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Most automobile liability insurance policies provide that the insurer will settle or defend, as it considers appropriate, any claim for damages covered under the terms of the policy and will pay all defense costs.[1] When an action is brought against the insured, the insurer's duty to defend becomes absolute.[2] Historically, insurance companies have employed independent attorneys ("local counsel")[3] to represent insureds.[4] More recently, insurers have used "house counsel"[5] to defend insureds and to prosecute subrogation claims[6] as a way to reduce costs.[7] A great majority of states now permit this use of house counsel.[8]

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1. Hirsch, *Insurer's Duty to Defend*, 1978 DEF. RES. INST. 7, 7-8.

2. *See* Strickland v. Hughes, 273 N.C. 481, 160 S.E.2d 313 (1968); Fireman's Fund Ins. Co. v. North Carolina Farm Bureau Mut. Ins. Co., 269 N.C. 358, 152 S.E.2d 513 (1966). The cost of defense is not necessarily limited by the policy limits. Record at 3, Gardner v. North Carolina State Bar, 316 N.C. 285, 341 S.E.2d 517 (1986) (No. 8410SC1265).

3. This Note uses the term "local counsel" to designate an attorney who is not an employee of an insurance company and who is hired to defend an insured or prosecute a subrogation claim. The term "independent counsel" is increasingly used to mean an attorney who is chosen by the insured and subsequently reimbursed by the insurer. *See* Mallen, *A New Definition of Insurance Defense Counsel*, 53 INS. COUNS. J. 108 (1986).

4. *Id.*

5. "House Counsel" means a licensed attorney who is a full-time, salaried employee of an insurance company. *See* Gardner v. North Carolina State Bar, 316 N.C. 285, 286, 341 S.E.2d 517, 518 (1986).

6. An insurer that pays a claim against its insured for damages caused by the wrongdoing of a third party is entitled to "step into the shoes" of the insured and assert the insured's rights against the third party in order to recover on the claims that it has satisfied. In prosecuting a subrogation claim, an insurer acquires no greater right than the insured would have had. The right of subrogation exists whether or not explicitly stated in the policy. 8B J. APPLEMAN & J. APPLEMAN, INSURANCE LAW AND PRACTICE § 4941 (1981).

7. *See* Mallen, *supra* note 3, at 110. "The initial savings is the elimination of the profit margin of outside counsel. Efficiency and expertise can be achieved because of the ability to train staff counsel in the particular liability lines written by the insurer." *Id.* at 110.

An added support for Mallen's observation is the result of an extensive study conducted by a large North Carolina insurance firm on the cost effectiveness of house counsel in some of the states east of the Mississippi River. The study showed, on an overall basis, that use of house counsel is cost effective and can result in an estimated savings of up to 50%. However, this is an average. The greater savings are in the larger metropolitan areas where attorney fees tend to be higher and where each house counsel can handle a larger volume of cases. In determining cost effectiveness, some of the factors considered were the size of the area to be serviced, the length of time cases await trial, whether local counsel charge on a periodic basis or when the cases are closed, and the average cost charged for the type of case house counsel can handle. The study also showed that on similar type cases, the amount of time spent, the type of work done, and the quality of work performed were consistent between house counsel and outside counsel.

8. Appellee's Brief at 25, Gardner v. North Carolina State Bar, 316 N.C. 285, 341 S.E.2d 517 (1986) (No. 8410SC1265). The appellee, Gardner, stated as follows: "From a thorough examination of authorities, it appears that no state, with the possible exception of Kentucky, has held such representation to be unethical or improper." *Id.* In its judgment, the superior court agreed with appellees stating: "The clear weight of authority outside of this state based both on court rulings and State Bar considerations support the position of the Petitioner [Gardner] that it is not unethical for House Counsel to appear in representation of an insurance company's insureds . . . ." Record at 38; *see, e.g., In re* Rules Governing the Conduct of Attorneys in Florida, 220 So. 2d 6 (Fla. 1969) (Florida Supreme Court rejected proposed Florida Bar rule that an attorney employed in master-servant relationship shall not render legal services on behalf of customers); Coscia v. Cunningham, 250 Ga. 521, 523, 299 S.E.2d 880, 882 (1983) (insurer furnished house counsel to defend insured in automo-

In *Gardner v. North Carolina State Bar*[9] the North Carolina Supreme Court upheld an ethics opinion of the North Carolina State Bar[10] which determined that an attorney who is a full time employee of an insurance company may not represent an insured as the counsel of record.[11] This decision represents the first time the court has reviewed a State Bar ethics opinion.[12] Endorsing the opinion, the court found that representation of an insured by an employee who is a licensed attorney would constitute the unauthorized practice of law by the insurance company.[13] This Note questions the ruling in *Gardner*, focusing particularly on the realities of the "tripartite relationship"[14] between attorney, insured, and insurer. In addition, the Note suggests that the *Gardner* court failed to examine the substantive issue presented by this challenge to the Bar's position—whether an attorney's status as employee of an insurer (house counsel) would render the attorney less capable than local counsel of handling the ethical problems that are endemic to insurance defense. The Note examines this issue by focusing on two ethical problems that exemplify the many concerns surrounding insurance defense—conflict of interest issues and issues of confidentiality.

