

West Virginia LOB

L.E.I. 99-01

Ethical Propriety of Insurance Company Captive Law Firms

The Lawyer Disciplinary Board undertook a review of a growing practice by insurance companies, when providing a legal defense for their insureds, to use lawyers who are salaried employees of those companies and who practice in a law firm setting using a law firm name. There are currently three such law firms in West Virginia. A subcommittee solicited public comments on the "captive law firm" issues from various legal associations; asked the three law firms to respond to a questionnaire; and invited representative of the firms to appear before the subcommittee.

The lawyers in the captive law firms are full-time, salaried employees of the insurance company, which also pays the office rental and all business expenses. The lawyers only work on defense or subrogation cases involving their employer. According to the responses to the questionnaires, the lawyers' compensation is not tied to the outcome of the cases; however, all had the potential to receive merit or performance bonuses.

At the time of the subcommittee's initial review, the captive firms had firm names which did not identify themselves as being affiliated with an insurance company, such as Taylor, Jones & White or Law Offices of William Black. These firms do not advertise or hold themselves out as accepting cases from the general public.

The Lawyer Disciplinary Board essayed to answer two basic questions: (a) May an insurance company use in-house attorneys to represent its insured under the Rules of Professional Conduct; and (b) is the operation of a captive law firm misleading to the public

in violation of the Rules of Professional Conduct.¹ To answer these two questions, the Board considered the following issues and made the following determinations:

(1) Are the lawyers' abilities to represent an insured materially limited by their full-time employment with the insurance company, in violation of Rule 1.7(b) of the Rules of Professional Conduct?

The Lawyer Disciplinary Board has serious concerns that the lawyers' full-time employment by the insurance company may, in some situations, materially limit the lawyers' ability to represent the interests of the insured, who is the sole client to whom the lawyer owes a primary duty of loyalty and confidentiality. This would be a violation of Rule 1.7(b), which provides in pertinent part:

(b) A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by a lawyer's own interests, unless:

- (1) the lawyer reasonably believes the representation will not be adversely affected; and
- (2) the client consents after consultation.

The problem arises because of the lawyer's dual loyalty. On the one hand, the lawyer owes a duty to the client pursuant to the Rules of Professional Conduct. On the other hand, the lawyer owes a duty of loyalty to his employer, the insurance company. In some situations, these conflicting loyalties may create tension, particularly in cases where the interests of the lawyer's client conflict with those of the lawyer's employer.

¹ The Board did not attempt to determine whether the use of in-house attorneys constitute the practice of law by a corporation in violation of West Virginia Code § 30-2-5. Unlawful practice questions are primarily within the domain of the Unlawful Practice Committee of The West Virginia State Bar, and the Board referred this question to the ULP.

In an ideal world, the lawyer should be expected to respond by resolving any conflict in favor of the client. In reality, however, these decisions often involve the exercise of judgment that may be influenced, consciously or unconsciously, by the pressures inherent in an employer-employee relationship, particularly where the employment relationship is "at will" and there are no guarantees of job security.

Although the Board does not find representation by in-house counsel a conflict of interest *per se*, the potential for conflict is significant enough that the Board has set forth guidelines which lawyers employed by an insurance company should follow and insist upon and which outline potential conflicts which the lawyers should review on a case by case basis.

A. The insured is the sole client.

For lawyers employed full time by an insurance company to function in an ethical manner, the lawyers and the insurance company must act according to the principle that the attorney represents the insured, not the insurance company.

[While] there is often a community of interest between the insured and the insurance company, there are instances, however, of potential conflicts. For purposes of analyzing a lawyer's responsibilities under the Rules of Professional Conduct, the lawyer must treat the client as the sole client, not a client being represented jointly with the insurance company. Attorneys who allow an employer to interfere with their duties under the Rules of Professional Conduct are subject to discipline. The fact that the insurance company employer encouraged, coerced or required conduct

in violation of the Rules of Professional Conduct will not excuse such a violation. Conversely, if an insurance company employer engages in policies or practices that discourage or may reasonably tend to discourage an attorney from fulfilling his or her duties under the Rules of Professional Conduct, then employment by such a firm may constitute a per se violation of the Rules.

The Board also concludes that a reasonable insurance company employing attorneys to represent its insureds should be expected to adopt written policies that protect its attorney employees from any conduct that might discourage them from complying with their duties and responsibilities under the Rules of Professional Conduct, that affirmatively state the insurance company's expectation that its attorneys will act in accordance with those Rules and that provide those attorneys with a reasonable and meaningful grievance procedure in the event that any problems arise. While the Lawyer Disciplinary Board does not presume to dictate the exact nature of those policies, they should insure that no adverse action will be taken against attorneys or support staff for conduct that they reasonably believe to be consistent with or required by the Rules of Professional Conduct.²

B. The insured is entitled to attorney-client confidentiality

Attorney-client confidentiality is one area in which the duty of loyalty must be accorded the insured. Certain disclosures are

² Given the importance of the public policies inherent in the Rules of Professional Conduct, the termination of an attorney-employee for acts or omissions required by those Rules may well be construed to support a cause of action under *Harless v. First National Bank in Fairmont*, 162 W.Va. 116, 246 S.E.2d 270 (1978), and its progeny.

