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The Supreme Court of Texas rules that insurers' use of staff counsel is not the unauthorized practice of law, while raising questions about independent counsel in Texas.

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UPLC v. American Home Assurance: Does Texas Still Recognize Independent Counsel?

A constant question across the country and in Texas is the legality of insurers' use of salaried staff attorneys to represent an insured when its interests are not necessarily in line with the client's. Or, in other words, as the Supreme Court of Texas framed the question in *Unauthorized Practice of Law Committee v. American Home Assurance Co.*, 2008 WL 821034 (Tex. Mar. 28, 2008): "The issue in this case is whether a liability insurer that uses staff attorneys to defend claims against its insureds is representing its own interests, which is permitted, or engaging in the unauthorized practice of law, which is not." *Id.* at*1. In a 7-2 opinion, authored by Justice Nathan Hecht, the Supreme Court of Texas held that an insurer may use staff attorneys so long as the insured's and the insurer's interests are aligned—that is, the two are aligned in defeating the claim and no conflict of interest exists. *Id.* In addition, the Court held that a staff attorney is obligated to inform the insured of its affiliation with the insurer. *Id.* The opinion, however, has implications that potentially reach far beyond the narrow issue of the use of staff attorneys.

A. Shaping the Issue

Liability insurers often include provisions in their policies that require them to defend their insureds, but give them "complete and exclusive control" of that defense. *Id.* In doing so, insurers utilize three "types" of attorneys: (1) private law firms, whose work is paid for and overseen by the insurer; (2) "captive" law firms, whose lawyers are not employees of the insurer, but who have no other clients; and (3) in-house, salaried corporate staff attorneys. *Id.* Regardless of the "type" of attorney hired, according to the Court at least, the obligations remain the same: an insurer must provide the insured with the same, unqualified loyalty that it would have if the insured had hired him or her directly and protect the interests of the insured if the insurer's instructions would otherwise compromise them. *Id.* (citing *Employers Cas. Co. v. Tilley*, 496 S.W.2d 552, 558 (Tex. 1973); *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 627 (Tex. 1998)). Arguments for and against the use of staff attorneys are abundant. Insurers claim that they are more efficient, which lowers costs and—more importantly—premiums. And, according to insurers, such attorneys are useful as an "advertising tool" in selling

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CASES TO WATCH:

Ulico Cas. Co. v. Allied Pilots Ass'n, 187 S.W.3d 91 (Tex. App.—Ft. Worth 2005, pet. granted) (argued on April 11, 2007) (whether Texas recognizes coverage by waiver and/or estoppel when an insurer undertakes the defense without adequately reserving rights)

OneBeacon Ins. Co. v. Don's Building Supply, Inc., 2007 WL 2258192 (5th Cir. Aug. 8, 2007) (certifying trigger issue to the Supreme Court of Texas)

Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co., 2006 WL 1892669 (Tex. App.—Houston [14th Dist.] July 6, 2006, pet. granted) (scope of the eight-corners rule and proper trigger theory to apply to "property damage" cases)

Johnson v. State Farm Lloyds, 204 S.W.2d 897 (Tex. App.—Dallas 2006, pet. granted) (scope of the standard appraisal clause)

Mid-Continent Cas. Co. v. JHP Development, Inc., 2005 WL 1123759 (W.D. Tex. Apr. 21, 2005) (appealed to the Fifth Circuit Court of Appeals) (application of exclusions j(5) and j(6))

policies. *Id.* Opponents, on the other hand, claim that if an insurer controls its staff attorneys as an employer would control any employee, then the attorney-client relationship is detrimentally impaired from the insured's standpoint. *Id.*

The use of staff attorneys began in the late 19th century and is widespread. Historically, both the American Bar Association Committee on Ethics and Professional Responsibility (in 1950 and 2003) and the State Bar of Texas Committee on Interpretation of the Canons of Ethics (in 1963) have found that such conduct was ethical. Amicus curiae in support of the use of staff counsel noted that 15 insurers in 39 offices employ 220 attorneys in Texas, and those attorneys currently defend insureds in over 10,000 cases in the state. *Id.* at 2.