On January 13, 1982, Nationwide Insurance Company and Robert R. Gardner[15] petitioned the North Carolina State Bar ("the Bar") for reconsideration of two of its previously adopted ethics opinions,[16] Ethics Opinion No. 682 ("Opinion 682")[17] and Code of Professional Responsibility Opinion 19 ("CPR

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bile liability action; this practice is within the meaning of the statute, which provides that corporations are not prohibited from employing attorneys "in or about their own, immediate affairs"); Virginia State Bar Unauthorized Practice of Law, Op. 60 (1985); *see also* ILL. ANN. STAT. ch. 32, para. 415, § 5 (Smith-Hurd Cum. Supp. 1986) (corporation may employ attorney in any litigation in which corporation may be interested by reason of the issuance of a policy of insurance).

9. 316 N.C. 285, 341 S.E.2d 517 (1986).

10. N.C. Code of Professional Responsibility Op. 326 (1986). N.C. Code of Professional Responsibility Op. 326 ("CPR 326") was a reaffirmation of two earlier Code of Professional Responsibility Opinions. *See infra* notes 16-19 and accompanying text.

11. *Gardner*, 316 N.C. at 288, 341 S.E.2d at 519.

12. *Supreme Court Affirms CPR 326 Prohibiting Insurance Companies From Using House Counsel to Defend Insureds*, 11 N.C. ST. B. NEWSL., Spring 1986, at 1.

13. *Gardner*, 316 N.C. at 294, 341 S.E.2d at 523.

14. R. MALLEN & V. LEVITT, LEGAL MALPRACTICE § 262 (1977).

15. Gardner, an attorney licensed to practice law in North Carolina, was employed as house counsel by Nationwide Insurance Company. *Gardner*, 316 N.C. at 286 n.1, 341 S.E.2d at 518 n.1.

16. *Id.* at 286, 341 S.E.2d at 518. Petitioners also asked the Bar to reconsider N.C. Code of Professional Responsibility Op. 624 (1986) ("CPR 624"), which prohibits a title company from employing a full-time, licensed attorney for title searching and real estate transactions. Record at 8. The supreme court did not mention CPR 624.

17. Ethics Opinion 682 provides in part:

> Is it improper and unethical for a member of the North Carolina State Bar who is employed full time by "A" as "house counsel" to represent the insured in active trial litigation in connection with claims arising out of automobile accidents?
>
> *Opinion.* Yes.
>
> (A) An insurance company would be engaged in the unauthorized practice of law and in violation of G.S. 84-2.1, G.S. 84-4 and G.S. 84-5 by employing "house counsel" to represent insureds in active trial litigation in connection with claims arising out of automobile accidents. Also see Ethics Opinion 624.
>
> (B) Since a corporation cannot practice law directly, it cannot do so indirectly by employing lawyers to practice for it. *Seawell v. Carolina Motor Club, Inc.*, 209 N.C. 624.

N.C. State Bar Comm. on Ethics, Op. 682 (1969).

19").[18] These opinions generally provide that it would be unethical for the house counsel of an insurance company to defend that company's insureds as counsel of record in claims arising out of the insured's policy.[19] The Ethics Committee of the Bar responded to this request for reconsideration by issuing Proposed Code of Professional Responsibility Opinion 326 ("CPR 326") on October 21, 1982.[20] This Ethics Committee proposal, affirming Ethics Opinion 682 and CPR 19, was adopted by the Bar Council[21] on January 14, 1983.[22]

On February 11, 1983, Gardner and Nationwide filed a petition seeking judicial review of CPR 326 in the Wake County Superior Court,[23] requesting that the court declare CPR 326 void.[24] The superior court struck down CPR 326[25] and declared that it would be "lawful for full time salaried employees of an insurance company who are attorneys licensed to practice in the State of North Carolina . . . to appear as counsel of record in actions brought against insureds."[26] In striking down the Bar's decision, the trial judge concluded that "the distinction made by the Bar between 'house' and 'outside independent' counsel was an arbitrary distinction and therefore unlawful."[27]