"impliedly authorized in order to carry out the representation" within the meaning of Rule 1.6(a), such as reports to the insurance adjuster. However, disclosures to the insurance adjuster which are outside the community of interest are not authorized.

For example, should coverage be an issue, and the insurance company is providing a defense under a reservation of rights, the lawyer must not convey to the company information adverse to the insured concerning coverage learned during his or her representation. To do so would be a violation of Rule 1.6 of the Rules of Professional Conduct. Asking the client for a waiver to provide this information would run afoul of the Comment section to Rule 1.7:

[W]hen a disinterested lawyer would conclude that the client should not agree to the representation under the circumstances, the lawyer involved cannot properly ask for such agreement or provide representation on the basis of the client's consent.

Because the insured is the client, the lawyer must also control access of others to the insured's file. The Lawyer Disciplinary Board is of the opinion that captive law firm attorneys must treat the client file as confidential and provide information needed by others outside the firm in summary form.

The captive law firms generally have a managing attorney within the office who answers to a regional or national level counsel. The insurance companies vary in terms of how much access lawyers outside the local captive law firm have to the files. Some want complete access and some insist on access during the litigation. Such a review might jeopardize attorney-client confidentiality if a coverage issue is present or if there are co-defendants or third party defendants also insured by the same

company. Even after the litigation has concluded, there may be privileged information or otherwise confidential information in the files which might cause an insurance company to cancel an insured's policy or substantially increase the insured's premium. Such information which would be adverse to an insured's interests, vis-à-vis the insurance company, must not be disclosed and must be held in the strictest confidence.

Oftentimes, and rightfully so, individuals who are assigned an attorney by their insurance carrier believe that person really is their attorney, even for matters beyond the automobile collision that initiated the process. For instance, many individuals will feel very comfortable in divulging confidential matters concerning their personal life, their marriage, their finances, and even their criminal history, whether known or unknown. Those individuals may not fully appreciate the divided loyalty present when a full-time employed lawyer of the insurance company is representing them.

This is an area in which outside counsel stand in a different position. They are not subject to review and supervision by a lawyer not from their own firm and not licensed in West Virginia.³ Although a large corporation may have its own counsel direct the conduct of local counsel in litigation, the important difference in that situation is that the corporation is the client. In this case, the insured, not the insurer, is the client.

³ The Comment to Rule 1.6 states that "Lawyers in a firm may, in the course of the firm's practice, disclose to each other information relating to a client of the firm, unless the client has instructed that particular information be confined to specified lawyers."

Closed case files must also be protected. The information in those files may not be used by the insurance company for any purpose. They are not the property of the insurance company, and the captive firm must take responsibility for the files and their confidentiality as would a private law firm. Should a captive firm cease functioning, the managing attorney must oversee the proper transfer or disposal of client files in accordance with the Rules of Professional Conduct. Under no circumstances can these client files be transferred to the insurance company even if the captive firm is dissolved or the managing lawyer leaves or is terminated. Such pending and closed client files must be handled in accordance with the Rules by a licensed member of the West Virginia State Bar.

C. Objectives of representation and Professional Independence

Rule 1.2(a) of the Rules of Professional Conduct provides in part that a lawyer shall abide by a client's decisions concerning the objectives of representation. Even though an insured usually does not have the right to reject or accept a settlement, by contract with the insurance company, there are still areas in which the objectives of the insured may conflict with those of the insurance company.

For example, when coverage is dependent upon whether the defendant is found at trial to have acted negligently or intentionally. Since the client is the insured, the lawyer must strive to achieve a result favorable to the client, not the insurance company.

Another example of the potential for conflict is when the insured is exposed to potential liability in excess of the policy limits. The insured has an interest in the insurance company

settling within policy limits. If there is a reasonable basis for settlement and the insurance company does not negotiate in good faith, the insured may have a claim against the company under common law and the Unfair Claims Settlement Practices Act. *Shamblin v. Nationwide Mutual Ins. Co.*, 183 W. Va. 586, 369 S.E.2d 766 (1991). It is a standard practice in cases where damages are sought in excess of policy limits for the lawyer representing the insured to write a letter to the company or its agents demanding a settlement within the policy limits. This is referred to as a *Shamblin* letter.