In Texas, to practice law, one must be licensed by the Supreme Court or have special permission. And, once admitted to practice in the state, attorneys are required to attend continuing education classes and be subject—as necessary—to a grievance process. Finally, the Unauthorized Practice of Law Committee (the "Committee") investigates and prosecutes the unauthorized practice of the profession. *Id.*

B. Background Facts

In 1998, the Committee sued Allstate Insurance Company ("Allstate"), alleging that Allstate's use of staff attorneys to defend liability claims violated Texas law regarding the unauthorized practice of law. *Id.* (citing *UPLC v. Collins*, No. 98-8269 (298th Dist. Ct., Dallas County, Tex. 1998).) Thereafter, Nationwide filed a declaratory judgment action against the Committee that Texas law did not prohibit the use of staff attorneys and that, if it did, such law was in violation of the U.S. Constitution. *Id.* (citing *Nationwide Mut. Ins. Co. v. UPLC*, 283 F.3d 650, 651 (5th Cir. 2002)). The district court in that case abstained under the *Pullman* doctrine and dismissed the case with prejudice, which the Fifth Circuit affirmed in substance but reversed the dismissal with prejudice and remanded the case for dismissal without prejudice. *Id.* (citing *Nationwide*, 283 F.3d at 657). In that case, the Fifth Circuit analyzed Texas law and held:

> [W]e believe that the law is fairly susceptible to a reading that would permit Nationwide to employ staff counsel on behalf of its insureds While the Texas courts certainly may decide that Nationwide's staff attorneys are engaged in the unauthorized practice of law, we believe that the law is uncertain enough on this issue that we should abstain from ruling on its federal constitutionality.

Id. (quoting *Nationwide*, 283 F.3d at 655).

As a result, Nationwide re-filed its lawsuit in state court, received a favorable ruling that was affirmed on appeal, and which the Committee petitioned the Court to review while the instant case was pending. The

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CASES TO WATCH: (continued)

D.R. Horton—Texas, Ltd. v. Markel International Ins. Co., Ltd., 2006 WL 3040756 (Tex. App.—Houston [14th Dist.] Oct. 26, 2006, pet. filed) (scope of the eight-corners rule and the relationship between the duty to defend and the duty to indemnify)

instant case arose out of a letter from the Committee to Katherine D. Woodruff, a staff attorney of American Home Assurance Co. ("American Home") at Woodruff & Associates, informing her that she and her firm were being investigated for the unauthorized practice of law. *Id.* at *3. American Home, Woodruff & Associates and Travelers Indemnity Co. ("Travelers") brought the instant suit, seeking a declaration that the use of staff counsel was not the unauthorized practice of law. *Id.* The Committee filed a counterclaim. Then, all the claims by and against Woodruff and her firm were nonsuited. Eventually, American Home, Travelers and the Committee cross-moved for summary judgment. The insurers' motions were denied and the Committee's granted. *Id.* The court declared that each insurer's "use . . . of staff counsel who are employees . . . to defend insureds (third parties) in Texas is the unauthorized practice of law." *Id.* Judgment was suspended by the court pending appeal, and the parties agreed to the following policy:

> If in the course of representing a party insured by [American Home and Travelers] any staff counsel employed in Texas by [such insurer, respectively] seeks advice about a potential conflict of interest between the insured and the insurance company, or any other question of professional ethics, such staff counsel will first consult with the Texas-licensed lawyer who is head of the staff counsel office, and thereafter, if the staff counsel's concerns are not resolved, counsel with an outside Texas firm, designated by [such insurer, respectively], on such question.

Id. The Eleventh District Court of Appeals in Eastland reversed the lower court, rejecting the Committee's position in its entirety. *Id.* (citing *UPLC v. Am. Home Assurance Co.*, 121 S.W.3d 831, 833, 846 (Tex. App.—Eastland 2003, pet. granted)). In sum, that court found: (1) staff counsel faced no different conflicts than outside counsel; (2) the use of staff counsel does not violate any one of a number of Texas' Disciplinary Rules of Professional Conduct; (3) the Supreme Court's statement that an insurance defense lawyer owes "unqualified loyalty" to an insured was dicta and does not prevent the insurer from being a client, so long as no conflict exists; (4) the use of staff counsel does not violate the Texas Business Corporation Act or the Texas Government Code—if the use of staff counsel is unauthorized, so also is the use of outside counsel; (5) Section 38.123 of the Texas Penal Code should not be read so as to prohibit the use of staff attorneys anymore than it should be read to prohibit insurance defense in general; and (6) only two states—North Carolina and Kentucky—prohibit the use of staff attorneys while several others do not. *Id.* at *3–*4 (citing *UPLC v. Am. Home*, 121 S.W.3d at 836–45).

