
Insurance Counsel

Liability Insurer May Use Lawyers that Are Its Employees to Defend a Suit against an Insured, If the Interests of the Insured and the Insurer are “Congruent,” but not Otherwise

Staff Attorney Must Fully Disclose to the Insured the Nature of the Lawyer’s Affiliation with the Insurer

Unauthorized Practice of Law Committee v. American Home Assurance Company, Inc. & The Travelers Indemnity Company, No. 04-0138, ___ S.W.3d ___, 2008 WL 821034 (Tex. March 28, 2008)

Case at a Glance

This case decides for Texas—after several years of controversy—whether a liability insurer (and, by implication, integrated groups of them) may legally discharge its duty to defend by using attorneys employed by the insurer (or a member of the group) to defend an insured. One of the main questions was whether an insurer trying to do this would itself be practicing law—an activity which the law forbids. The court held, by a 7-2 vote, that an insurer’s use of staff counsel to defend its insured is not the practice of law if the interests of the insurer and the insured are “congruent,” which means they are the same under some circumstances and very nearly the same under others, and if the staff counsel provided the insured—his/her client—with a (timely) full disclosure of the relationship between the insurer and the defense lawyer. The interests of the defending liability insurer and the defended insured are congruent when (1) the insurer and the insured are “aligned in defeating the claim,” and (2) “there is no conflict of interest between the insurer and the insured.” The two judge minority took the opposite view. It would have held that the State Bar Act forbids a corporate insurer from representing anyone other than itself, and when an employee of a corporation is performing an act, the corporation is performing that act. Hence, when a staff attorney of an insurer is representing an insured, so is the insurer. Consequently it is practicing law

without a license, and so is engaged in the unauthorized practice of law.

Summary of Decision

Many liability insurers have, as a result of their insurance contracts with their insureds, a duty to defend their insureds under appropriate circumstances; often if they have that right, they also have the right to control the defenses of those cases. This right has long included, under most circumstances, the right to select counsel. According to Justice Hecht, the author of the seven-judge majority opinion, this right has long included—at the discretion of the insurer—the right to use in-house or staff counsel. Apparently, this practice runs back to at least 1892, and it has been approved as “not unethical” twice in opinions issued by the American Bar Association and once by the appropriate Texas Bar committee. Thus, Justice Hecht asserts, “it is safe to say that the practice is now, and has long been widespread [across the country, and t]he same is true in Texas.” An amicus curiae brief filed by several insurers states that 15 or more liability insurers use staff counsel, that there are at least 220 staff counsel employed in Texas, that they utilize at least 39 offices, and that over 10,000 cases were handled by staff counsel in 2005.

The long and widespread use of staff counsel plays a significant role in the court’s decision. Justice Hecht also notes that liability insurers have long defended the practice as “significantly more efficient and economical . . . thereby reducing the costs and [hence] premiums.” Significantly, neither the majority nor the minority express any doubt about the conclusion in this argument.

Past Litigation. The use of house counsel to defend policyholders has been controversial in Texas for more than a decade. Although the court does not make this point, the defense bar is hostile to the practice, for obvious reasons, and insurers often don’t like it either.

In 1998, Nationwide Insurance Company sued the Texas Unauthorized Practice of Law Committee in federal court. Nationwide went to federal court and sought a declaration that Texas law did not forbid the practice and that if it did, the law was unconstitutional. The district court dismissed Nationwide’s case, and the circuit court affirmed, noting in passing that Texas law could be interpreted so as to permit a liability

insurer to hire and use staff counsel, Texas law on the unauthorized practice of law was “uncertain enough” that a federal court should abstain from ruling on federal constitutional issues. *Nationwide Mutual Insurance Company v. Unauthorized Practice of Law Committee*, 283 F.3d 650 (5th Cir. 2002). Nationwide then started over again in Texas state court, won its case, and that case was affirmed on appeal. *Unauthorized Practice of Law Committee v. Nationwide Mutual Insurance Company*, 155 S.W.3d 590 (Tex. App.—San Antonio 2004, petition pending). On the same day that the Texas Supreme Court issued its opinion in the present case, it denied review in the *Nationwide* case.

