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## *Brown v. Lumbermens Mutual Casualty Co.*: The Rock, the Hard Place, and the Insurance Defense Attorney

A consumer buying an insurance policy expects that the insurer will pay claims that arise under the policy and defend the insured in court if necessary. The policyholder is not likely to consider who will provide legal representation in the defense of a claim or what that attorney's relationship will be to the insurer<sup>1</sup>—whether the attorney will be from the insurer's staff, a private attorney hired and controlled by the insurer, or an attorney selected by the insured.<sup>2</sup> These distinctions, however, can prove important in situations in which the insured's interests conflict with the insurer's and in which the insured seeks to assert rights against the insurer relating to the quality of the defense.

Recently in *Brown v. Lumbermens Mutual Casualty Co.*<sup>3</sup> the North Carolina Court of Appeals held that an attorney hired by an insurance company was an independent contractor<sup>4</sup> and that the insurer therefore was not vicariously liable for the attorney's negligence.<sup>5</sup> This Note examines *Brown*, analyzing first the relationship between insurer, insured, and attorney and second the responsibilities that arise from this relationship. The Note examines North Carolina's established principles of agency and independent contractors and attempts to place the relationship within these defined frameworks. The Note concludes that, contrary to the court's pronouncement in *Brown*, the relationship between attorney and insurer should be considered one of agency when the insurance company exerts control in the defense of the policyholder.

In *Brown* Doyle Brown and his wife were sued by Joan Hinson as a result of a car accident. The Browns' insurance company, Lumbermens Mutual Casualty Company (LMCC), employed the law firm of Tuggle, Duggins, Meschan & Elrod to defend the Browns pursuant to their insurance contract.<sup>6</sup> The Browns claimed that their brakes had been designed defectively by the car's manufacturer, General Motors Corporation (GMC). The law firm filed an answer denying any negligence on the part of the Browns.<sup>7</sup> The answer, however, did not contain a claim against GMC as a third-party defendant. At this point, the Browns' attorneys—against the Browns' wishes but at the direction of LMCC—offered settlement in the amount of twenty-five thousand dollars, the policy

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1. The relationship between the policy holder, the insurer, and the attorney hired by the insurer is a unique one: "[i]n no other instance is a litigant represented by an attorney who is selected and paid by a third party which may have interests adverse to the client." Weithers, *The Coverage Role of Defense Counsel*, 48 INS. COUNS. J. 156, 156 (1981). In most cases, however, the policy holder and insurer have a common interest in resolving the litigation. *Id.*

2. In North Carolina, the prohibition on the practice of law by corporations prevents insurance companies from defending policyholders with staff attorneys. *See infra* notes 40-47 and accompanying text (discussing *Gardner v. North Carolina State Bar*, 316 N.C. 285, 314 S.E.2d 517 (1986)).

3. 90 N.C. App. 464, 369 S.E.2d 367, *disc. rev. granted in part*, 323 N.C. 363, 373 S.E.2d 542 (1988).

4. *Id.* at 471, 369 S.E.2d at 371.

5. *Id.* at 473, 369 S.E.2d at 372; *see infra* text accompanying note 22.

6. *Brown*, 90 N.C. App. at 466, 369 S.E.2d at 368.

7. *Id.*

limit.<sup>8</sup> When Hinson refused this offer, LMCC made a payment of twenty-five thousand dollars to Hinson to secure a release of its obligation pursuant to section 1-540.3 of the North Carolina General Statutes.<sup>9</sup> LMCC subsequently terminated the Browns' defense and discharged the law firm.<sup>10</sup> The firm withdrew as counsel and informed the Browns that they should employ their own attorney.<sup>11</sup> The Browns did not hire counsel and the court subsequently entered a forty-five thousand dollar judgment against them, crediting to defendants the twenty-five thousand dollar payment to plaintiff under the insurance policy.<sup>12</sup>

The Browns brought an action against GMC and LLMC, asserting three claims. First, the Browns alleged fraud<sup>13</sup> and products liability against GMC.<sup>14</sup> Second, they made a claim against LMCC for the negligence of the law firm, alleging that the firm failed to include a products liability claim against the manufacturer in the original action before the statute of repose had run.<sup>15</sup> Third, the Browns asserted that LMCC was obligated to provide a defense even after paying the limit on the policy.<sup>16</sup> The trial court dismissed plaintiffs' claims on each of the three issues.<sup>17</sup>