On appeal to the Court, two issues were presented:

(1) Does the use of staff attorneys to defend liability claims as contractually required constitute the unauthorized practice of law?

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(2) If not, must the staff attorneys' affiliation with the insurer be fully disclosed to the insured?

Id. at *4. In looking at these issues, the Court rejected the request by amicus curiae to determine what the practice of law *should be*, and focused instead on what it *is* under current law. *Id.*

C. Corporations Cannot Practice Law and An Insurer with Staff Counsel Is Not Doing So

The parties agreed that a corporation is unable to practice law and that the Supreme Court of Texas has inherent power to regulate the practice of law. The Court adopts rules governing admission to the practice of law, permitting only individuals meeting particular criteria that opportunity. "Entities, including insurance companies, are excluded." *Id.* at *5.

The Committee, however, relied upon a more general provision of the Texas Business Corporation Act, which prohibits a corporation from transacting business in the state:

> If any one or more of its purposes . . . is to engage in any activity which cannot lawfully be engaged in without first obtaining a license under the authority of the laws of this State . . . and such a license cannot lawfully be granted to a corporation.

Id. (citing TEX. BUS. CORP. CODE art. 2.01(B)(2)). The appellate court rejected that argument, finding that an insurance company is not organized to practice law. *Id.* (citing *UPLC v. Am. Home*, 121 S.W.3d at 839). The Court disagreed with that finding because the provision applies whenever "any one" of the corporation's purposes is to engage in a licensed activity. The Court also rejected the appellate court's finding that an insurer's defense of its insured is "collateral" to its purpose of indemnifying its insured, as one is no less important than another. *Id.* The Court said, however, that it need not construe that provision because its rules "governing admission to practice law are sufficient to exclude insurance companies from engaging in *that* activity." *Id.* (emphasis in original).

The Court then acknowledged that the parties were in agreement that an insurance company is not engaging in the practice of law when it uses salaried staff counsel to represent its own interests. *Id.* The Court explained that such practice has long been held acceptable. Insurers can hire in-house counsel to provide advice regarding the legal affairs of the company and can appear in court on that entity's behalf. *Id.* And while the article of the Penal Code the Court relied upon to make that finding had been repealed, the repeal had no bearing on the use of house counsel. *Id.* (explaining that Article 430a of the Texas Penal Code was repealed because the Legislature found that in light of the Court's power to govern the practice of law the article "had no practical value"). The

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Court also explained that this view is bolstered by the State Bar of Texas Committee on Interpretation of the Canons of Ethics, which has found nothing unacceptable about the use of in-house counsel by a corporation. *Id.* at *6. Quite simply, "a corporation does not engage in practicing law by employing an attorney to represent itself, together with the common interests of other employers and affiliates." *Id.*

Further, when an insurance company hires private counsel to defend its insured, such action does not constitute the practice of law. *Id.* This was true under Article 430a of the Texas Penal Code before its repeal, and remains true under Section 81.101(a) of the Texas Government Code, which defines the practice of law today. Implicit in either is the understanding that the practice of law involves the rendering of legal services *for someone else*. "Only when a corporation employs attorneys to represent the unrelated interests of others does it engage in the practice of law." *Id.* at *7.

Thus, when an insurer uses staff counsel to defend its insureds, is it practicing law or merely defending its interests by discharging its duty to the insureds and fighting claims for which it would be required to indemnify the insured? On that, the Court found that American Home's and Travelers' reliance upon its decision in *Utilities Insurance Co. v. Montgomery*, 138 S.W.2d 1062 (Tex. 1940), was misplaced because that case involved the obtaining of non-waiver agreements, which are used to protect the insurer's interest and not the insured's. *Id.* (citing *Montgomery*, 138 S.W.2d at 1064, and mistakenly suggesting that unilateral reservation of rights letters are the same thing as bilateral non-waiver agreements). The Court said nothing about the insurer's interest in defending its insureds in that case, and, more importantly, the Court never suggested that the counsel at issue in that case were staff counsel instead of private practice attorneys. *Id.*

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More on point, the Court said, was its decision four years later in *Hexter Title & Abstract Co. v. Grievance Committee*, 179 S.W.2d 946 (Tex. 1944). There, the Court found that Hexter was engaged in the unauthorized practice of law. The Court said that its opinions regarding defects of title and instruments that could be used to correct them, which were conveyances in which the insurance company was not a party but rather had a prospective interest in them, affected the rights of individuals apart from Hexter's interest in the title insurance industry. *Id.* at *8 (citing *Hexter*, 179 S.W.2d at 952). In other words, the corporation's purpose was to take applications for insurance and insure title as it was or reject it. If defects existed, then the applicant had to cure them, not the title insurance company. *Id.* Thus, the Court concluded in *Hexter* that the company was engaged in the unauthorized practice of law, but "emphasized that Hexter was permitted to employ salaried attorneys to advise it on the state of title for its own uses; it was prohibited only from providing the same service to customers and prospective customers for their use." *Id.* at *9.