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18. CPR 19 provides in part:

> The [subrogation] claim is single and indivisible. Where the insurance company pays only a portion of the loss, the insured is a necessary party plaintiff in any action against the third party tort-feasor. The insured may recover judgment for the full amount of the loss, and the insured holds the proceeds of the judgment as trustee for the benefit of the insurance company to the extent of the insurance paid by it. The third party tort-feasor has the right to have the amount of his liability determined in a single action. Therefore, the salaried lawyer of an insurance company would be representing the insured on the record and in fact. In effect, therefore, the insurance company would be practicing law through its salaried lawyer. An insurance company cannot practice law. Therefore, it would be unethical for the salaried lawyer of the insurance company to handle the subrogation claim or a possible suit arising out of the claim. *See* Opinions 682 (1969) and 624 (1968).

N.C. Code of Professional Responsibility Op. 19 (1974).

19. *Gardner*, 316 N.C. at 286, 341 S.E.2d at 518.

20. Record at 32-33; *see infra* note 76 (partial textual reference to N.C. CPR 326).

21. The North Carolina General Assembly created the North Carolina State Bar as an agency of the State. N.C. GEN. STAT. § 84-15 (1985). The Bar Council is the governing body of the Bar and is composed of fifty appointed or elected councilors. *Id.* § 84-17. This Council is vested with "the control of the discipline, disbarment and restoration of attorneys practicing law in this State." *Id.* § 84-23. Additionally, the Council is empowered to "formulate and adopt rules of professional ethics and conduct." *Id.*

This statutory grant of power to the Bar does not abridge the inherent power of the North Carolina Supreme Court to discipline attorneys. *See id.* § 84-36. The court and the Bar have "co-equal and co-extensive" powers. Swenson v. Thibaut, 39 N.C. App. 77, 109, 250 S.E.2d 279, 299 (1978), *disc. rev. denied*, 296 N.C. 740, 254 S.E.2d 181 (1979).

22. Record at 33.

23. *Gardner*, 316 N.C. at 286, 341 S.E.2d at 518. The petition was filed pursuant to N.C. GEN. STAT. § 150A-45 (1983) (provision for judicial review of a declaratory ruling of a state agency under the Administrative Procedure Act), *amended by* N.C. GEN. STAT. § 150B-45 (1986). *Gardner*, 316 N.C. at 287, 341 S.E.2d at 518. Plaintiffs Gardner and Nationwide argued that because the Bar is a state agency they were entitled to judicial review of the Bar's decision by a superior court as outlined by the Administrative Procedure Act. *See id.* at 286, 341 S.E.2d at 518-19.

24. Record at 1-3.

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

26. Record at 39.

27. *Gardner*, 316 N.C. at 287, 341 S.E.2d at 518. In declaring the distinction between house and local counsel arbitrary, the trial court found that "[t]he clear weight of authority outside of this State based both on Court rulings and State Bar considerations support the position of the Petitioner

On appeal[28] the Bar advanced two arguments in support of CPR 326. First, it maintained that the legal representation of insureds by salaried, full-time employees who are licensed to practice law in North Carolina would violate North Carolina General Statutes section 84-5, which prohibits the unauthorized practice of law by a corporation.[29] The Bar contended that the insurer and insured do not share a common interest and, therefore, the representation of an insured amounts to representing "another person."[30] Because the insurance company acts through an employee when it represents another person in court, the Bar maintained that the company violates the general prohibition against a corporation practicing law or appearing as an attorney for any person in any state court.[31] Second, the Bar asserted that "the proposed practice would result in an increased risk of conflicts of interest."[32] These conflicts of interest are "endemic" to the relationship between the insurer and the insured and justify a prophylactic rule prohibiting the insurer from representing insureds through employees.[33]

Nationwide and Gardner advanced three arguments[34] in support of the trial court's finding.[35] First, because of the nature of the contract between the insured and insurer,[36] the insurance company is simply "acting in furtherance of its business" when it employs counsel to defend suits under liability policies and

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that it is not unethical for House Counsel to appear in representation of an insurance company's insured . . . ." Record at 38.

28. The Bar was granted leave to appeal directly to the supreme court. *Gardner*, 316 N.C. at 287, 341 S.E.2d at 318.

29. Appellant's Brief at 4, *Gardner; see* 316 N.C. 285, 341 S.E.2d 517 (1986); *see infra* notes 61-75 and accompanying text (discussing the general prohibition against the practice of law by corporations announced in N.C. GEN. STAT. § 84-5 (1985)).

