

PROVIDING A DEFENSE TO INSUREDS: ARE INSURERS VIOLATING THE LAW BY CONTROLLING LEGAL COSTS?

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Introduction

Attorneys generally seek to provide the best representation, while insurers seek to control legal costs. The tension this dichotomy creates in insurance defense representation is reflected in the nationwide attacks on insurers' attempts to control costs by the use of salaried counsel,¹ billing guidelines and audits. These practices are not new. They long have been the source of acrimony between insurers and attorneys. They continue to be under siege, primarily by attorneys, as violating ethical rules. There is no evidence that they pose substantial ethical problems and, as trends toward cost control and increased specialization grow, their use is evolving. This article briefly addresses the myriad of issues raised by insurers' efforts to manage legal costs in view of the unique tripartite relationship among insurer, insured and defense counsel.

Settled Territory? The Use of Salaried Counsel

All but two states considering the question have rejected these arguments.² In upholding the use of salaried counsel by insurers, courts recognize that the practice of law is regulated "for the purpose of protecting the unwary and the ignorant from injury at the hands of persons unskilled or unlearned in the law."³ Salaried counsel are neither "unskilled nor unlearned." They "are not second-class lawyers; these are first-class lawyers who are delivering legal services in an evolving format."⁴ Courts also recognize that an insurer has the right to protect its pecuniary interests by an attorney of its own choosing. "If the potential loss is within the policy limits, then there is no reason to deprive the insurer – the only one appearing to have a pecuniary interest in the ultimate liability and the only source of the funds to be paid in settlement – of its absolute right to control the litigation."⁵

In Connecticut, a former insurance company staff counsel attacked his employer's use of a captive law firm as the unauthorized practice of law and claimed that the attorneys who represent such insureds assist their employer in the unauthorized practice of law.⁶ The court rejected these arguments. Observing the real purpose of the rule, to protect the public, the court noted that the prohibition exists because "[t]he relation of an attorney to his client is pre-eminently confidential ... Only a human being can conform to these exacting requirements. Artificial creations such as corporations or associations cannot meet these prerequisites and therefore cannot engage in the practice of law."⁷

The Supreme Court of Missouri considered a similar challenge, where the petitioners alleged that the use of house counsel constitutes the unauthorized practice of law and raises impermissible conflicts of interests.⁸ The petitioners contended that the challenged services could not be provided by house counsel, but could be provided by outside counsel hired and paid for by the insurer. The Court, in upholding the practice, recognized the identity of interest between an insurer and insured, and rejected the attempted distinction between outside counsel and house counsel. The Court noted, with some skepticism, that the petitioners simply sought to obtain business for private practitioners by denying it to employed attorneys.

Under Georgia's statute prohibiting corporations from engaging in the unauthorized practice of law, the plaintiff sought to disqualify the defendant's attorney on the ground that he was a full-time employee of the insurer.⁹ Georgia's statute exempts a corporation from the prohibition, if it employs attorneys "in and about their own immediate affairs or in any litigation to which they are or may be a party."¹⁰ The issue presented was whether the use of staff counsel to defend a lawsuit was "in and about" the insurer's "own immediate affairs." The Court found that it was and that the insurer had not engaged in the unauthorized practice of law, noting that the insurer "is fulfilling contractual obligations which arise under the policy as well as defending its own interest in eliminating or limiting any recovery under the policy ... That the insured has an equal or greater interest in the outcome of the litigation does not eliminate the insurance company's interest therein."¹¹ Indeed, the position of the American Bar Association's Committee on Ethics and Professional Responsibility is that an insurer's use of attorney-employees or outside counsel on behalf of its insureds does not constitute the unauthorized practice of law. "The furnishing of legal services to an insured by a liability insurance company involves such a community or identity of financial interest so as to define the service involved as in the insurer's own interest."¹²

Despite the obvious identity of interest, critics continue to charge that the practice also violates ethical rules which provide that a lawyer shall not represent a client if the representation of that client will be directly adverse to another client. However, the majority of jurisdictions reject this argument as well, and choose instead to rely upon an attorney's professional expertise and ethical obligations as providing sufficient safeguards. Both house counsel and outside counsel owe the same unqualified loyalty to the insured, as if they had been personally retained by him. "The intrusion of the insurance contract does not alter the fact that the relationship with the insured is that of attorney and client. It cannot be overemphasized that the relationship is the same if the attorney were hired and paid directly by the insured."¹³ Counsel's ethical obligations are the same.

