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INSURANCE LAW

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Using Staff Counsel to Represent Insureds

A carrier's use of in-house counsel raises ethical considerations

Insurance carriers often utilize in-house, or staff, counsel to represent their insureds in an effort to manage defense costs and expenses. The use of in-house counsel, while generally permitted in most states and specifically permitted in New Jersey, gives rise to some significant ethical considerations for both the in-house counsel and the insurance carrier. While many of these ethical considerations extend, to some degree, to the retention of outside counsel, the unique nature of the relationship between the carrier and in-house counsel creates a special set of problems that require additional safeguards and scrutiny.

The use of salaried staff counsel to represent the insured is inherently rife with potential conflicts of interest. Typically, a policy of insurance gives the carrier the right to select the attorney who will represent its insured. The selection of the attorney and payment of fees by the carrier has been identified as one source of potential conflict recognized by the New Jersey Committee on the Unauthorized Practice of Law (the Committee). The Committee's view is predicated on the principle that both in-house counsel and outside counsel owe an unqualified duty of loyalty to the insured. The New Jersey Rules of Professional Conduct (RPC) set forth the duties owed by the attorney. RPC 1.7(a) states, in relevant part, that the duty of loyalty is violated if the representation of one client will be directly adverse to another client, or there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibility to another client, a former client or a third person or by a personal interest of the lawyer. RPC 1.7(a)(2) is violated if the attorney's responsibilities to a third person (e.g., the carrier) or the attorney's personal interests (e.g., his or her employment) "materially" limit his or her representation of the client.

However, the notion that in-house counsel is unable to honor the duty of loyalty has been rejected by the Committee, and the practice of using in-house counsel has been given "more than nodding acceptance" by the Supreme Court. See *In re Weiss, Healey & Rea*, 109 N.J. 246, 254 (1988). In Opinion 23, the Committee concluded that "insurance companies conducting the defense of litigation in which they owe indemnification to their insureds through house counsel does not constitute the practice of law." See *Use of House Counsel by Insurance Companies to Defend Insureds*, Opinion No. 23, New Jersey Supreme Court Comm. on the Unauthorized Practice of Law, 114 N.J.L.J. 421 (1984).

Twelve years later, in its supplement to Opinion 23, the Committee directly addressed the "ethical concerns" arising out of the insured being represented by house counsel. *See Use of House Counsel by Insurance Companies to Defend Insureds*, Supplement to Opinion No. 23, New Jersey Supreme Court Comm. on the Unauthorized Practice of Law, 145 N.J.L.J. 935 (August 26, 1996). The Committee expressly rejected the notion that in-house counsel is unable to honor ethical obligations (e.g., the duty of loyalty) to the insured. The Committee reasoned that the ethical issues confronting in-house counsel were no different from those confronting appointed counsel in most insurance defense contexts. Accordingly, whether the insured was represented by staff counsel or outside counsel was merely a "distinction without a difference."

The clearest case in which no conflict will be found to exist is where the carrier is defending without a reservation of rights and the potential liability or exposure falls within the carrier's policy limits. Under those circumstances, only the carrier's money is at risk. However, in many instances, the

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carrier will defend subject to a reservation of rights and may not be obligated to indemnify the insured for some aspect of the claim or portion of the liability. Presumably, even in instances where the carrier has agreed to indemnify the claim in its entirety without reservation and it is believed that the claim will fall within the policy limits, the erosion of aggregate policy limits can create a potential conflict.

In Opinion 165, the New Jersey Advisory Committee on Professional Ethics (Advisory Committee) considered a situation where an attorney retained by the carrier (here, the Advisory Committee made no distinction between in-house and outside counsel) ascertains facts during the course of litigation which will expose the insured to liability not covered by the policy. See *Disputed Facts Regarding Coverage,* Opinion 165, New Jersey Advisory Committee on Professional Ethics, 92 N.J.L.J. 831 (December 18, 1969). In this instance, if counsel endeavors to prove or utilize the newly discovered facts, he will be taking a position adverse to the insured in violation of RPC 1.7 (duty of loyalty). Conversely, as an employee, he has at least some obligation to inform the insurance carrier of these facts, which may determine the availability of insurance coverage.

The Advisory Committee determined that the attorney is forbidden from taking a position adverse to the interest of the insured. However, the Committee also recognized that the attorney's duty to the carrier requires that he disclose the information. The Advisory Committee recommended that a declaratory judgment action be instituted by the carrier against the insured and the plaintiff. The Advisory Committee set further guidelines to deal with such conflicts when they arise: The assigned defense attorney is forbidden from appearing for any of the parties in the declaratory judgment action. Under no circumstances is the original assigned defense attorney allowed to proceed with the defense of the insured in the main case until the disputed facts have been determined through the declaratory judgment action. The original action is to be stayed pending the determination of these issues, after which, the original counsel may, with the consent of both the insured and the carrier, continue as counsel of record for the insured.