30. Appellant's Brief at 5-6.

31. *Id.* at 7. The Bar contended that the employee's status as a licensed attorney would not prevent a finding that the corporation engaged in the unauthorized practice of law. In fact, the attorney's participation in the proposed arrangement would constitute unethical conduct in violation of N.C. CODE OF PROFESSIONAL RESPONSIBILITY DR 3-103(A) (1981), which forbids a lawyer from assisting a nonlawyer in the unauthorized practice of law.

32. *Gardner*, 316 N.C. at 289, 341 S.E.2d at 519. The Bar acknowledged that conflict of interest problems between insured and insurer occur regardless of whether the attorney is local counsel or house counsel. *See* Appellant's Brief at 16-18. The areas of potential conflict include "liability evaluation, compulsory counterclaims, economics of the defense, policy coverage and confidentiality," as well as "qualitative factors" (avoidance of the emotional trauma of a trial, maintenance of reputation, or maintenance of an "unsullied" driving record). *Id.* at 16-17. Although these conflicts also may arise when local counsel represents the insured, the Bar argued that the participation of house counsel in the representation of insureds would involve house counsel in "situations fraught with unethical conflicts of interest between their corporate employers and the insureds." *Id.* at 16, 30. The Bar surmised that house counsel could not handle these conflicts as well as local counsel because house counsel could not exercise the independent judgment needed to identify and manage these conflicts. *Id.* at 16, 18.

33. *Id.* at 16; *see infra* notes 136-38 and accompanying text.

34. Petitioners also contended that CPR 326 violated Robert Gardner's individual rights under the North Carolina Constitution and the fourteenth amendment to the United States Constitution because it prevented Gardner "from practicing law by denying him the right to appear before a court." *Gardner*, 316 N.C. at 295, 341 S.E.2d at 523. The supreme court dismissed this argument by stating that Gardner had chosen to contract his entire time with Nationwide. *Id.* Discussion of the constitutional implications of the court's decision is beyond the scope of this Note.

35. *See supra* note 27 and accompanying text.

36. *See supra* text accompanying note 1.

to prosecute claims under collision policies.[37] Second, pointing to the universal practice of insurance companies' payment of local counsel to litigate claims,[38] Nationwide and Gardner argued that no reasonable distinction exists between "the employment of house counsel and the employment of local counsel by the insurance company."[39] Third, Nationwide and Gardner argued that any potential conflicts of interest[40] would develop whether the insurer employed house counsel or local counsel.[41] Furthermore, because all attorneys are bound by the Code of Professional Responsibility, the house counsel will serve the insureds just as effectively as local counsel.[42]

In a unanimous opinion written by Justice Frye, the North Carolina Supreme Court accepted the Bar's position and held that Nationwide's "proposed practice of allowing employees, in the course and scope of their employment, to represent insureds would constitute the unauthorized practice of law as defined by N.C.G.S. § 84-5."[43] The court's analysis involved two inquiries: (1) whether the corporation would be the actor in the proposed practice and (2) whether the statute would prohibit an appearance[44] by such a corporation.[45] The supreme court held that because house counsel is an agent of the insurance company, the company, not the house counsel, would be the actor practicing law under Nationwide's plan.[46] Furthermore, because the insurance company

37. Appellee's Brief at 14. Nationwide and Gardner argued that the furnishing of defense is not a substantial part of the contract with insureds. This defense is only incidental to Nationwide's obligation under the policy to insure the policy holders. *Id.* at 6-7.

38. *Id.* at 7.

39. *Id.* at 10, 14-15; *see also Gardner*, 316 N.C. at 292, 341 S.E.2d at 521 (petitioners arguing that the court failed to distinguish between house and local counsel in State *ex rel.* Seawell v. Carolina Motor Club, 209 N.C. 624, 184 S.E.2d 540 (1936), and has permitted use of local counsel).

40. The Bar argued that potential conflicts of interest necessarily arise when house counsel represents the insurer's insureds. *See infra* notes 133-38 and accompanying text.

41. Appellee's Brief at 28. Appellees noted that when an insurance company consistently hires a local counsel for thirty years, as Nationwide had, an allegiance develops between local counsel and the insurance company. *Id.*

42. *Id.*

43. *Gardner*, 316 N.C. at 294, 341 S.E.2d at 523. The court used a statutory analysis to reverse the superior court ruling. The court failed to reach the conflicts of interest issue. *Id.* at 295, 341 S.E.2d at 523. Furthermore, the supreme court declined to rule on the Administrative Procedures Act's general applicability to the Bar and the decisions of its Council. Instead, the court based its jurisdiction in *Gardner* on "the court's inherent power to deal with its attorneys." *Id.* at 287, 341 S.E.2d at 519.