The North Carolina Court of Appeals, in an opinion by Judge Greene, affirmed dismissal of the products liability action against GMC, finding it was initiated after the period of repose had expired.<sup>18</sup> The court, however, did allow the fraud claim based on GMC's alleged representation that it would defend the Browns' interests.<sup>19</sup> The court refused to impute the law firm's alleged negligence to LMCC, holding that the firm was an independent contractor of the insurance company.<sup>20</sup> Finally, the court ruled that because the terms of the insurance contract were ambiguous, the insurance company had a duty to defend the insured despite having paid the policy limit.<sup>21</sup>

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8. *Id.*

9. *Id.* at 466-67, 369 S.E.2d at 368. The statute provides for advance payments to an injured person by a party, or that party's insurance carrier, against whom a claim may be asserted. Such a payment does not, in itself, discharge any claims of the person receiving payment. N.C. GEN. STAT. § 1-540.3(a) (1983).

10. *Brown*, 90 N.C. App. at 467, 369 S.E.2d at 368.

11. *Id.*

12. *Id.* at 467, 369 S.E.2d at 368-69.

13. *Id.* at 467, 369 S.E.2d at 369. The Browns alleged that an employee of GMC deceptively represented that GMC would provide counsel for their defense in the Hinson case. *Id.* at 469-70, 369 S.E.2d at 370.

14. *Id.* at 467, 369 S.E.2d at 369.

15. *Id.* at 467, 471, 369 S.E.2d at 369, 371. See N.C. GEN. STAT. § 1-50(6) (1983) ("No action for the recovery of damages for personal injury, death or damage to property based upon or arising out of any alleged defect or any failure in relation to a product shall be brought more than six years after the date of initial purchase for use or consumption.").

16. *Brown*, 90 N.C. App. at 467, 369 S.E.2d at 369.

17. *Id.*

18. *Id.* at 468, 369 S.E.2d at 369.

19. *Id.* at 470, 369 S.E.2d at 370-71.

20. *Id.* at 473, 369 S.E.2d at 372.

21. *Id.* at 477, 369 S.E.2d at 374. The court considered the insurance policy ambiguous on whether the duty to defend continues after the policy limit is paid and thus construed the language of the policy against the drafter. *Id.* at 476, 369 S.E.2d at 374. The North Carolina Supreme Court has granted review on this issue. *Brown v. Lumbermens Mut. Casualty Co.*, 323 N.C. 363, 373 S.E.2d 542 (1988).

The court's decision to declare the law firm an independent contractor of the insured was directly related to the decision not to hold the company vicariously liable for the alleged negligence. Generally, an employer is not liable for torts committed by an independent contractor.<sup>22</sup> The employer may be held liable, however, if the duty between the employer and the contractor is nondelegable,<sup>23</sup> if the activity delegated is inherently dangerous,<sup>24</sup> or if the employer was negligent in hiring the independent contractor.<sup>25</sup> On the other hand, when the employer controls the work performed by a party, that party is an agent of the employer, who is thus vicariously liable for torts committed within the scope of the agent's employment.<sup>26</sup>

North Carolina courts have distinguished carefully the relationship between an employer and independent contractor from the employer's relationship with an agent or employee, relying primarily on an analysis of the degree of control exerted by the employer. The North Carolina Supreme Court developed a list of factors to be considered in determining the nature of an employment relationship in *Hayes v. Board of Trustees of Elon College*.<sup>27</sup> In *Hayes* defendant's business manager hired several off-duty power company employees to replace electrical poles, providing a truck and two helpers. The workers were instructed where to place the new poles and to shorten them to avoid interference with nearby trees.<sup>28</sup> In finding that they were independent contractors, the court focused on the interaction between the workers and the employers: "[T]he retention by the employer of the right to control and direct the manner in which the details of the work are to be executed and what the laborers shall do as the work

22. *Hendricks v. Leslie Fay, Inc.*, 273 N.C. 59, 62, 159 S.E.2d 362, 365 (1968) (quoting W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 70 (3d ed. 1964)); see RESTATEMENT (SECOND) OF TORTS § 409 (1965).

