IN-HOUSE INSURANCE DEFENSE COUNSEL: PERMISSIBLE COST SAVING MEASURE OR IMPERMISSIBLE CONFLICT OF INTEREST

by Nathan Price Chaney[1]

Around the State of Arkansas, in-house insurance company lawyers are currently seeking represent policyholders in court in actions against those same policyholders. This article explores the legality and potential pitfalls of such representation.

I. ARKANSAS LAW PROHIBITS COMPANIES ACTING AS FIDUCIARIES FROM REPRESENTING THEIR CLIENTS.

Representation of a policyholder by in-house insurance defense counsel may violate the statutory prohibition on the unauthorized practice of law by a corporation. Arkansas law prohibits the practice of law by a corporation and provides a fine of not less than one hundred dollars ($100) nor more than five thousand dollars ($5,000) for any such activity, which is defined as follows:

> It shall be unlawful for any corporation or voluntary association to practice or appear as an attorney at law for any person in any court in this state or before any judicial body, *to make it a business to practice as an attorney at law for any person in any of the courts*, to hold itself out to the public as being entitled to practice law, *to tender or furnish legal services or advice, to furnish attorneys or counsel*, *to render legal services of any kind in actions or proceedings of any nature or in any other way or manner*, or in any other manner to assume to be entitled to practice law or to assume or advertise the title of lawyer or attorney, attorney at law, or equivalent terms in any language in such a manner as to convey the impression that it is entitled to practice law or to furnish legal advice, service, or counsel or to advertise that either alone or together with or by or through any person, whether a duly and regularly admitted attorney at law or not, it has, owns, conducts, or maintains a law office or any office for the practice of law or for furnishing legal advice, services, or counsel.

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> *The fact that any officer, trustee, director, agent, or employee shall be a duly and regularly admitted attorney at law shall not be held to permit or allow any such corporation or voluntary association to do the acts prohibited in this section* nor shall that fact be a defense upon the trial of any of the persons mentioned for a violation of the provisions of this section.[2]

Furthermore, injunctive relief, contempt proceedings, and disciplinary proceedings may be pursued against unlicensed entities handling cases on behalf of fiduciaries:

> (a) Any person, not a member of the Bar of Arkansas, … who shall solicit for himself … in any manner or by any method the handling of claims or litigation involving injuries to persons or damage to property, in such a manner as would constitute the practice of law, shall be deemed to have submitted himself to the personal jurisdiction of any circuit or chancery court having territorial jurisdiction of the county where the act was committed for disciplinary proceedings in the same manner as if he were a member of the Bar of Arkansas.
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> (b) In addition to any other lawful action the court might take in proceedings under this section, the court shall be authorized to enter an injunction restraining the commission of any acts mentioned in subsection (a) of this section and may enforce the injunction with contempt proceedings as provided by law in other cases.[3]

These two statutes were originally enacted in 1929 and 1947, respectively; thus, it has been the law in Arkansas for eighty (80) years that a corporation cannot practice law within this State.

The most pertinent opinion addressing these statutes is *Arkansas Bar Ass'n v. Union Nat'l Bank of Little Rock*, 224 Ark. 48, 273 S.W.2d 408 (1954) ("*UNB*"), in which the Arkansas Supreme Court upheld an injunction against Union National Bank ("UNB") prohibiting the bank from further violating the restriction on the unauthorized practice of law by corporations. In that case, the bank had two full-time employees who were licensed attorneys.[4] These attorneys drafted wills, trust instruments, and similar documents for bank customers, and the attorneys drafted pleadings and made appearances in both probate and chancery court on behalf of bank

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[2] Ark. Code Ann §16-22-211(a) and (c) (emphasis added).

[3] Ark. Code Ann. §16-22-208.

[4] *Id.* at 49, 273 S.W.2d at 409.

customers.[5] The Arkansas Supreme Court began its analysis by referring to the statute that ultimately became Ark. Code Ann. § 16-22-211 for the proposition that "corporations may not practice law."[6] The Court ultimately held that the banking corporation could not practice law in Arkansas courts on behalf of its customers. The Court rejected the theory that UNB was conducting its own business through its attorney employees and concluded that UNB's representation of customers in court constituted the unauthorized practice of law.[7] Thus, under the *UNB* case, it is unlawful for a corporation, either directly or indirectly through an employee who is a licensed attorney, to practice law except in connection with its own affairs.