44. As used in this Note, the term "appearance" or "to appear" refers to the representation of insureds by a licensed attorney who is the counsel of record in an action brought by a third party against the insured or in a subrogation claim.

45. *Gardner*, 316 N.C. at 289-90, 341 S.E.2d at 520.

46. *Id.* at 290, 341 S.E.2d at 520. The court based this finding on State v. Pledger, 257 N.C. 634, 127 S.E.2d 337 (1962). *Gardner*, 316 N.C. at 289-90, 341 S.E.2d at 520. The *Pledger* court reasoned as follows:

> A corporation can act only through its officers, agents and employees. A person who, in the course of his employment by a corporation, prepares a legal document in connection with a business transaction in which the corporation has a primary interest . . . does not violate the [unauthorized practice] statute, for his act in so doing is the act of the corporation in the furtherance of its own business.

Pledger, 257 N.C. at 637-38, 127 S.E.2d at 339-40; *accord* Title Guarantee Co. v. Denver Bar Ass'n, 135 Colo. 423, 312 P.2d 1011 (1957) (attorney preparing documents does so as agent of the corporation; attorney's acts are acts of the corporation); *see also infra* text accompanying notes 71-75 (detailed discussion of *Pledger*).

would appear on behalf of a "person,"[47] "this appearance [would fall] within the ban of N.C.G.S. § 84-5."[48] In addition to this statutory analysis, the court supported its decision with policy considerations derived from an interpretation of state law "according to the policies expressed by [the] legislature and the best interests of [the] state."[49]

To understand the *Gardner* decision thoroughly, it is necessary to examine its statutory and historical context. The unauthorized practice of law is a legal concept comprised of fragmentary bits of doctrine with only an "underdeveloped" and "sketchy" body of abstract legal concepts.[50] Most statutory enactments and court decisions in the United States concerning the unauthorized practice of law occurred during the period 1914 to 1977. During this period the legal profession mounted its most vigorous campaign against the so-called unauthorized practice of law, resulting in the passage of statutes against it.[51] "Although many of these statutes were clear and unambiguous, their broad wording gave the courts ample leeway to determine on a case-by-case basis what practice was unauthorized."[52] In most cases in which individual defendants engaged in activities that the legal profession claimed were reserved for lawyers, the stated goal of the courts in finding a particular activity subject to the unauthorized practice statute was the protection of the public from unqualified persons over whom judges could exert no control.[53]

During this same period, however, the profession became less concerned with individuals engaged in unauthorized practice and more intent on shifting its campaign to combat practice by corporations and lawyers employed by those

47. *Gardner*, 315 N.C. at 291, 341 S.E.2d at 521. The court rejected petitioner's argument, which cited State v. Pledger, 257 N.C. 634, 127 S.E.2d 337 (1962), to support the proposition that because an insured's and insurer's interests coincide, the insurance company can represent through an employee what is essentially its own "primary interests." *Gardner*, 316 N.C. at 291, 341 S.E.2d at 521.

48. *Gardner*, 316 N.C. at 291, 341 S.E.2d at 521.

49. *Id.* at 293, 341 S.E.2d at 522. The court observed that North Carolina has a strong policy of personal representation as evidenced by the legislature's insistence that certain functions which other states permit corporations to perform be carried out by independent attorneys. *Id.*; *see, e.g.*, N.C. GEN. STAT. § 58-132(a) (1982) (title certification).

50. Q. JOHNSTONE & D. HOPSON, LAWYERS AND THEIR WORK 168 (1967). To determine the scope of what the authors term the "legal monopoly," "heavy reliance must be placed on specific factual examples of what is and is not the illegal practice of law." *Id.*

51. Note, *Assisting the Pro Se Litigant: Unauthorized Practice of Law or the Fulfillment of a Public Need?*, 28 N.Y.L. SCH. L. REV. 691, 701 (1983). Lawyers became increasingly concerned about the "unauthorized practice problem" as corporations became involved "in many areas traditionally considered reserved to lawyers." *Id.* For a detailed historical discussion of unauthorized practice, see *id.* at 694-706.

52. *Id.* at 701-02; *see, e.g.*, State *ex rel.* Johnson v. Childe, 147 Neb. 527, 23 N.W.2d 720 (1946). In these opinions, many courts determined what constitutes the practice of law by asking "whether the activity, if undertaken by laymen will harm the public." Note, *Control of the Unauthorized Practice of Law: Scope of Inherent Judicial Power*, 28 U. CHI. L. REV. 162, 166 (1960).