A lawyer in a captive law firm must be willing to write to his or her own employer, a *Shamblin* letter when circumstances would require a prudent attorney to do so. An insurance company which attempts to direct its in-house lawyers not to write *Shamblin* letters or any other communication critical of the company impinges of the lawyer's professional independence.

The Rules of Professional Conduct stress that a lawyer must maintain the lawyer's independent judgment to be exercised on behalf of the client. Rule 1.8(f) provides:

Rule 1.8. Conflict of interest: Prohibited transactions.

(f) A lawyer shall not accept compensation for representing a client from one other than the client unless:

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

Rule 5.4(c) repeats this point:

Rule 5.4. Professional independence of a lawyer.

(c) a lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal

service for another to direct or regulate the lawyer's professional judgment in rendering such legal services.

Lawyers' struggles to maintain professional independence while representing insureds, has been well chronicled in law review articles.⁴ The risk of insurance defense lawyers violating Rules 1.8(f) and 5.4(c) of the Rules of Professional Conduct is endemic to the type of practice. The Board considers that lawyers in captive law firms face even greater dangers and must remain acutely aware of their ethical responsibilities to the insured.

Attorneys employed by a captive law firm risk losing their job and their employment benefits if they take action on behalf of their clients which displeases their employer, the insurance company. Outside counsel may face losing a large portion of their business in a similar situation, but the loss is not as abrupt or severe.

D. Decisions from Other Jurisdictions

The Lawyer Disciplinary Board's opinion falls within the mainstream of thought on the subject of captive law firms, although

⁴ Charles Silver, "Flat Fees and Staff Attorneys: Unnecessary Casualties in the Continuing Battle over the Law Governing Insurance Defense Lawyers," *Connecticut Insurance Law Journal* ___ (1997); Nancy J. Moore, "The Ethical Duties of Insurance Defense Lawyers: Are Special Solutions Required?" *Connecticut Insurance Law Journal* ___ (1997); Charles Silver and Kent Syverud, "The Professional Responsibilities of Insurance Defense Lawyers," 45 *Duke L.J.* 255 (1995); "Insurance Defense Ethics," 9 *Georgetown Journal of Legal Ethics* 475 (1996); "Ethics Principles for the Insurer, the Insured, and Defendant Counsel: The Eternal Triangle Reformed," 66 *Tulane Law Review* 511 (1991); "A Conflicts-of-Interest Roadmap for Insurance Defense Counsel: Walking an Ethical Tightrope without a Net," 26 *Willamette Law Review* 1 (1989).

jurisdictions have reached the same conclusion under different rationales. The decisions reviewed by the Board are set out below:

In the reported decision, *In re Rules Governing the Conduct of Attorneys in Florida*, 220 So.2d 6 (Fla. 1969), the Florida Supreme Court refused to implement an ethical rule proposed by the Florida Bar which prohibited an attorney employed by a lay agency from rendering legal services on behalf of a customer or insured unless the sole financial interest and risk involved was that of the lay agency. The Court considered the potential for conflict to be the same whether the lay agency employed a lawyer full time or hired a lawyer on an isolated attorney-client basis.

In *Coscia v. Cunningham*, 299 S.E.2d 880 (Ga. 1983), the Georgia Supreme Court rejected a motion to disqualify a captive law firm employee. The Court found that both salaried attorneys and outside attorneys have the same potential for conflict since they represent both the insured and the insurer.

The Missouri Supreme Court rendered a more limited decision on the question in *In re: Allstate Insurance Company*, 722 S.E.2d 947 (Mo. 1987)(en banc). In that case, the Court turned back a challenge to Allstate's use of its own lawyers in insurance defense case on conflict of interest and other grounds, noting that Allstate used its employees only when there was no question of coverage and when the claim is within policy limits. Allstate had a contractual right to direct the litigation, and its lawyers were bound by the same rules of professional conduct.

The Supreme Court of Tennessee reversed in part a formal ethics opinion by the Board of Professional Responsibility. *In re*

Youngblood, 895 S.W.2d 322 (Tenn. 1995). The Court found that in-house counsel could represent insureds. The employer-employee relationship did not create a "reasonable probability" of a real conflict. The employment did not create an attorney-client relationship between the insurer and the attorney or necessarily impose upon the attorney any duty of loyalty to the insurer which would impair the attorney-client relationship with the insured. The employer could not control the details of the attorney's performance or limit his or her discretion. The same loyalty would be owed to the insured whether the attorney is an employee or outside counsel.