23. *Hendricks*, 273 N.C. at 62-63, 159 S.E.2d at 366 (duties relating to contract with security guard held nondelegable). If the duty is nondelegable, the contractor will have the status of an agent. *Id.* at 62, 159 S.E.2d at 366.

24. *Deitz v. Jackson*, 57 N.C. App. 275, 279-81, 291 S.E.2d 282, 285-86 (1982) (no showing that the use of a ramset gun for construction work was inherently dangerous); see also *Dockery v. World of Mirth Shows, Inc.*, 264 N.C. 406, 410, 142 S.E.2d 29, 32 (1965) ("where it is reasonably foreseeable that harmful consequences will arise from the activity of the [independent] contractor unless precautionary methods are adopted, the duty rests upon the employer to see that these precautionary methods are adopted and he cannot escape liability by entrusting this duty to an independent contractor").

25. *Deitz*, 57 N.C. App. at 278, 291 S.E.2d at 285.

26. *Vaughn v. Department of Human Resources*, 296 N.C. 683, 686, 252 S.E.2d 792, 795 (1979).

27. 224 N.C. 11, 16, 29 S.E.2d 137, 140 (1944). The court stated that an independent contractor relationship exists when

[t]he person employed (a) engaged in an independent business, calling, or occupation; (b) is to have the independent use of his special skill, knowledge, or training in the execution of the work; (c) is doing a specified piece of work at a fixed price or for a lump sum or upon a quantitative basis; (d) is not subject to discharge because he adopts one method of doing work rather than another; (e) is not in the regular employ of the contracting party; (f) is free to use such assistants as he may think proper; (g) has full control over such assistants; and (h) selects his own time.

*Id.*

28. *Id.* at 14, 29 S.E.2d at 139.

progresses is decisive. . . .”<sup>29</sup> The court found, over a strong dissent,<sup>30</sup> that the directives to cut the poles to avoid the trees, while of “some consideration,” did not rise to the level of control over details that would make the laborers employees of defendant.<sup>31</sup>

The supreme court has, however, found an agency relationship in circumstances where control was arguably less apparent. In *Vaughn v. Department of Human Resources*,<sup>32</sup> for example, the court ruled that North Carolina’s Social Services Commission of the Department of Human Resources was liable for the negligence of the Durham County Director of Social Services in his placement of foster children.<sup>33</sup> Although the Commission had no role in the actual placement of foster children, the court found it implicitly had exerted control merely by promulgating generalized rules. First, in making placement decisions, the County Director was required to “comply with the rules and regulations of the Social Services Commission” as provided by statute.<sup>34</sup> The court noted that the commission in fact had developed comprehensive guidelines for the licensing and inspection of foster homes and placement of children in them.<sup>35</sup> Second, the Department of Human Resources used its funding power to influence the County Director’s placement practices.<sup>36</sup> To receive reimbursement funds, the County Director was required to place foster children in licensed homes that met the standards prescribed by the Commission.<sup>37</sup> Finally, while the Commission did not have the exclusive power to hire, discharge, or compensate the county director, it did have “some influence” on personnel decisions through its minority representation on the County Board of Social Services.<sup>38</sup> The court concluded that “the Department of Human Resources through the Social Services Commission ha[d] the right to control the manner in which the County Director . . . place[d] children in foster homes . . . [and, therefore, was] liable under the rule of *respondet superior* for the negligent acts of the County Direc-

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29. *Id.* at 15, 29 S.E.2d at 139-40.

30. The dissent’s definition of an independent contractor, one who “contracts to do a piece of work according to his own judgment and methods, without being subject to his employer except as to the results of the work,” similarly focused on control. *Id.* at 20, 29 S.E.2d at 143 (Devin, J., dissenting). However, the dissent viewed the degree of instruction given by the employer, combined with the employer’s supplying all the tools and materials, as sufficient to represent control. *Id.* at 22, 29 S.E.2d at 144 (Devin, J., dissenting).

31. *Id.* at 18, 29 S.E.2d at 142. The supreme court continues to have difficulty applying the *Hayes* factors to distinguish an independent contractor from an employee. *See, e.g.,* *Youngblood v. North State Ford Truck Sales*, 321 N.C. 380, 364 S.E.2d 433 (1988) (the court, divided four to three, held that a person hired to instruct employees in the use of specialized equipment was an employee under the *Hayes* factors).