53. Q. JOHNSTONE & D. HOPSON, *supra* note 50, at 173; *see, e.g.*, West Virginia State Bar v. Earley, 144 W.Va. 504, 527, 109 S.E.2d 420, 435 (1959). Johnstone and Hopson observe, however, that court decisions generally have failed to explore and articulate "the goals they are working towards in allocating functions to the bar and its competitor." Q. JOHNSTONE & D. HOPSON, *supra* note 50, at 173. Additionally, courts have not considered the implications of the goals they do not articulate. Q. JOHNTSONE & D. HOPSON, *supra* note 50, at 173.

corporations.[54] Courts utilized a rationale based on the personal nature of the lawyer-client relationship to justify the ban against corporate practice.[55] "This . . . rationale emphasized the personal qualities brought by lawyers to that relationship . . . and focused directly upon a core issue—the lawyer's professional independence."[56] That courts relied on statutes to enforce the ban on unauthorized practice, however, did not signify a relinquishing of courts' claims to their inherent power to monitor and control the practice of law.[57]

In North Carolina the unauthorized practice of law by corporations is governed by North Carolina General Statutes sections 84-2.1[58] and 84-5.[59] Section 84-2.1 defines the practice of law as "performing any legal service for any other person, firm, or corporation, with or without compensation."[60] Section 84-5

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54. Christensen, *The Unauthorized Practice of Law: Do Good Fences Really Make Good Neighbors—or Even Good Sense?*, 1980 AM. B. FOUND. RES. J. 159, 187. A very influential law review article in the early 1930s proclaimed: "Opponents of unauthorized practice of the law consider the performance of such acts by corporations as even more objectionable than when done by individual laymen." Hicks & Katz, *The Practice of Law by Laymen and Lay Agencies*, 41 YALE L.J. 69, 72 (1931).

55. Christensen, *supra* note 54, at 188.

56. Christensen, *supra* note 54, at 188. Christensen notes that the arguments of competency and cost were not effective against corporations practicing law because the corporations were hiring licensed attorneys to handle legal matters and could provide these services at lower cost. *Id.* at 188. The new argument was aptly summarized by Hicks and Katz:

> As the corporation is an artificial being, it obviously cannot satisfy the educational and character requirements for admission to the bar, nor can it take an oath and become an officer of the court subject to its discipline. As the attorney-client relationship is a purely personal one, involving mutual trust and confidence, it cannot exist between an attorney employed by a corporation and a client of the latter. The litigation would be controlled by the corporation which collected the fee. It seems inevitable that, when the interests of the corporation and the client happened to conflict, the attorney would deem his primary duty to be owing to the corporation which employed him, rather than to the client of the corporation. Whenever presented with the problem, courts have therefore held that corporations cannot practice law.

Hicks & Katz, *supra* note 54, at 72; *see also In re* Co-operative Law Co., 198 N.Y. 479, 92 N.E. 15 (1910). Courts frequently cite this case as authority when they find corporations guilty of unauthorized practice. The New York court stated:

> The relation of attorney and client is that of master and servant in a limited and dignified sense, and it involves the highest trust and confidence. It cannot be delegated without consent and it cannot exist between an attorney employed by a corporation to practice law for it, and a client of the corporation, for he would be subject to the directions of the corporation and not to the directions of the client. . . . [The attorney's] master would not be the client but the corporation, conducted it may be wholly by laymen, organized simply to make money and not to aid in the administration of justice which is the highest function of an attorney and counselor at law. . . . There would be no remedy by attachment or disbarment to protect the public from imposition or fraud, no stimulus to good conduct from the traditions of an ancient and honorable profession, and no guide except the sordid purpose to earn money for stockholders. The bar, which is an institution of the highest usefulness and standing, would be degraded if even its humblest member became subject to the orders of a money-making corporation engaged not in conducting litigation for itself, but in the business of conducting litigation for others. The degradation of the bar is an injury to the state.

In re Co-operative Law Co., 198 N.Y. at 483-84, 92 N.E. at 16.

57. Q. JOHNSTONE & D. HOPSON, *supra* note 50, at 169. Courts considered statutory regulation of the practice of law to be in aid of inherent judicial power and not a limitation on it. *See, e.g.*, *In re* Baker, 8 N.J. 321, 335-36, 85 A.2d 505, 512 (1951).

58. N.C. GEN. STAT. § 84-2.1 (1985).

59. *Id.* § 84-5.