Insurance companies owe their policyholders "the duty to exercise the utmost good faith,"[8] which is comparable to the fiduciary duties owed by UNB to its banking customers. Accordingly, were it presented with the question, the Arkansas Supreme Court could very well follow the *UNB* precedent and hold that insurance companies (and their in-house counsel) may not represent policyholders in Arkansas courts.

II. OTHER JURISDICTIONS PROHIBIT THE UNAUTHORIZED PRACTICE OF LAW BY INSURANCE COMPANIES SEEKING TO REPRESENT THEIR POLICYHOLDERS.

While there is no Arkansas case directly on point, case law from other jurisdictions holds that it is illegal for an insurance company, through its attorney employees, to practice law by representing policyholders.[9] The Kentucky Supreme Court recently reiterated this holding by stating:

> The age-old adage of "if it ain't broke, don't fix it" seems appropriate in disposing of Complainants' argument herein, especially in light of the fact that … there is now no compelling reason to overrule the more than fifty years of legal precedent which recognizes the principles outlined in that opinion. There is scarcely any judicial dissent from the proposition that a corporation cannot lawfully engage in the practice of law…. Moreover, a corporation cannot obtain license to practice law, since it is wholly incapable of acquiring the educational qualifications necessary to obtain such license, nor can it possess in its corporate name the necessary moral character required

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[5] *Id.*

[6] *UNB*, 224 Ark. at 50, 273 S.W.2d at 410.

[7] The Arkansas Supreme Court specifically distinguished the situation where a corporation is a named party to a lawsuit; in such cases, corporations may be represented by in-house counsel. *Id.* at 51-52, 273 S.W.2d at 410-11.

[8] *Southern Farm Bureau Casualty Ins. Co. v. Parker*, 232 Ark. 841, 848, 341 S.W.2d 36, 41 (1960).

[9] *See Gardner v. North Carolina State Bar*, 316 N.C. 285, 294, 341 S.E.2d 517, 523 (N.C. 1986).

> therefor. Nothing has changed … to assuage the moral dilemmas and ethical concerns connected to the unauthorized practice of law. *In fact, no situation is more illustrative of the inherent pitfalls and conflicts therein than that in which house counsel defends the insured while remaining on the payroll of the insurer*. No man can serve two masters, regardless here of either any perceived "community of interest," or Complainants' Pollyanna postulate that house counsel will continue to provide undivided loyalty to the insured. Complainants' pleas for logic are unpersuasive, as we are inclined to view U-36 in the way in which Respondent characterizes the opinion -- as a prophylactic measure, not unlike the imputed disqualification rules. As such, we believe that U-36 logically discerns when house counsel would fall into that precarious position between employee of insurer and advocate of insured, and, thus, logically prevents the occurrence of such a happening, and its onerous fallout.[10]

Likewise, the Eighth Circuit Court of Appeals recognizes that an attorney employed by an insurance company will be under pressure to conform his efforts to satisfy the demands of his corporate employer:

> [W]e stress that the record does not indicate and the appellant does not contend that USF&G's attorney acted improperly. However, we cannot escape the conclusion that it is impossible for one attorney to adequately and fairly represent two parties in litigation in the face of the real conflict of interest which existed here. *Even the most optimistic view of human nature requires us to realize that an attorney employed by an insurance company will slant his efforts, perhaps unconsciously, in the interests of his real client [to] the one who is paying his fee and from whom he hopes to receive future business[,] the insurance company.*
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> Although it has perhaps become trite, the biblical injunction found in Matthew 6:24 retains a particular relevancy in circumstances such as these, "No man can serve two masters . . . ."[11]

While this case did not specifically involve the use of in-house counsel to represent an policyholder, the Eighth Circuit thought it was important to highlight the potential for conflict as between the wants and needs of the insurance company and its policyholder.

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[10] *American Ins. Ass'n v. Kentucky Bar Ass'n*, 917 S.W.2d 568 (Ky. 1996) (citations and quotations omitted) (emphasis added).