32. 296 N.C. 683, 252 S.E.2d 792 (1979).

33. *Id.* at 690-91, 252 S.E.2d at 797.

34. *Id.* at 687, 252 S.E.2d at 795.

35. *Id.* at 687-88, 252 S.E.2d at 795-96. The standards covered, for example, the circumstances that require the separation of a child from his or her natural parents, the characteristics of a suitable foster home, the types of food, clothing, and medical care that must be provided, and the manner of evaluating foster care. *Id.* at 687, 252 S.E.2d at 796.

36. *Id.* at 688, 252 S.E.2d at 796.

37. *Id.* at 688-89, 252 S.E.2d at 796.

38. *Id.* at 691, 252 S.E.2d at 798.

tor . . . ."<sup>39</sup>

The nature of the relationship between an insurer and the attorney hired to represent the policyholder had been considered, albeit indirectly, in one North Carolina decision prior to *Brown*. In *Gardner v. North Carolina State Bar*<sup>40</sup> the supreme court reviewed a Bar ethics opinion that prohibited insurance companies from using their own "house counsel" to represent policyholders.<sup>41</sup> The petitioner urged that the distinction "between 'house' and 'outside independent counsel'" was arbitrary and thus unlawful.<sup>42</sup> The Bar claimed, and the court held, that use of attorneys employed by the insurer to represent insureds would constitute the practice of law by a corporation, which is forbidden by statute.<sup>43</sup> In making the distinction between outside attorneys hired by the insurer and staff counsel, the court focused on the persona of the party providing the legal representation.<sup>44</sup> When a staff attorney provides legal services, the court ob-

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39. *Id.* at 690-91, 252 S.E.2d at 797. The court illustrated that these cases turn on close analyses of facts to determine whether control was exerted by finding *Turner v. Board of Educ.*, 250 N.C. 456, 109 S.E.2d 211 (1959), "factually distinguishable." *Vaughn*, 296 N.C. at 691, 252 S.E.2d at 798. In *Turner* the court ruled that the State Board of Education did not have the authority to control the lawn mower operator hired by the local school district and thus could not be held vicariously liable. *Turner*, 250 N.C. at 462-63, 109 S.E.2d at 216.

The control issue also has arisen in the relationship between hospitals and medical personnel. *Compare Willoughby v. Wilkins*, 65 N.C. App. 626, 635, 310 S.E.2d 90, 96 (1983) (agency relationship found despite a statement in the doctor's contract that he was an independent contractor), *disc. rev. denied*, 310 N.C. 631, 315 S.E.2d 697 (1984) with *Smock v. Brantley*, 76 N.C. App. 73, 75-76, 331 S.E.2d 714, 716 (1985) (doctor deemed an independent contractor because, unlike *Willoughby*, no elaborate contract controlled the details of the physician's work), *disc. rev. denied*, 315 N.C. 590, 341 S.E.2d 30 (1986).

40. 316 N.C. 285, 341 S.E.2d 517 (1986).

41. *Id.* at 288-89, 341 S.E.2d at 519-20. The ethics opinion provided in part that

[i]t would be unethical for a full time salaried employee of an insurance company, who is an attorney licensed to practice in the State of North Carolina, to appear as counsel of record in an action brought against an insured by a third party for a claim covered by the terms of the insurance policy or to appear in the prosecution of subrogation claims for the property damage unless such actions are defended or prosecuted only in the name of the insurance company and the insurance company assumes or is subrogated to the complete legal liability and pecuniary interest of the claim. Independent counsel must be retained for the insured when he is the named defendant or plaintiff and thereby the real party in interest. . . .

The attorney's paramount responsibility is to the court and client which he serves before the court. This responsibility should not be influenced by any other entity. When an attorney, who is employed by a corporation, is directed by his employer in the representation of other individual litigants, he is subject to the direct control of his employer, which is not itself the litigant and which is not itself subject to strict professional discipline as an officer of the court. This diluted responsibility to the court and the client must be avoided.

N.C. State Bar Ethics Comm., CPR Op. 326 (Oct. 21, 1982), *reprinted in* 7 N.C. STATE BAR NEWSLETTER 7 (Dec. 2, 1982) (quoted in *Gardner*, 316 N.C. at 288-89, 341 S.E.2d at 519).