These include a duty not to undertake or continue a representation if the exercise of the lawyer's professional judgment on behalf of the client is or reasonably may be adversely affected by his other interests or representations ... The essential point of ethics is that the lawyer so employed shall represent the insured as his client with undivided fidelity.¹⁴

The presumption that salaried counsel are unable to faithfully execute these obligations solely because of their employment status has been soundly rejected. "The determinative factor is whether ... in-house counsel can maintain professional independence comparable to that of an outside law firm."¹⁵

The Florida Bar, over 30 years ago, sought a *per se* rule prohibiting the use of house counsel, asserting that conflicts could develop where a claim exceeds policy coverage, or when a compromise is in the making, and that the best interests of an insured require independent counsel.¹⁶ The Bar argued: "the compulsive economic pressure of retaining one's full time means of livelihood precludes the possibility that a lawyer under such circumstances can give unadulterated devotion to divergent interests."¹⁷ The Court rejected this argument, finding that house counsel's responsibilities are no different than any other lawyer's responsibilities to one of two clients whose interests are in conflict.

[T]he ethical problem might well arise regardless of the nature of the employment relationship ... There may come a time when the lawyer must decide which of two 'masters' he will continue to serve because the presence of a conflict makes it ethically impossible to serve both. Consequently, the proposed rule does not completely solve the problem which the Bar seeks to remedy. It merely discriminates against a class with no reasonable basis for the distinction.¹⁸

Where an attorney is engaged to defend in the insured's name, it is well-settled that he cannot ethically seek a result that would leave the insured liable and uncovered. Where a question of coverage arises at the inception of suit, the insured should be directed to retain personal counsel. Where there is a declaratory judgment action regarding coverage, the attorney cannot appear for either party. Where the attorney learns facts which suggest that the insured is not entitled to coverage, the attorney owes to the insured, his client, "an undeviating and single allegiance," which forbids the attorney from taking a position adverse to the insured.¹⁹ In *Montanez v. Irizarry-Rodriguez*,²⁰ an attorney assigned by an insurer to defend the insured was surprised by the insured's testimony at trial. The issue the court addressed was whether the attorney may impeach the insured's credibility. Because an attorney's ethical obligations run directly to the insured, he cannot. When a conflict arises, the attorney must advise both the insurer and insured and, in the absence of written consent from both, withdraw from representation.²¹

The ultimate responsibility for handling conflicts must be placed on the attorney, and there is no basis to conclude that employed attorneys have less regard for ethical considerations than private practitioners, or that this type of representation is so fraught with conflicts that it should never be allowed. Attorneys who depend on an insurer's referrals for a significant portion of their income could be said to be at risk of favoring the company over the client in a conflict situation in order to keep the carrier's business.²² Outside counsel billing by the hour arguably have a built-in incentive to prolong litigation. Any time a third party pays the costs of representation, the attorney owes undivided loyalty to the client served and not the source of compensation. When interests collide, it is the attorney, regardless of the quantum of employment, who must make the ethical decision.

The Next Frontier? Negotiated Fees, Billing Guidelines and Legal Fee Audits

Where the insurer chooses to hire outside counsel, the insurer sometimes will negotiate set fees, impose billing guidelines and/or audit billings in order to control costs. Recent challenges to such practices have been brought

under ethical rules which prohibit a lawyer from permitting a person who employs or pays an attorney to render legal services to another to direct or regulate that lawyer's professional judgment, or as compelling the disclosure of attorney-client privileged information.

In *American Insurance Ass'n v. Kentucky Bar Ass'n*,²³ the Kentucky Supreme Court considered the validity of a contract between a law firm and liability insurer to perform all of the insurer's defense work for a set fee. The Court affirmed the determination of the Bar Association's Board of Governors that the practice violates Kentucky's Rules of Professional Conduct, since the lawyer would stand to gain by limiting the services rendered, and the set fee arrangement would result in the insured's loss of control of the litigation. Whether this decision represents the majority view is questionable, since Kentucky is one of only two jurisdictions which prohibits the use of salaried counsel.