Not all jurisdictions agree. *Gardner v. North Carolina State Bar*, 341 S.E.2d 517 (N.C. 1986). The North Carolina Supreme Court found that in-house counsel defending an insured would be the unauthorized practice of law. In deciding this issue, the Court made a distinction between in-house counsel and retained outside counsel. With outside counsel, the Court reasoned, the insurance company is not purporting to defend or represent the insured itself. It agrees to furnish a defense and carries out its obligation by paying an independent attorney assumed to be an independent contractor. The Court noted that North Carolina has a strong policy favoring personal representation.

The Kentucky Bar Association issued an ethics opinion, U-36, which prohibited insurance companies from having in-house counsel represent insureds. Opinion U-36 was cited with approval by the Kentucky Supreme Court in *American Insurance Assoc. v. Kentucky Bar Association*, 917 S.W.2d 568 (1996). The Court observed that there

were inherent pitfalls and conflicts when an attorney on the insurance carrier's payroll defends the insured, because "No man can serve two masters." It described the insurance carriers' position that in-house counsel could provide undivided loyalty to the insured as a "Pollyanna postulate."

(2) Is a captive firm's name misleading if it does not disclose its affiliation with the insurance company in violation of Rules 7.5(a) and (d)?⁵

The Lawyer Disciplinary Board finds that the captive law firms' names are misleading to the general public, even though the firm sends a disclosure letter to insureds at the beginning of the representation. The purpose of having in-house counsel practice under a firm name in a separate office may be to facilitate or demonstrate the attorneys' independence from their employer. But it has the effect of concealing the nature of the lawyers' relationship with the insurance company. The Board advises captive law firms to disclose their affiliation with the insurance company on their letterhead, business cards, phone book identification, phone answering method, office entrances and pleadings and to explain this relationship to each client. One exception to this would be a pleading or other communication that might be submitted

⁵ Rule 7.5. Firm names and letterheads.

(a) A lawyer shall not use a firm name, letterhead or other professional designation that violates Rule 7.1. A trade name may be used by a lawyer in private practice if it does not imply a connection with a government agency or with a public or charitable legal services organization and its not otherwise in violation of Rule 7.1

* * * *

(d) Lawyers may state or imply that they practice in a partnership or other organization only when that is the fact.

to a jury, so that jurors will not be made aware that a party had insurance. This opinion is consistent with the Board's prior opinion, L.E.I. 97-01, Use of a Trade Name for Advertising Purposes (attorneys who use a trade name for advertising purposes and a partnership name for providing legal services must disclose both names in all forms of communication).

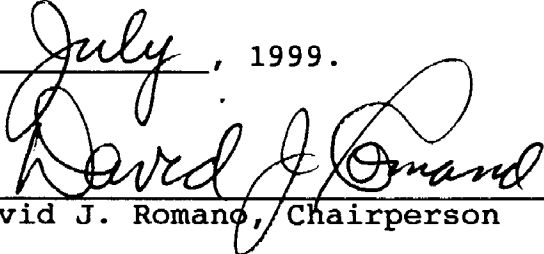
Other jurisdictions share this view. The *Youngblood* Court held that the holding out of an in-house attorney/employee as a separate and independent law firm constituted an unethical and deceptive practice. It gave "the Public" the impression that the lawyers were engaged in the general practice of law as partners or as sole practitioners. The Tennessee Court cited a New Jersey case which also prohibited this conduct. *In re Weiss, Healey & Rea*, 536 A.2d 266 (N.J. 1988).

Opinion 775 by the Virginia State Bar, issued in 1986, held it was improper for an attorney/employee of an insurance carrier to fail to disclose his or her status as an employee on name cards, letterhead, phone answering method and office door. Opinion 95-14 by the Ohio Board of Commissioners on Grievances and Discipline, issued December 1, 1995 opined that "captive" law firms which use a firm name are engaging in misrepresentation, citing a New Jersey ethics opinion that attorney employees may not combine their names for an office designation that implied a partnership.

In summary, although the captive law firm scenario creates a great potential for conflict of interest and unauthorized disclosure of client confidences due to the tension inherent in a captive lawyer's master-servant relationship with his employer.

However, even though some States ethic's committees, and subsequently, their Supreme Courts, have upheld a per se "prohibition" of captive law firms, this Board believes that West Virginia lawyers acting in that capacity will follow the Rules of Professional Conduct and will place the best interests of their client, the insured, above any tensions created by the captive law firm method of representation. Further, this Board believes that West Virginia lawyers acting in that capacity will resist any attempt to interfere with their attorney-client relationship and will, if necessary, take appropriate action to assure that their clients suffer no adverse action because of this method of representation. Consequently, based upon the facts before the Board and a review of the law, the West Virginia Lawyer Disciplinary Board finds that representation of insureds by employed lawyers in a "captive law firm" is permissible under the Rules of Professional Conduct subject to the criteria set forth in this Legal Ethics Opinion.

Issued this 9th day of July, 1999.



David J. Romano, Chairperson