42. *Gardner*, 316 N.C. at 287, 341 S.E.2d at 518.

43. *Id.* at 298-90, 341 S.E.2d at 520; *see* N.C. GEN. STAT. § 84-5 (1985) ("It shall be unlawful for any corporation to practice law or appear as an attorney for any person in any court in this State. . . ."). In *Gardner* the Bar also claimed that the suggested practice would increase the risk of a conflict of interest. *Gardner*, 316 N.C. at 289, 341 S.E.2d at 519. Having decided for the Bar on the ground that allowing employees in the scope of their employment to represent insureds would be the unlawful practice of law by a corporation, the court declined to consider the conflict of interest argument. *Id.* at 295, 341 S.E.2d at 523. For a more detailed exposition of the *Gardner* decision, *see* Note, *The Unauthorized Practice of Law by Corporations: North Carolina Holds the Line*, 65 N.C.L. REV. 1422 (1987).

44. *Gardner*, 316 N.C. at 292-93, 341 S.E.2d at 521-22.

served, the insurer is the actor.<sup>45</sup> The court expressly assumed, however, that an outside attorney would be an independent contractor; thus, the attorney alone would be the actor in the ensuing litigation.<sup>46</sup> Although this assumption was helpful in obtaining the desired result, the court made it without considering the degree of control exerted by the insurer over the outside attorney.<sup>47</sup>

The relationship between insurer, insured, and attorney may be established in three ways. Each method raises issues of conflict of interest<sup>48</sup> and of vicarious liability. First, although prohibited in North Carolina, many states allow insurance companies to employ staff attorneys to defend insurance claims.<sup>49</sup> In this situation, courts have held the insurer vicariously liable for the attorney's actions.<sup>50</sup> Such organization raises compelling ethical questions in conflict of interest situations<sup>51</sup> and should be limited to situations in which there is no question of coverage and in which the claim is within policy limits.<sup>52</sup>

A second form of the relationship is also clear cut. Several courts mandate that in conflict situations the policyholder be permitted to hire an attorney who will be paid by the insurance company.<sup>53</sup> This reduces the possibility of improper ties between the insurer and the attorney. The absence of control also negates an agency relationship; therefore, the insurer cannot be held vicariously liable for the attorney's negligence.<sup>54</sup> This solution, not surprisingly, is not popular with insurance companies because it impinges on their contractual right to direct the litigation.<sup>55</sup> Without control, it has been asserted, the insurer cannot investigate the lawsuit to make an "honest, intelligent, and knowledgeable evaluation of the claim for purposes of settlement negotiations."<sup>56</sup>

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45. *Id.* at 292, 341 S.E.2d at 522.

46. *Id.* at 293, 341 S.E.2d at 522.

47. *See infra* text accompanying notes 81-84.

48. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7 (1983). When the insurer and policyholder have conflicting interests, legal representation should be arranged to ensure counsel's "professional independence." *Id.* Rule 1.7 comment (Interest of Person Paying For a Lawyer's Service); *see infra* notes 85-87 and accompanying text.

49. *See, e.g., In re Allstate Ins. Co.*, 722 S.W.2d 947, 950-51 (Mo. 1987) (en banc) (explicitly declining to follow *Gardner*).

50. *See Bevevino v. Saydjari*, 76 F.R.D. 88, 93 n.4, 94 n.11 (S.D.N.Y. 1977), *aff'd*, 574 F.2d 676 (2d Cir. 1978); *Allstate*, 722 S.W.2d at 953.

51. As a dissenting justice in *Allstate* remarked, "[A]nyone who believes that in conflict of interest situations, a salaried lawyer employee of Allstate would not place the welfare of the corporation above that of the policy holder, who theoretically he represents, probably also believes in the Tooth Fairy and the Easter Bunny." *Allstate*, 722 S.W.2d at 959 (Greene, S.J., dissenting).