[11] *USF&G v. Louis A. Roser, Co.*, 585 F.2d 932, 938 n.5 (8th Cir. 1978) (emphasis added).

III. ETHICAL RULES PROSCRIBING CONFLICTS OF INTEREST ARE RELEVANT TO REPRESENTATION OF A POLICYHOLDER BY IN-HOUSE COUNSEL.

Given the ethical undertones for the statutory proscription against the corporate practice of law, it is important to look to the Arkansas Rules of Professional Conduct to determine when an attorney has a conflict between a client and a third party:

> (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
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> (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to … a third person or by a personal interest of the lawyer.
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> (b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:
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> (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
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> (2) the representation is not prohibited by law;
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> (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
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> (4) each affected client gives informed consent, confirmed in writing.[12]

"[W]hen a liability insurer retains a lawyer to defend an insured, the insured is the lawyer's client."[13] Indeed, in such a situation the lawyer must represent the policyholder "with undivided fidelity."[14] The insurer must give at least equal consideration to the interests of the

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[12] Ark. R. Prof. Conduct 1.7.

[13] *First American Carriers, Inc. and David Newman vs. The Kroger Company*, 302 Ark. 86, 90, 787 S.W.2d 669, 671 (1990) (adopting ABA Comm. on Ethics and Professional Responsibility, Informal Op. 1476 (1981)).

[14] *Id.* (adopting ABA Comm. on Professional Ethics and Grievances, Formal Op. 282 (1950)).

policyholder as to its own interests, or the insurer acts in bad faith.[15] Accordingly, the policyholder is undoubtedly the client in situations involving in-house insurance counsel. The real question is whether there is a significant risk of a conflict of interest between the policyholder's right to "undivided fidelity" and the attorney's obligations to the insurance company.

A. AN ARGUMENT CAN BE MADE THAT THERE IS CONCURRENT CONFLICT OF INTEREST BETWEEN A POLICYHOLDER AND HIS OR HER LIABILITY INSURER.

In most cases where in-house counsel seeks to enter an appearance in a case on behalf of a policyholder, the insurer has agreed to indemnify the policyholder within certain policy limits for specified acts of negligence. As discussed above, courts recognize that the employment of an attorney creates pressure upon the attorney to conform his efforts to satisfy the demands of his corporate employer.[16] In the context of an in-house attorney representing policyholders, courts outside of Arkansas have held that this pressure creates the presumption of a conflict of interest and the appearance of impropriety because it presents a significant risk that the representation of the policyholder will be materially limited by the personal interests of the lawyer (e.g., continued employment with the insurer).[17]

When insurers agree to provide a defense to policyholders, implicit in such agreement is that the counsel employed must be competent, unbiased, and able to exercise independent judgment on behalf of the client. Where the lawyer takes a stake in the litigation or where restraints are placed on the lawyer's exercise of independent judgment, a conflict of interest arises.[18] The Arkansas Rules of Professional Conduct provide many specific instances that demonstrate concurrent conflicts of interest, several of which are applicable in this situation.

For instance, in-house attorneys are not compensated by their clients, the policyholders. This requires in-house counsel to follow a specific rule:

> A lawyer shall not accept compensation for representing a client from one other than the client unless:
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> (1) the client gives informed consent;[19]

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[15] *Southern Farm Bureau Casualty Ins. Co. v. Parker*, 232 Ark. 841, 848, 341 S.W.2d 36, 41 (1960) (quoting *American Fidelity & Cas. Co. v. Nichols*, 173 F. 2d 830, 832 (10th Cir. 1949)).

[16] *USF&G v. Louis A. Roser, Co.*, 585 F.2d 932, 938 n.5 (8th Cir. 1978).

[17] Ark. R. Prof. Conduct 1.7(a)(2).

[18] *See* Ark. R. Prof. Conduct 1.7 cmt. 1.

[19] Informed consent is required to waive any conflict of interest; as a component of Ark. R. Prof. Conduct 1.7, it is discussed in a later section.

> (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and
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> (3) information relating to representation of a client is protected as required by Rule 1.6.[20]

This situation raises at least three problems. First, where an attorney is an employee of an insurer, his files belong to his employer, which prevents the attorney from complying with the mandate that the client's files be maintained in strict confidence. While some conflicts may be waived following informed consent, where would the attorney store a policyholder's litigation files if the policyholder refused to waive the right of confidentiality?