From that decision the Court found three factors to be considered in determining the issue before it:

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(1) Is the company's interest being served by the rendition of legal services existing or only prospective?

(2) Does the company have a direct, substantial financial interest in the matter for which it provides legal services?

(3) Is the company's interest aligned with that of the person to whom the company is providing legal services?

Regarding the first factor, the Court found that insurers render legal services to fulfill its contractual obligations to its insured and not to attract business even though the insurer may advertise the use of staff counsel and the resulting lower premiums. As for the second factor, the insurer clearly has a direct, substantial financial interest because if it defeats the claim, then the insurer is benefited by not having to pay the claim. Finally, with respect to the third factor—the most important factor according to the Court—the Court found that "in the vast majority of cases," the interests of an insurer and its insured are aligned against the claim, and such interests differ only when a coverage question exists or the rendering of the legal defense causes consequences that affect them differently. *Id.* Applying those factors, the Court said:

> [W]e conclude that 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 insurer is indistinguishable.

Id. at *10.

Having reached that conclusion, the Court turned to the serious concerns raised by the Committee and several amici about conflicts between an insured and an insurer being exacerbated because of the employment relationship between the insurer and its staff counsel. *Id.* In particular, those parties argued that the pressures and loyalties of that employment relationship jeopardize a staff attorney's ability to exercise independent judgment to which the insured is entitled. Moreover, they argue, "the insurer's profit motive . . . is fundamentally inconsistent with the provision of independent legal services through staff attorneys." *Id.*

The Court noted that the Committee and amici were unable to point to an ounce of empirical evidence of injury to a private or public interest stemming from the representation of an insured by staff counsel. This is important in light of the fact that staff counsel has been used for decades across the nation. *Id.* The Court explained that conflicts that arise may be resolved by staff attorneys just as other attorneys would or—if unable to be resolved—they can withdraw just as other attorneys would. *Id.* Importantly, the Court explained that most often the coverage questions at issue are whether a claim is within the policy limits and the type of coverage provided. The insurer in such instances can issue a

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reservation of rights letter, and, in fact, insurers seem to do so now merely as a prophylactic measure, even if they have no specific intent to pursue a coverage question. *Id.* Then, while seemingly brushing aside the importance of reservation of rights letters, the Court said that "[a] reservation-of-rights letter ordinarily does not, by itself, create a conflict between the insured and the insurer" because it only recognizes that a conflict might exist later. *Id.* The Court refused to say that staff counsel can never represent an insured when a "routine" reservation of rights letter is issued. *Id.*

The Court also found that problems may arise when defense counsel acquires information that the insured would expect to be kept confidential and not disclosed to the insurer. It explained, though, that in such situations withdrawal by the attorney may be the best option regardless of whether the attorney is staff counsel or in private practice. *Id.* at *11. Under Texas' law, which imputes knowledge of confidential information held by one attorney to all of the attorneys in his office, a staff attorney's knowledge of such information may or may not be imputed to non-attorneys outside the legal department. The Court said that such knowledge could estop an insurer from using it altogether. But, while these risks are present, "they do not necessarily destroy the congruence of the insurer's and insured's interest." *Id.* The Court also failed to find that a staff attorney's obligation of unqualified loyalty in a *Stowers* situation is any different from that of an attorney in private practice. While it is possible that counsel may fail to render the loyalty required because of business pressure, no evidence exists that a staff attorney is more likely to fail in that regard. *Id.* The Court also failed to find that a staff attorney is more likely to adhere to its employer's restrictions found in litigation guidelines even when it could compromise an insured's interests. *Id.*

The Court seemingly answered a long-standing debate in Texas as to whether Texas is a one-client or two-client state. *Id.* at *12. In particular, the Committee claimed that Texas law only allows defense counsel to represent the insured and that staff attorneys violate that rule because they necessarily represent the insurer and thus cannot represent the insured as well. In response, the Court said: "But we 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." *Id.* Accordingly, at least where a congruence of interest exists, the Court suggests that Texas is a two-client state.