60. *Id.* § 84-2.1.

states: "It shall be unlawful for any corporation to practice law or appear as an attorney for any person in any court in this state . . . ."[61]

Prior to *Gardner* few North Carolina cases discussed the unauthorized practice of law by corporations. In *State ex rel. Seawell v. Carolina Motor Club*[62] the North Carolina Supreme Court considered whether the acts of defendant motor club in operating a "claim and adjustment" department constituted a violation of the statutory predecessor to section 84-5.[63] These "claim and adjustment services"[64] were performed "by lay employees and agents of the club, and in part by attorneys employed, retained and paid by the defendants."[65] The retained attorneys were apparently local practitioners whom the motor club did not directly employ.[66] The *Seawell* court sustained the trial court's conclusion that the offering of services for compensation violated the ban on unauthorized practice by corporations.[67] In its opinion the court espoused a rationale from a widely quoted New York case that concluded: "A corporation cannot lawfully practice law. It is a personal right of the individual . . . [that] cannot be delegated or assigned. . . . Since a corporation cannot practice law directly, it cannot do so indirectly by employing lawyers to practice for it."[68] Defendant motor club's activity fell within this ban under the *Seawell* court's broad definition of the practice of law.[69] This definition included:

> the preparation of pleadings and other papers incident to actions and special proceedings, and the management of such actions and proceedings on behalf of clients before judges and courts, and, in addition, conveyancing, the preparation of legal instruments of all kinds, and, in general, all advice to clients, and all action taken for them in matters connected with the law.[70]

The next North Carolina case involving the unauthorized practice of law by a corporation was *State v. Pledger*.[71] In *Pledger* an employee of a corporation that built homes was convicted of violating section 84-4[72] for preparing deeds of

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61. *Id.* § 84-5.

62. 209 N.C. 624, 184 S.E. 540 (1936).

63. *See* N.C. GEN. STAT. § 157 (1931); *Survey of Statutory Changes in North Carolina 1955—Attorneys*, 33 N.C.L. REV. 528 (1955).

64. *Seawell*, 209 N.C. at 628-30, 184 S.E. at 542-43. The trial court's finding of fact established that the motor club maintained a "Legal Department and Claim and Adjustment Department." The club advertised that this department would give advice to members on legal questions, assist in the collection of damages out of court, and furnish representation to members in criminal cases. *Id.*

65. *Id.* at 629, 184 S.E. at 543.

66. *See Gardner*, 316 N.C. at 292, 341 S.E.2d at 521. The *Gardner* court acknowledged that these attorneys were the equivalent of local counsel. *Id.*

67. *Seawell*, 209 N.C. at 632, 184 S.E. at 545.

68. *Id.* at 631, 184 S.E. at 544 (citing *In re* Co-operative Law Co., 198 N.Y. 479, 483, 92 N.E. 15, 16 (1910)).

69. *Id.* at 632, 184 S.E. at 545.

70. *Id.* at 631, 184 S.E. at 544 (quoting *In re* Duncan, 83 S.C. 186, 189, 65 S.E. 210, 211 (1909)).

71. 257 N.C. 634, 127 S.E.2d 337 (1962).

72. N.C. GEN. STAT. § 84-4 (1985) states that "[i]t shall be unlawful for any person or association of persons, except members of the Bar of the State of North Carolina admitted and licensed to practice as attorneys-at-law, to appear as attorney or counselor at law in any action or proceeding in any court in this State . . . ." *Id.*

trust for customers and corporations. The court's inquiry focused on whether the employee's actions fell within the ban on preparation of documents "for another person, firm, or corporation" by anyone other than members of the Bar.[73] The *Pledger* court reversed defendant's conviction for two reasons. First, the opinion declared that "[a] person, firm or corporation having a primary interest, not merely an incidental interest, in a transaction, may prepare legal documents necessary to the furtherance and completion of a transaction . . . ."[74] Second, the court reasoned that a corporation can act only through its agents. Thus, "[a] person who . . . prepares a legal document in connection with a business transaction in which the corporation has a primary interest" does not violate the law because his or her act constitutes an act of the corporation in furtherance of its own business.[75]

Code of Professional Responsibility Opinion 326, which instigated *Gardner*, was a reconsideration and subsequent reaffirmation of Ethics Opinion 682 and CPR 19.[76] The Bar ruled in Ethics Opinion 682[77] that "it would be improper and unethical" for a member of the bar who is employed full-time by an insurance company as "house counsel" to represent insureds in litigation arising out of automobile accidents. The opinion cited *Seawell* as authority for the ruling. In CPR 19[78] the Bar affirmed this same view in the context of an insurance company's house counsel handling a subrogation claim and possible suit against a third party. The Bar ruled that because the house counsel would represent the insured, the insurance company would, in effect, be practicing law.