52. *See id.* at 951. It also has been asserted that when the independence of staff counsel is preserved, the appearance of impropriety created is not in itself sufficient to warrant disqualification. Mallen, *A New Definition of Insurance Defense Counsel*, 53 INS. COUNS. J. 108, 112 (1986). An opinion on a coverage issue given by the staff counsel to the insurer, however, would warrant disqualification. *Id.*

53. *See, e.g., Klein v. Salama*, 545 F. Supp. 175, 179 (E.D.N.Y. 1982). It has been suggested that the insurer, if it wishes, should be permitted to select outside counsel to control the defense. This solution takes the control of the defense from the insurer without giving it to the policyholder. A. WINDT, *INSURANCE CLAIMS AND DISPUTES* § 420, at 178-79 & n.172 (2d ed. 1988).

54. A. WINDT, *supra* note 53, § 420, at 178-79, § 438, at 219.

55. *See Allstate*, 722 S.W.2d at 952.

56. *Duty to Defend Exists Where Insured Admits He Intentionally Injured a Third Party and Surrounding Circumstances Indicate Insured Acted in Self Defense*, 8 INS. LIT. RPTR. (Miller Freeman) 1055, 1056 (1986).

The third type of relationship—exemplified in *Gardner*—is more complex. Here, the insurer hires outside counsel to represent the policyholder's interests while retaining control of the defense.<sup>57</sup> There is a split of authority in such cases. Some courts deem the attorney an independent contractor;<sup>58</sup> others consider the attorney's actions a component of the duty to defend and impose an agency relationship.<sup>59</sup>

An early case examining the nature of this three-way relationship was *Smoot v. State Farm Mutual Automobile Insurance Co.*<sup>60</sup> In *Smoot* the United States Court of Appeals for the Fifth Circuit refused to allow an insurance company to escape liability for the negligence of an attorney it hired to defend the policyholder.<sup>61</sup> The court reasoned that the insurance policy implicitly created a duty to provide an adequate defense.<sup>62</sup> Hiring outside counsel did not absolve the insurer of this duty when the attorney, though not incompetent, damaged the insured through negligence or bad faith.<sup>63</sup> The court expressly refused to designate the attorney an independent contractor, stating that “[t]hose whom the Insurer selects to execute its promises, whether attorneys, physicians, no less than company-employed adjusters, are its agents for whom it has customary legal liability.”<sup>64</sup> By contrast, the court in *Merritt v. Reserve Insurance Co.*<sup>65</sup> rejected *Smoot*'s implication that an insurance policy imposes a nondelegable duty on the insurer to present an adequate defense.<sup>66</sup> Here, the California Court of Appeal noted that because the insurance company was not permitted to appear in court, all parties understood that the duty to defend was delegable.<sup>67</sup> Nevertheless, subsequent decisions in other jurisdictions have tended to follow the *Smoot* analysis.<sup>68</sup>

The *Brown* court was not oblivious to this contrary authority. It recognized that other jurisdictions had reached a different conclusion in determining the nature of the relationship between an insurer and the attorney it hires.<sup>69</sup> Nevertheless, the court perfunctorily stated that it was bound by “traditional agency principles” and by the recent *Gardner* decision.<sup>70</sup> It is not clear, however, that

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57. See *infra* text accompanying notes 81-83.

58. See *infra* note 68 and accompanying text.

59. See *infra* text accompanying notes 62-63.

60. 299 F.2d 525 (5th Cir. 1962).

61. *Id.* at 530.

62. *Id.*

63. *Id.*

64. *Id.* (citations omitted).

65. 34 Cal. App. 3d 858, 110 Cal. Rptr. 511 (1973).

66. *Id.* at 881, 110 Cal. Rptr. at 526.

67. *Id.* at 880-81, 110 Cal. Rptr. at 526.

68. Cases following *Smoot* include: *Boyd Bros. Transp. Co. v. Fireman's Fund Ins. Co.*, 729 F.2d 1407, 1410-11 (11th Cir. 1984); *Brinkley v. Farmers Elevator Mut. Ins. Co.*, 485 F.2d 1283, 1286 (10th Cir. 1973); *Continental Ins. Co. v. Bayless & Roberts, Inc.*, 608 P.2d 281, 294 (Alaska 1980); *Petersen v. Farmers Cas. Co.*, 226 N.W.2d 226, 228-29 (Iowa 1975). While North Carolina is the only jurisdiction to follow the *Merritt* rationale expressly, *Merritt* has been favorably cited by commentators. See, e.g., 7 C.J. APPLEMAN, *INSURANCE LAW & PRACTICE* § 4687, at 192-93 (rev. ed. 1979); A. WINDT, *supra* note 53, § 4.38, at 220.