This Case. In 1999, a staff defense lawyer with American Home received notice that the Committee was investigating whether she and other staff lawyers at American Home for engaging in the unauthorized practice of law. Almost immediately, American Home and Travelers filed suit, and the Committee counterclaimed shortly thereafter. On cross-motions for summary judgment, the motions of the insurers were denied, but that of the Committee was granted. The judgment was suspended pending appeal, subject to conditions apparently regarding the avoidance of conflicts of interest. The court of appeals reversed, in a complex opinion addressing a variety of issues regarding insurance defense and the law of lawyering. *American Home [Etc.] v. Unauthorized Practice of Law Committee*, 121 S.W.3d 831 (Tex. App.—Eastland 2003, aff’d as modified). The Committee appealed to the Supreme Court on only two issues, however. First, if a liability insurer uses staff counsel to defend an insured, is the insurer engaged in the unauthorized practice of law? Second, if not, must the insurer-attorney relationship be fully disclosed to the defended insured?

Agreed-to Starting Points. All parties agreed that corporations are not authorized to practice law in Texas. This follows from the rules set down by the Texas Supreme Court. (The court does not need to—and so does not consider whether applicable rules have been set down by article 2.02(B)(2) of the Texas Business Corporation Act.) The parties also agreed, as does the court and Texas legal history, that a company does not engage in the practice of law by hiring lawyers for its salaried staff to represent its own interests. Similarly, everyone relevant agreed that a liability insurer is not practicing law when it retains

private counsel to defend one of its insured, when it gives that lawyer directions in accordance with its rights under the relevant contract of insurance—whether these being the right to defend or the right to settle.

Under existing Texas law, says Justice Hecht, a corporation is engaging in the unauthorized practice of law, only if it performs legal services *for someone else* (or provides them to someone else). See §81.101(a) of the Texas Government Code. As we shall see, according to the majority, if a corporation represents itself it is not practicing law at all. Here is how the majority interprets the statute just mentioned: “This section does not mean that a corporation engages in the practice of law when its attorney-employees provide legal advice regarding the corporation’s own affairs *or represent others with identical interests in court*. Only when a corporation employs attorneys to *represent the unrelated interests of others* does it engage in the practice of law.” (Italics added.)

The last two sentences are the key element in Justice Hecht’s argument! The following question is how Justice Hecht formulates the central issue in the case. “[W]hether an insurer that uses staff attorneys to defend claims against insureds is practicing law or simply *defending its own interests in discharging its contractual duty to the insureds and defending claims it would be required to indemnify[?]*”

The question came up before in the historically significant case of *Hexter Title & Abstract Company v. Grievance Committee*, 179 S.W.2d 946 (Tex. 1944). In that case, Hexter, a title conveyance and title insurance company, prepared legal opinions regarding defects in title and distributed them without charge to at least some customers. Hexter maintained that the express purpose for distributing these opinions was to recruit customers for the sale of insurance; it was not therefore the practice of law. The Texas Supreme Court unequivocally rejected this view *Hexter* and reiterated that position in the present case. After outlining the facts in *Hexter*, Justice Hecht observed: “If Hexter’s rendition of legal services to customers and prospective customers was not the practice of law, then it was difficult to imagine what would be.”

From *Hexter*, Justice Hecht distilled three factors for determining whether an insurer/corporation is engaged in the unauthorized practice of law. First, the

corporation does not have already existing interests at stake being served by the legal services. Second, the corporation does not have "a direct [and] substantial financial interest in the matter for which it provide[d] legal services." Third, and most important, the corporation and the customer do not have identical financial interests. Exactly these three principles were met in *Hexter*. Significantly, none of them need be met when a liability insurer defends an insured, because in that case "there is for all practical purposes only one client involved." (Significantly, Justice Hecht is here quoting from a 1968 opinion—#343—of the Committee on Interpretation of the Canons of Ethics of the State Bar of Texas.) Defending liability insurers and defended insureds will have different and divergent interests only if there are coverage questions or when there is an argument about the manner of the defense.