Second, and more troubling, is that the interests of an insurer are often adverse to those of a policyholder. The most common situation happens when the potential damages recoverable by the plaintiff exceed the liability insurance coverage extended by the insurer. In such circumstances, the policyholder is potentially liable for an excess verdict over and above the amount of insurance coverage. This potential conflict is illustrated by the U.S. Supreme Court case of *State Farm v. Campbell*.[21] That case involved a bad faith claim against an insurer for refusing to settle within policy limits following an automobile collision that killed one innocent victim and permanently maimed another.[22] Instead of settling the case within policy limits, which would have insulated its policyholder from an excess verdict, the insurer elected to gamble by taking the case to trial and contesting liability, all the while assuring the policyholder that his interests would be protected.[23] The insurer's attempt to escape payment of policy limits was catastrophic to the policyholder, which wound up with an excess verdict against him for more than $135,000.[24] Because the insurer had so clearly violated its duty of good faith to protect the interests of its policyholder, the U.S. Supreme Court held that punitive damages were warranted.[25] On remand, the Utah Supreme Court entered judgment against the insurer for approximately $1,000,000 in compensatory damages and $9,000,000 in punitive damages.[26]

While the *State Farm v. Campbell* case did not involve an insurer using in-house counsel to represent a policyholder, it does capture one of the many potential conflicts of interest between an insurer and its policyholder. Recently, many insurers have taken a hard line against paying even meritorious claims by adopting a "delay, deny, defend" strategy in order to cut costs

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[20] Ark. R. Prof. Conduct 1.8(f).

[21] *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 123 S. Ct. 1513, 155 L. Ed. 2d 585 (2003).

[22] *Id.* at 412-13, 125 S. Ct. at 1517-18, 155 L. Ed. 2d at 598.

[23] *Id.*

[24] *Id.*

[25] *Id.* at 429, 125 S. Ct. at 1526, 155 L. Ed. 2d at 608.

[26] *Campbell v. State Farm Mut. Auto. Ins. Co.*, 2004 UT 34, ¶ 1, 98 P.3d 409, 410-11 (2004).

and increase returns to shareholders at the expense of their policyholders.[27] Outside attorneys that exercise independent judgment, make fair and ethical recommendations regarding settlement, and confirm their advice in writing often find themselves out of work.[28] The "delay, deny, defend" strategy now pervades every aspect of the claims handling process, including litigation, and is based upon the recognition that increased profits can only come from paying claims quickly or fairly, but not both.[29]

As mentioned above, outside defense attorneys who are not willing to use hardball tactics routinely find themselves out of work.[30] Rightly or wrongly, the perception is that in-house insurance counsel find such work precisely because they are willing to play ball with the insurer's hardnosed tactics. However, such willingness implicates another ethical rule:

> 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.[31]

As employees, in-house attorneys necessarily report to superiors within the insurance company and are paid by the company itself. It is reasonable to expect that in-house attorneys receive bonuses based upon their performance on litigation files. However, compensation packages that reward in-house counsel raise concerns about the following ethical rule:

> A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client, except that the lawyer may:
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> (1) acquire a lien granted by law to secure the lawyer's fee or expenses; and

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[27] *See* "Insurance companies fight paying billions in claims," available at http://www.cnn.com/CNN/Programs/anderson.cooper.360/blog/2007/02/insurance-companies-fight-paying.html (Feb. 7, 2007).

[28] *See* Sue Di Paola, "Confessions of a Former Insurance Defense Lawyer," California Applicant's Attorney Association Journal (2002).

[29] *See* "In Tough Hands at Allstate," Business Week, May 1, 2006, available at http://www.businessweek.com/print/magazine/content/06_18/b3982072.htm?chan=gl (last visited Mar. 16, 2010).

[30] *See* Sue Di Paola, "Confessions of a Former Insurance Defense Lawyer," California Applicant's Attorney Association Journal (2002).

[31] Ark. R. Prof. Conduct 5.4(c).

(2) contract with a client for a reasonable contingent fee in a civil case.[32]

When attorneys receive compensation for performance on litigation files by someone other than the client, then the attorney arguably receives a proprietary interest in the cause of action.