69. *Brown*, 90 N.C. App. at 472-73, 369 S.E.2d at 372.

70. *Id.* at 471, 369 S.E.2d at 371.

traditional principles and precedent mandated such a result. First, the court correctly noted that in North Carolina "a principal's vicarious liability for the torts of his agent depends on the degree of control retained by the principal *over the details of the work as it is being performed*. The controlling principle is that vicarious liability arises from the right of *supervision and control*."<sup>71</sup> In contrast to most North Carolina cases determining the nature of employment,<sup>72</sup> however, the *Brown* court did not examine closely the underlying relationship between the parties,<sup>73</sup> a remarkable omission given the intricate legal and ethical problems the situation presents. In fact, insurers generally, as LMCC here, retain a great deal of control over litigation even when outside counsel is hired.<sup>74</sup> This includes control over trial preparation, expenses, expert witnesses, and discovery, as well as the ultimate authority on whether to settle.<sup>75</sup> Illustrative of the insurer's control in *Brown* was the attorney's recommendation to LMCC that the company pay the policy limit<sup>76</sup> and LMCC's subsequent instruction to the attorney to offer judgment and withdraw from the case<sup>77</sup> despite LMCC's continuing duty to provide a defense under the terms of the insurance policy.<sup>78</sup>

Second, in following the approach taken in *Merritt*, the court went beyond the scope of that decision. In *Merritt* the court found no conflict between the interests of the insurer and insured—they were parallel at all times.<sup>79</sup> In *Brown*, because the amount of the claim was far in excess of the amount of LMCC's coverage, a vigorous defense—one that asserted all possible claims and defenses—was critical to the Browns. The insurance company was likely to lose twenty-five thousand dollars regardless of the action taken. In contrast to the Browns, then, the insurance company's interest in defending the claims was not great. Several courts have declined to follow *Merritt* for this very reason.<sup>80</sup>

Third, the court's reliance on *Gardner* is questionable. In *Gardner* the State Bar asserted that there was no difference in substance between hiring an outside attorney to conduct the litigation and delegating it to a staff attorney.<sup>81</sup> The court rejected this argument, noting that in the latter situation the insurance

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71. *Id.* at 471-72, 369 S.E.2d at 371 (quoting *Hayman v. Ramada Inn, Inc.*, 86 N.C. App. 274, 277, 357 S.E.2d 394, 397, *disc. rev. denied*, 320 N.C. 631, 360 S.E.2d 87 (1987)).

72. *See supra* notes 27-39 and accompanying text.

73. The court, without providing a factual analysis, found that although LMCC "controlled the ultimate decision to settle or defend under the policy," it saw no evidence that the insurer had "control over the details of the litigation." *Brown*, 90 N.C. App. at 472, 369 S.E.2d at 371.

74. *See Note, supra* note 43, at 1433.

75. *In re Allstate Ins. Co.*, 722 S.W.2d 947, 952 (Mo. 1987) (en banc); *see Note, supra* note 43, at 1433; C. WOOLFRAM, *MODERN LEGAL ETHICS* § 8.4.1, at 428 (1986).

76. Record at 29, *Brown v. Lumbermens Mut. Cas. Co.*, 90 N.C. App. 464, 369 S.E.2d 367 (No. 8722SC426), *disc. rev. granted in part*, 323 N.C. 363, 373 S.E.2d 542 (1988).

77. *Brown*, 90 N.C. App. at 466-67, 369 S.E.2d at 368.

78. *Id.* at 477, 369 S.E.2d at 374.

79. *Merritt v. Reserve Ins. Co.*, 34 Cal. App. 3d 858, 877, 110 Cal. Rptr. 511, 524 (1973).