Upon this basis, the majority reaches its conclusion. "[A] liability insurer does not engage in the practice of law by providing staff attorneys to defend claims against insureds, provided that the insurer's interests and the insured's interests in the defense in the particular case at bar are congruent. In such cases, a staff attorney's representation of the insured and the insurer is indistinguishable." (Notice that Justice Hecht is asserting that the insurer is not practicing law at all. He is not asserting that the insurer is not engaging in the unauthorized practice of law. This different will come up again in the "Comment" below. Notice also that he says that the staff attorney is representing the insurer and the insured but that there is only one representation. This too will come up in the "Comment" section.)

Court Rejected Arguments. The Committee and its amici argued before the Texas Supreme Court that the employment relationship between the insurer and the staff defense counsel essentially conflicts with the attorney client relationship and that this conflict is so strong that it is not only ever present but also dangerously influential. The court rejects this view since the Committee presented no empirical evidence supporting this assertion. "Given that insurers have used staff attorneys across the country for decades, the last of evidence of harm is an important consideration."

The presence of a coverage dispute between a liability insurer and an insured entitled to a defense is a different matter. History and custom indicate that

when adjusters identify a serious conflict, they do not use staff counsel. As already stated, the presence of a conflict which establishes or is equivalent to the relevant incongruence of interests therefore blocks the use of staff counsel. The court, however, recognizes that not every situation which might look like a conflict actually is a real or dangerous conflict. Routine reservation of right letters do not automatically entail the existence of a conflict. "A reservation-of-rights letter ordinarily does not, by itself, create a conflict between the insured and the insurer; it only recognizes the possibility that such a conflict may arise in the future," observes the court. (Still, says Justice Hecht, it may be prudent to use outside counsel when there is a reservation-of-right letter, and some doubt of what will happen in the future.)

Justice Hecht examines several unclear situations which raise interesting questions but do not obviously and automatically generate a duty to use outside counsel:

- If a defense counsel learns a fact about his client which would injure coverage, the lawyer must keep it to himself. This would apply to in-house, staff counsel. The fact that staff counsel has knowledge of this kind of secret implies that other staff counsel may also automatically be deemed to know it—just as it would in a law firm—but, in Justice Hecht's view, it is not clear that the knowledge of staff counsel would automatically be attributable to any adjuster in the company. Justice Hecht concludes that these problems "do not necessarily destroy the congruence of the insurer's and insured's interests." He points out that "it could be argued that a staff attorney's knowledge of confidential information would estop the insurer from using it altogether."

- There is the problem of demands to settle within policy limits—known in Texas as "the *Stowers* Demand." The Committee argued that staff counsel cannot be counted upon to advocate the point of view of the client to the insurer—as s/he must, given the lawyer's duty of undivided loyalty—and would have an obligation to argue and act only in accordance with his employer's internal rules. The

majority implicitly acknowledges the power of this argument, but points out that outside counsel often have an analogous problem and—more significantly—that there is no empirical evidence to support even the occurrence of the type of event contemplated.

- The Committee argued that staff counsel cannot exercise independent judgment for his client because of being an employee of the insurer. The court rejects this view because there was evidence to support the idea that either of the party-insurers do not so restrict their staff counsel.

- An amicus alleged that staff counsel cannot attend to relevant personal concerns of an insured client in the same way that outside defense counsel could. The majority sees to reason to believe this.

- The Committee argued that staff counsel is more likely to represent both the insured and the insurer. The court points out that there is no Texas rule against doing this. “[W]e have never held that an insurance defense lawyer *cannot* represent both the insurer and the insured, only that the lawyer *must* represent the insured and protect his interests from compromise by the insurer.”

First Majority Conclusion. There are circumstances under which a corporate insurer is practicing law and would therefore be engaged in the unauthorized practice of law. To put the matter simply, this would happen when the insurer and the insured are not really united in opposition to the claim against the insured. Here is what Justice Hecht says about this. “If [1] an insurer’s interest conflict with an insured’s or [2 if] the insurer [other than staff counsel] acquires confidential information that it cannot be permitted to use against the insured or [3 if] an insurer attempts to compromise a staff attorney’s independent, professional judgment, or [4 if] in some other way the insurer’s and insured’s interests do not have the congruence they have in 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.” And, of course, any such practice would be unauthorized. However, the court said “there are a great many cases that can be defended by staff attorneys without conflict and *to the benefit of mutual interests*. The use of staff counsel in those cases does not constitute the unauthorized practice of law [by the insurer, since it is not practicing law at all, although the staff lawyers are].” (Italics added.) As already stated, this is true because staff counsel is, (1) in economic reality, representing only the insurer, since only its money is at stake, or s/he is (2) in pragmatic reality representing the insurer and the insured—granted: two different entities, formally speaking, but—two very closely related entities (that are in some sense really only one entity).