B. SOME CONFLICTS OF INTEREST BETWEEN POLICYHOLDERS AND INSURERS CANNOT BE WAIVED.

As discussed at length above, longstanding Arkansas code and case law prohibit a corporation from practicing law on behalf of its customers, even by and through attorneys employed by the corporation. Ark. R. Prof. Conduct 1.7(b)(2) prohibits a waiver of a conflict of interest when the representation is prohibited by law. Therefore, if representation of a policyholder is illegal under the *UNB* case discussed previously, then such representation also violates the Arkansas Rules of Professional Conduct because it involves a conflict that cannot be waived.

C. EVEN FOR A WAIVABLE CONFLICT, THE CONFLICT MUST BE FULLY DISCLOSED AND INFORMED CONSENT RECEIVED BEFORE REPRESENTATION BEGINS.

Until the Arkansas Supreme Court addresses the issue, trial courts in Arkansas may elect to treat representation by in-house counsel as a nonwaivable conflict (due to illegality) or as a waivable one. For a waivable conflict, the attorney must receive informed consent before commencing representation.[33]

Informed consent requires an acknowledgement that an actual or potential conflict exists, as well as "adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct." [34] In order to receive informed consent, it would appear that in-house counsel would be required to offer competent evidence by showing that he or she has informed the policyholder of the following:

- The attorney is employed by the insurance company;
- The attorney receives additional compensation from the insurance company based upon his or her performance, which could lead to decisions made for personal financial gain rather than made in the best interest of the policyholder;
- The attorney takes direction from the insurance company regarding the course and conduct of the policyholder's litigation;

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[32] Ark. R. Prof. Conduct 1.8(i).

[33] Ark. R. Prof. Conduct 1.7.

[34] Ark. R. Prof. Conduct 1.0(e).

- The policyholder may be exposed to excess liability if the insurance company refuses to settle the plaintiff's claim; and

- The attorney is under pressure to perform his job to the expectation of his supervisors, rather than exercising personal judgment on how to conduct litigation.

There are many other possible pitfalls associated with in-house insurance counsel representing policyholders set forth above. Unless and until a showing of informed consent has been made as to each of the possible ethical problems raised by in-house insurance defense counsel, the ethical rules appear to prohibit representation of a policyholder by an in-house lawyer for an insurance company.

The Arkansas Rules of Professional Conduct state that the duty to avoid conflicts of interest and the appearance of impropriety begin with the lawyer undertaking the representation.[35] Where it appears that the lawyer has neglected his responsibility to avoid such conflicts, the court before which the matter is pending may investigate.[36] Where the conflict "calls in question the fair or efficient administration of justice," opposing counsel may question the propriety of representation.[37] These rules remind us that ours is a self-policing profession, and if we are to maintain the public's trust, we must govern ourselves to high ethical standards.

IV. CONCLUSION: ANY REQUEST FOR INFORMED CONSENT WOULD REQUIRE A PATENTLY UNFAIR HOBSON'S CHOICE.

Most insurance contracts today contain a duty to defend clause. The duty to defend requires that the insurer provide the policyholder with an attorney who will protect the policyholder's interests. The issue of informed consent really begs the question of what the policyholder must do if he refuses to waive the conflicts posed by being represented by his insurer's employee-attorney.

If the in-house attorney has an actual or perceived conflict between the insurer and the policyholder, is the insurer really complying in good faith with its duty to defend? What if the policyholder declines to waive the conflicts? Is he required to hire his own attorney? What good is the duty to defend clause to the policyholder then? Is the policyholder only entitled to independent judgment under his insurance policy if he pays for it out of his own pocket, over and above his insurance premiums?

It is unfair for an insurer to require, as a condition precedent of providing an attorney under a duty to defend clause, that the policyholder make a Hobson's choice of having no attorney or waiving any conflict as to the confidentiality of his litigation files, the personal and financial motivations of the attorney, and the election by the insurer and its employee-attorney of litigation strategies adverse to the policyholder's best interests.

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[35] Ark. R. Prof. Conduct 1.7 cmt. 36–37.

[36] *Id.* at 36.

[37] *Id.*