cost of transitioning the defense to new counsel. Should the withdrawal come close enough to trial, it could even result in prejudice to the insured and expose the insurer to a claim for damages. Moreover, the court noted that the law of imputed knowledge is not well developed in this setting. Were a staff attorney a member of a law firm, Texas law irrebutably would impute knowledge of the confidential information to all firm members, but there has been no case law concerning the rule for imputation beyond the legal department of an insurer. *Id.* at **45-46. An insurer conceivably risks a broad imputation of knowledge beyond its legal department that "would provide a basis for estopping the insurer from asserting an issue to which the information pertained" or even "using it altogether." *Id.* Looking ahead, insurers might benefit from devising protocols declaring limits on the contact between staff attorneys and those outside the legal department in an effort to demonstrate that a broad imputation would be unwarranted.

Insurers using staff attorneys where they do not have interests identical to their insureds face risks beyond the direct cost of the staff attorneys' withdrawal. Failure of a staff attorney to withdraw when warranted would constitute the practice of law:

> If an insurer's interest conflicts with an insured's, or the insurer acquires confidential information that it cannot be permitted to use against the insured, or an insurer attempts to compromise a staff attorney's independent, professional judgment, or in some other way the insurer's and insured's interests do not have the congruence they have in the many cases in which they are united in simple opposition to the claim, then the insurer cannot use a staff attorney to defend the claim *without engaging in the practice of law. Id.* at *52 (emphasis added).

Insurers using staff attorneys to defend their insureds also face the risk of malpractice claims that can be brought against them as responsible parties pursuant to the principles of respondent superior or more directly as the party who committed the malpractice (because the corporation was acting through its agent employee). *See Baptist Mem'l Hosp. Sys. v. Sampson,* 969 S.W.2d 945, 947 (Tex. 1998) ("an employer is vicariously liable for the negligence of an agent or employee acting within the scope of his or her agency or employment"); *Holloway v. Skinner,* 898 S.W.2d 793, 795 (Tex. 1995) ("the actions of a corporate agent on behalf of the corporation are deemed the corporation's acts"). This may be a good thing for insureds given that the typical insurance company is likely to have deeper pockets than virtually all defense counsel.

Staff attorneys also face heightened risk. As the opinion makes clear, staff attorneys are to exercise their independent professional judgment and comply with their ethical obligations as lawyers regardless of the direction or limitation provided by their employers. Unauthorized Practice of Law Comm., 2008 Tex. LEXIS 233 at *17. In the event clients file charges with bar counsel, staff attorneys will be held to professional standards, with accompanying professional sanctions that can be applied to them personally, not just to their employer. Moreover, there will be instances in which staff attorneys must withdraw from the client representation, *Id.* at *45, and withdrawal itself could come with obligations and duties to the insured. By writing of withdrawal from a representation, the court indicates that an attorney-client relationship has formed, but leaves staff attorneys in an uncertain position by not addressing the extent of the staff attorney's obligation to explain to the client the implications of the attorney's reasons for withdrawing and what advice in connection with the withdrawal the attorney owes the client.

Conclusion

The impact of the Texas Supreme Court's decision specifically allowing the use of staff attorneys for the defense of insureds where the interests of the insurer and insured are identical or sufficiently congruent will not emerge for some time. To the extent that insurers use staff attorneys judiciously for common cases presenting no coverage issues save a remote potential for an excess verdict, insurers and insureds should benefit. In such cases, the interests really will be identical, the legal issues familiar to staff attorneys who will have handled other such cases and thus who should have expertise that will inure to the benefit of the insured, and the prospect of costs savings genuine, such that insurers' reduced-premium arguments are plausible. The mischief will arise, however, when insurers start using staff attorneys for matters where the interests are similar, but not identical, or where a conflict arises only after the representation has been underway for some time.