Second Majority Conclusion. The Committee wanted the court to require insurers using staff counsel to make sure that the insured are notified as to who is representing them. The insurer defendants did not oppose this idea. Indeed, they virtually insisted that this was already done. The court therefore granted the Committee’s request. The Committee also wanted staff counsel forbidden from using a company name which sounded like a law firm. The court declined to consider this idea, however, since the Committee did not include this issue in its appeal.

Dissent. The unauthorized practice of law cannot exist unless there is a client, because unless there is a client, there is no practice of law. If a corporation uses staff counsel to represent itself, the acts of the staff counsel are the acts of the corporation, so there is no client. Things are different if staff counsel represents an insured. In that case, there is a client, and typically lawyerly things are done for that client, e.g., the filing of pleadings. “Insureds are, quite simply, legal entities *completely separate* from the insurance corporation who must be defended because of acts or omissions not considered to be those of the insurer. So the insurance corporation is *not representing itself* when it represents its insureds.” (Italics added.)

Comment

The holdings in this case are of no particular consequence. They are small in scope; they will not transform the practice of law to any significant degree; they do not buck a trend; they do not raise new issues.

Indeed, the holdings in this case fit with the existing legal tendency. The reasoning in this case is quite different.

The reasoning in this case is striking for two reasons. First, the Texas Supreme Court's majority and minority opinions embrace distinct approaches to legal reasoning. Under formalistic legal reasoning, statutes say what they say—or what the legislature intends them to mean—and the courts are subordinate to the legislature when it comes to interpreting statutes. Legal interpretation is to be as deductive as possible. Courts do not have the function of getting the language of statutes or rules revised to fit with social needs. The majority opinion is not a formalistic opinion. It is highly creative and innovative. The minority opinion, in contrast, is a paradigm of a formalistic opinion. Formalistic legal opinions eschew pragmatism. The minority opinion does exactly that, whereas the majority opinion embraces with hidden passion both pragmatism and responding to and dealing with social need.

Second, Texas has a nearly ironclad rule that no one can sue a lawyer for malpractice except for a client of that lawyer. The opinion in this case begins to undermine that rule. On one hand, it acknowledges that liability insurers and their insured are separate entities. On the other hand, it argues that there is another sense in which they are not really separate entities. After all, they have congruent interests regarding given litigation and so have roughly the same interests. If they have the same interests, then—in some pragmatic sense—they can be thought of as the same client, if not quite (from a metaphysical standpoint) the same entity. (But the minority asked, "How can two metaphysically distinct entities really be the same client?")

Justice Hecht's opinion has three more dramatic implications. First, it is pretty much committed to the view that if a staff-counsel defense lawyer represents an insured whose interests are relevantly identical to the interests of the insurer, then that lawyer represents the insurer. Second, and more importantly, this conclusion is not restricted to staff counsel; it would apply to out-of-house, hired defense counsel as well as it would apply to employee lawyers. Third, if the second point is correct, then liability insurers should be permitted to sue defense counsel for malpractice when they screw up cases of the insured and there is a congruence of insurer and insured

interests.

If I were advising liability insurer as to this new "Hechtian Insurance Defense World," I would advise carriers to adopt explicit rules directing staff counsel to serve the interests of the insured-clients. The rules would begin with a general rule, and would then include each of Justice Hecht's situations in which there might be a conflict of interest. The rules should require the staff counsel to act and speak on behalf of the interests of the insureds who are their clients. I might also recommend that insurers have actual, fully in-house counsel to whom staff defense counsel report, so that these lawyers could review their recommendations from the point of view of the interests of the insurer. Obviously, these insurer-oriented lawyers should not be part of the staff counsel staff. // Quinn