However, other challenges directed towards the use of billing guidelines or legal audits raise more troubling concerns. It has been reported that approximately 35 jurisdictions have addressed insurers' use of billing guidelines and legal fee audits through nonbinding state bar advisory opinions or, more recently, by litigation or legislation.²⁴ Because the insurer bears the financial risk and typically has the right and obligation to defend and control the defense under the insurance contract,²⁵ courts have permitted insurers to impose reasonable restrictions on the conduct of the defense, including the cost of litigation. Such restrictions vary, but where they become so unreasonable or inflexible as to interfere with an attorney's ability to exercise independent professional judgment, they are vulnerable. *Ricketts v. Farmers Group, Inc.*²⁶ is an example. In that case, the California court found that the insurer's control over outside counsel's work was so extreme as to constitute the unauthorized practice of law. Similarly, last year, the Montana Supreme Court unanimously held that because the defense lawyer's client is the insured and not the insurer, the use of a pre-approval process fundamentally interferes with the attorney's independent judgment, and audit practices which require disclosure of legal bills to third party auditors without fully informed contemporaneous consent violate client confidentiality.²⁷

An insurer's requirement that counsel provide billing information to a third party auditor arguably intrudes upon the attorney-client privilege and requires counsel to reveal confidential information in violation of ethical rules.²⁸ Numerous states have issued advisory opinions warning against such disclosures without the authorizations of all parties. Moreover, such audits can become so intrusive as to suggest that it is the auditor, not the attorney, who is managing the litigation, raising other ethical and legal questions.²⁹

In 1999, the Florida State Bar established a special committee to examine the use of billing guidelines and legal audits. In the past year, the Georgia State Bar asked Georgia's Supreme Court to adopt a prohibition against outside counsel sharing information with insurers' auditors. In an effort to reach a compromise and avert a stalemate with insurers, the Defense Research Institute recently approved a set of non-binding guidelines to address billing procedures, reporting requirements and case management.³⁰ Whether these guidelines will meet the competing needs presented by the tripartite insurer, insured and defense counsel relationship remains to be seen.

Conclusion

The use of salaried counsel and billing guidelines can increase insurers' efficiency, which ultimately benefits the public in the form of reduced costs. In view of the benefits, the adoption of a *per se* prohibition against their use is unwarranted. However, an insurer's guiding cardinal principle should be that counsel always must be permitted to exercise independent professional judgment ultimately to protect the interests of the client.

Endnotes

1. The terms "salaried counsel," "house counsel," "staff counsel" and "captive law firms" are used interchangeably and generally refer to those arrangements in which legal staff are salaried employees of the insurer.
2. Kentucky and North Carolina prohibit the use of house counsel. *American Insurance Ass'n v. Kentucky Bar Ass'n*, 917 S.W.2d 568 (Ky. 1996); *Gardner v. North Carolina State Bar*, 341 S.E.2d 517 (N.C. 1986). See generally, *Cincinnati Ins. Co. v. Wills*, 717 N.E.2d 151, 155 (Ind. 1999); Restatement (Third) of Law Governing Lawyers § 4 (1998).