80. *See, e.g.*, *Continental Ins. Co. v. Bayless & Roberts, Inc.*, 608 P.2d 281, 294 (Alaska 1980). The conflict in *Bayless* was more egregious. The policyholder's attorney recommended that the insurer send a reservation of rights letter to the insured and subsequently drafted it. He also contacted the insurer for permission before taking certain actions. *Id.*

81. *Gardner v. North Carolina State Bar*, 316 N.C. 285, 292, 341 S.E.2d 517, 521 (1986).

company is the actor. With the outside attorney conducting the litigation, however, the insurer

does not purport to defend or represent its insureds itself. It agrees to furnish a defense and carries out its obligation by paying an independent attorney, *assumed for the purpose of this opinion to be an independent contractor*, to represent its insureds. It also has certain contractual rights, supported by its pecuniary interest, to select this attorney and to have some control over the suit. Nevertheless, the independent attorney is the "actor" who provides legal representation for the insured.<sup>82</sup>

*Gardner's* assumption that an outside attorney would be an independent contractor does little to answer the question, however. The court, for example, did not examine the nature of the relationship to determine the degree of control over the manner and method of the work, the traditional agency test.<sup>83</sup> In fact, the court indicated that the insurer has the right "to have some control" over the litigation, a conclusion that belies the assumption that the attorney is an independent contractor. Furthermore, when viewed in context, it is apparent that this assumption was made only to highlight the fact that if a house counsel defends the insured, the insurer itself is the actor providing the legal services. While delegating the defense to an outside attorney very well may create a new actor for the purpose of avoiding the illegal practice of law by a corporation,<sup>84</sup> it does not necessarily limit the insurer's control of the litigation.

Thus, the court's decision in *Brown* that an attorney hired by an insurance company to defend the insured is an independent contractor was not as well grounded in existing law as the court suggested. First, the court ignored the weight of authority in this area, choosing instead to follow dicta in *Gardner*. Second, the court failed to recognize the insurer's control over the litigation, a factor that traditional agency principles would have deemed sufficient to establish an agency relationship. Clearly, the insurer does not want to give up control, and this should not be required under the circumstances of *Brown*, because lack of control will hamper both the insurer's investigation and its coverage decisions. To retain control, however, the insurer must sacrifice the independent contractor status of the attorney it hired, thus subjecting the company to vicarious liability for that attorney's negligence in the policyholder's defense.

The ethical responsibilities of the defense attorney are of paramount concern in situations where the interests of the insurer and policyholder diverge. The Model Rules of Professional Conduct prohibit a lawyer from representing clients with directly adverse interests.<sup>85</sup> A comment notes that a liability insurer-

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82. *Id.* at 292-93, 341 S.E.2d at 522 (emphasis added).

83. *See supra* text accompanying note 29.

84. *See supra* notes 44-46 and accompanying text.

85. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7 (1983). The rule states in full:

(a) A lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless:

(1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and  
(2) each client consents after consultation.

ance agreement may create conflicting interests between the insurer and insured, but requires only that "the arrangement . . . assure the special counsel's professional independence."<sup>86</sup> While these rules do not provide specific standards of behavior, it is reasonably clear that if the defense attorney must align herself with one party it must be the insured.<sup>87</sup>

Because the policyholder still may maintain a negligence action directly against the defense attorney—who generally will have her own malpractice insurance—the court's failure to impute the attorney's negligence to the insurance company will make little difference to the policyholder in a majority of claims. Only where the damages exceed the limit of the attorney's malpractice insurance will a complete recovery be endangered. The burden of the *Brown* decision falls not on the policyholder, but on the insurance defense attorney and her malpractice insurer. As an independent contractor the attorney is liable for any negligence; the insurance company, despite exerting significant control and assuming a share of the risk in the defense, will escape responsibility. At its next opportunity the court should examine the ethical and legal issues in the complex relationship between the insurer, attorney and policyholder. This examination should include a factual analysis of the degree of control the insurer actually asserts in the litigation before placing it in an established framework of agency or independent contractor. Finally, the court should reconsider the position declared in *Brown* and treat an attorney hired by an insurer as its agent where the insurer has exerted control over the litigation.

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(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 the lawyer's own interests, unless:

- (1) the lawyer reasonably believes the representation will not be adversely affected; and
- (2) the client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.

*Id.*

86. *Id.* comment (Interest of Person Paying for a Lawyer's Service). A related provision states: "[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 judgement or with the client-lawyer relationship; and (3) information relating to representation of a client is protected as required by rule 1.6 [regarding confidentiality]."

*Id.* Rule 1.8(f).

87. C. WOOLFRAM, *supra* note 75, § 8.4.1, at 429 (1986).