In sum, the Court looked at the concerns of the Committee and of amici, but found that those concerns should not be avoided at all cost when some are satisfactorily resolved. The Court acknowledged that the use of staff counsel "comes with risks." *Id.* Accordingly, the Court held:

> If an insurer's interest conflicts with an insured's, or the insurer acquires confidential information that it cannot be permitted to use against the insured, or an insurer attempts to compromise a staff attorney's independent, professional judgment, or in some

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other way the insurer's and insured's interests do not have the congruence they have in the 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. But 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 attorneys in those cases does not constitute the unauthorized practice of law.

Id.

In its final comments, the Court rejected the Committee's argument that section 38.123 of the Texas Penal Code prohibits the use of staff counsel. *Id.* at *13. The Court found that that section could not apply to liability insurers' defense of their insureds because part of the section would make every insurer a felon. That is, the section at issue "prohibits any contract that grants one party the exclusive right to select and retain legal counsel to represent the other." *Id.* Considering insurers have done that for years, reading the section to apply in the situation at bar was "too much to believe." *Id.*

In conclusion, the Court said that insurers could use staff attorneys to defend claims against their insureds so long as their interests were congruent as described in the opinion. In addition, such attorneys are required to disclose their relationship with the insurer to the insured. *Id.* at *14.

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D. The Dissent

A lengthy dissent was authored by Justice Johnson, and it was joined by Justice Green. In sum, those Justices argued that there is understandably nothing wrong with an insurer representing its own interests in a lawsuit if it so chooses. The concern, however, is that an insurer simply cannot represent a client (i.e., its insured) under the State Bar Act. The dissenters contend that the acts of staff attorneys are imputed to their employer, the insurer. Accordingly, they argue that when staff attorneys represent an insured, the *insurer* is representing the insured in violation of the Act because it is practicing law without a license. Based on that logic, Justices Johnson and Green would have reversed the appellate court's decision.

Commentary:

The Court's holding regarding the use of staff counsel not being the unauthorized practice of law comports with the findings of most states across the country. Accordingly, the Court's opinion is somewhat unremarkable in that sense. What is surprising, however, is the Court's discussion of reservation of rights letter in which it said that such letters oftentimes do not create a conflict of interest between the insurer and the insured. The Court explained that such letters are becoming "routine" and used more often for prophylactic measures. While it is true that not every reservation of rights letter creates a conflict of interest,

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the Court's somewhat nonchalant treatment of reservation of rights letters raises an interesting question as to the viability of other decisions wherein reservation or rights letters were found to create a conflict of interest so as to afford the insured with the right to select independent counsel. Notably, after *UPLC*, it may be more difficult to argue that a reservation of rights entitles an insured to independent counsel. Stated otherwise, while the Court recognized the long-standing rule that any "type" of attorney owes unqualified loyalty to the insured, the opinion begs the question of when a sufficient conflict exists so as to give an insured the right to select independent counsel. And, although the Court noted a lack of empirical data in the record, the question still must be asked: "Are you really in 'good hands' with the 'Good Hands' people?"

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GETTING TO KNOW LEE H. SHIDLOFSKY AND THE INSURANCE LAW PRACTICE GROUP . . .

Lee H. Shidlofsky is a founding partner of Visser Shidlofsky LLP. His practice is devoted to representing and counseling corporate policyholders in the area of insurance law, risk management, contractual risk transfer, and extra-contractual issues. He is Treasurer of the Insurance Law Section and holds a council position in the Construction Law Section of the State Bar of Texas. He is the author of numerous articles and seminar papers and is a frequent speaker at continuing legal education seminars in Texas and across the country. Lee has been named a "Super Lawyer" by Texas Monthly Magazine each year since 2004, including a ranking as a Top 50 attorney in the Central and West Texas Region for 2007, and is ranked as a top insurance coverage lawyer by Chambers USA and Who's Who Legal. Lee was recently elected a Fellow of the Texas Bar Foundation.

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The Insurance Law Practice Group represents corporate policyholders that are in disputes with their insurance companies, provides advice to plaintiffs in complex litigation on how to best maximize an insurance recovery, and provides risk-management consultation in connection with a wide-variety of contractual risk transfer issues. The Insurance Law Practice Group handles first-party and third-party insurance claims in state and federal courts at both the trial and appellate court levels. The Insurance Law Practice Group is committed to practical and pragmatic solutions to insurance issues.

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