3. *N.J. State Bar Ass'n v. Northern N.J. Mortgage Associates*, 123 A.2d 498, 504 (N.J. 1956).
4. *In re Weiss, Healey & Rea*, 536 A.2d 266, 269 (N.J. 1988).
5. *Fireman's Fund Ins. Co. v. Security Ins. Co. of Hartford*, 367 A.2d 864, 870 (N.J. 1976).
6. *King v. Juliani*, 1993 WL 284462 (Conn. Super. 1993).
7. *Id.* at *3.
8. *In Re Allstate Ins. Co.*, 722 S.W.2d 947 (Mo. 1987) (en banc).
9. *Coscia v. Cunningham*, 299 S.E.2d 880 (Ga. 1983).
10. *Id.* at 882 (citation omitted).
11. *Id.* at 883 (citation omitted). *See also In re Petition of Youngblood*, 895 S.W.2d 322 (Tenn. 1995); *Kittay v. Allstate Ins. Co.*, 397 N.E.2d 200 (Ill. App. 1979).
12. Formal Op. 282 (1950). *Accord* Alabama Ethics Op. RO-81-533 (1982); Alaska State Bar Op. 99-3 (2000); Arizona Ethics Op. 75-4 (1975); California Standing Comm. on Professional Responsibility and Conduct, Formal Op. 1987-91, 1987 WL 109707 (1987); Colorado Bar Ass'n, Formal Ethics Op. 91 (1993); Illinois State Bar Op. 89-17 (1990); Iowa State Bar Op. 88-14 (1989); Michigan Ethics Op. CI-1146 (1986); New Jersey Supreme Court Comm. on Unauthorized Practice, Op. 23 (1984; Supp. to Op. 23, 1996); New York State Bar Ethics Op. 109 (1969); Texas State Bar Op. 167 (1958); Virginia Unauthorized Practice Op. 60 (1984); Virginia Legal Ethics Op. 598 (1985). *But see* Kentucky Unauthorized Practice Op. 11-48 (1981).
13. *Lieberman v. Employer's Ins. of Wausau*, 419 A.2d 417, 424 (N.J. 1980) (citations omitted). *See also King v. Juliani*, *supra* note 6, 1993 WL 284461; *In Re Allstate Ins. Co.*, *supra* note 8, 722 S.W.2d at 951; *Joplin v. Denver-Chicago Trucking Co.*, 329 F.2d 396 (8th Cir. 1964).
14. ABA Comm. on Ethics and Professional Responsibility, Informal Op. 1402 (1977).
15. California Formal Op. 1987-91, *supra* note 12 at *3. *See also Coscia v. Cunningham*, *supra* note 9, 299 S.Ed. at 683; *In Re Allstate Ins. Co.*, *supra* note 8, 722 S.W.2d at 953; *Strother v. Ohio Cas. Ins. Co.*, 14 Ohio Op. 139 (Ohio Com. Pl. 1939); *United Services Auto Ass'n v. Zeller*, 135 S.W.2d 161 (Tex. Civ. App. 1939).
16. *In Re Rules Governing Conduct of Attorneys in Fla.*, 220 So.2d 6, 7 (Fla. 1969).
17. *Id.* at 7. *See also Atlanta Int'l Ins. Co. v. Bell*, 475 N.W.2d 294, 297, n6 (Mich. 1991).
18. *Id.*
19. *Williams v. Bituminous Cas. Corp.*, 238 A.2d 177 (N.J. 1968).
20. 641 A.2d 1079 (N.J. App. Div. 1994).
21. California Formal Op. 1987-91, *supra* note 12 at *5.
22. *See, e.g.*, Arizona Comm. on Professional Ethics, Op. 75-4, *supra* note 12.
23. *Supra* note 2, 917 S.W.2d at 568.
24. *See, e.g.*, 60 Ala. Law 35 (1999); 73 Fla. B.J. 14 (May 1999). In 1999, the California Legislature enacted Insurance Code § 115802, which authorizes insurers to conduct billing reviews under certain circumstances.

25. *See, e.g., Davenport v. St. Paul Fire & Marine Ins. Co.*, 978 F.2d 927, 931 (5th Cir. 1992).
26. Nat'l L.J. A1, Col. 4 (May 15, 2000).
27. *In the Matter of the Rules of Professional Conduct*, 2 P.3d 806 (Mont. 2000). *See also State Farm Mut. Auto Ins. Co. v. Traver*, 980 S.W.2d 625, 633 (Tex. 1998).
28. *See, e.g., U.S. v. Massachusetts Institute of Technology*, 129 F.3d 681 (1st Cir. 1997).
29. Legalgard Information Services (*see* www.legalgard.com) is an audit firm whose practices have been criticized in two separate lawsuits filed in California. In another case, an insurer was held liable for interference with contractual relations between a law firm and its insured by refusing to pay a bill based on a legal audit. *Seltzer Caplan v. National Union Ins. Co.*, No. 684799 (San Diego County Superior Court). *See* Corp. Legal Times 1, Col. 1 (June 1997).
30. 2000 LWUSA 495 (May 29, 2000).