In Opinion 502, the Advisory Committee on Professional Ethics considered the duty of assigned defense counsel where there is a question of coverage raised by the carrier at the inception of the lawsuit. In many instances, a carrier may properly provide a defense subject to a reservation of rights. The Advisory Committee recognized that the obligation of the carrier to provide the insured with a defense is a duty distinct from the carrier's obligation to indemnify the insured. The Advisory Committee was mindful that the duty of the attorney hired by the insurance carrier "runs to the insured" and is not diluted because the attorney is paid by the carrier.

The Advisory Committee recognized and cautioned that it is customary for the carrier to forward to the assigned defense counsel a copy of its investigation file, which may include notes or other commentary relevant to the availability of insurance coverage. This presents a potential conflict for defense counsel because counsel may learn which portions of the claim are not covered and may be tempted to defend the case in such a way that liability attaches to the uncovered claims.

This scenario is common and, while controls may be put in place which will minimize or prevent the disclosure of coverage information to assigned defense counsel, the use of in-house counsel presents special difficulties. This problem is further complicated by New Jersey's elimination of the "appearance of impropriety" doctrine from the New Jersey Rules governing attorney ethics. Many of the prior New Jersey Court and Advisory Committee rulings, which would generally provide guidance, may no longer be applicable after the 2004 amendment to the RPC.

While conflicts may be waived, provided each affected client gives informed consent, in writing, after full disclosure and consultation, such waiver will rarely be obtained in view of the inherently prejudicial effect such waiver would have on one party, usually the insured, if client information is shared with the carrier.

RPC 1.6(a) requires the lawyer to preserve in confidence all "information relating to representation of a client." The duty includes all information relating to the client, regardless of the source from which it is acquired. This duty applies to accidentally or casually acquired information.

The problem for in-house counsel in this regard is somewhat unique, especially for in-house counsel who share office space with the claims department. Suppose, for example, in-house counsel is defending claims contained in one count of a complaint. The second count contains claims not covered under the policy and the insured is being defended by personal counsel against these claims. In-house counsel learns that the insured must avoid the publicity of a trial at all costs. If this confidential information is revealed to the carrier, the carrier may be inclined to limit its contribution to a settlement, understanding that the insured will be inclined to contribute a disproportionate share so as to avoid trial. While outside counsel may be privy to such information and may be inclined to reveal it to the carrier, it is likely that in-house counsel will have more opportunity and perhaps more incentive to make such a revelation.

The New Jersey Rules of Professional Conduct, which address the independence of the lawyer, present the most daunting obstacle for the practice of in-house attorneys. RPC 5.4 prevents a lawyer from allowing a nonlawyer to direct or control his professional judgment. RPC 5.5 treats such directional control as the unauthorized practice of law and the lawyer who fails to maintain professional independence is unethically contributing to the unauthorized practice.

This mandate is often not easily achieved. In-house counsel often operate within a nonlawyer management structure, which may be contrary to the professional independence espoused by the RPCs. The judgment of in-house counsel may also be compromised by corporate policies, staffing limitations or other strictures which materially affect independent judgment.

The insurance carrier and the in-house counsel must work together to minimize or eliminate the ethical issues that may arise.

1. Carriers should prohibit or carefully limit the use of in-house counsel where the defense is being provided sub-

ject to a reservation of rights or where the carrier's indemnity obligation has not been fully determined to avoid potential conflicts of interest.

2. In-house counsel should not have access to computer files or systems maintained by the claims department. Likewise, the claims department should have only limited access to computer files or systems maintained by the legal department. In the same regard, the carrier should not forward to the assigned defense counsel those portions of its investigation file, which may include correspondence, notes or other commentary, relevant to the availability of insurance coverage.

3. A nonlawyer may not control the means by which the objectives of the litigation are pursued. In-house counsel may not be directed by management or the claims department. A managing attorney should supervise in-house counsel.

4. When staff or outside counsel ascertains facts during the course of litigation which will expose the insured to liability not covered by the policy, a declaratory judgment action should be filed by the carrier against the insured and the plaintiff. The assigned defense counsel should not appear for any of the parties in the declaratory judgment action. The original action should be stayed until the issue of coverage has been determined through the declaratory judgment action.

5. Carriers should restrict the use of in-house counsel where the carrier believes that the claim will exceed its policy limits or where erosion of aggregate policy limits could expose the insured to liability over policy limits. ■