By challenging the reaffirmation of these two ethics opinions, the petitioners in *Gardner* placed squarely before the court the issue of whether the distinction between house counsel and local counsel warrants a prophylactic rule or whether the distinction is purely arbitrary. The *Gardner* court adopted the Bar's rationale for CPR 326 and found that the proposed practice by petitioners would

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73. *Pledger*, 257 N.C. at 636-37, 127 S.E.2d at 339. The trial court found that defendant had solicited sales for "shell homes" and that he had prepared deeds of trust for his corporate employer. Defendant was not a member of the Bar. *Id.*

74. *Id.* at 637, 127 S.E.2d at 339. The court noted that all businesses complete documents and make contracts regularly and that these activities are legal. *Id.*

75. *Id.* at 637-38, 127 S.E.2d at 339-40.

76. *Gardner*, 316 N.C. at 286, 341 S.E.2d at 518. CPR 326 reads in part:

> This reconsideration affirms Opinion 682 and CPR 19 and those decisions' premise that it is unethical to engage in the unauthorized practice of law as proscribed by G.S. 85-5
>
> . . . .
>
> Protecting and preserving the relationship of the attorney to his client and the court and avoiding professionally reprehensible conflicts of interest also prohibit this manner of legal representation.
>
> 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.

Gardner, 316 N.C. at 288-89, 341 S.E.2d at 519 (quoting N.C. Code of Professional Responsibility Op. 326 (1986)).

77. *See supra* note 17.

78. *See supra* note 18.

violate the statutory prohibition against corporations practicing law. The employment of local counsel, however, would not violate the statute because the court characterized local counsel as an independent contractor and not as an agent of the insurance company. Thus, the court concluded that CPR 326 was not based on an arbitrary distinction between house counsel and local counsel.[79]

This statutory analysis[80] relied on the distinction between house and local counsel, but failed to demonstrate the validity of such a distinction.[81] To decide the case exclusively on statutory grounds, the *Gardner* court had to find that the corporation is the actor[82] when house counsel represents the insured but that local counsel is the true actor in the case of retained counsel.[83] Citing the equation of house counsel and independent counsel in *Seawell*,[84] petitioners Nationwide and Gardner argued that this distinction simply could not exist.[85] They reasoned that if the companies' current practice of hiring outside counsel to represent insureds did not violate section 84-5,[86] then "they [saw] no compelling reason why they [could not] use salaried attorney-employees to accomplish the same purpose."[87]

The *Gardner* court rejected this argument and distinguished the two types of representation by examining the "character" of the actor in each practice.[88] Justice Frye reasoned that the practice in *Seawell* involved the corporation as actor regardless of whether the club used house or local counsel.[89] He pronounced that the insurance corporation likewise would be the actor if house counsel represented the insured. The court "assumed for the purposes of this opinion" that local counsel used in the current practice would be an independent contractor. Although acknowledging that the insurance company has "some control" over an insurance suit, the court found that the independent attorney is the "actor" who provides legal representation for the insured.[90]

This reasoning does not provide an adequate distinction between counsel for two reasons. First, the *Gardner* court's artificial distinction between the employment of house counsel and the employment of independent counsel is not consistent with other authority or with *Seawell*. Other commentators and courts have concluded that both the use of house counsel and the use of local counsel

79. *Gardner*, 316 N.C. at 294, 341 S.E.2d at 523.

80. The court also gave a policy justification. *See supra* note 49.

81. The trial court could find no distinction between local counsel and house counsel. *See supra* note 27 and accompanying text.

82. *Gardner*, 316 N.C. at 289-90, 341 S.E.2d at 520. The court summarily disposed of this "first point of inquiry" by citing its holding in *Pledger* to mean that an employee's acts are the acts of the corporation. *Id.*; *see supra* note 46.

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

84. *Id.* at 292, 341 S.E.2d at 521; *see* Appellee's Brief at 9.

85. *Gardner*, 316 N.C. at 292, 341 S.E.2d at 521.

86. *See id.* at 292-93, 341 S.E.2d at 521-22; *see also* Spencer, *The House Counsel and the Unauthorized Practice of Law*, 33 UNAUTHORIZED PRAC. NEWS 20, 23 (1967) ("[T]he propriety of liability insurance companies employing outside counsel to defend a third person assured was questioned in the past . . . .").

87. *Gardner*, 316 N.C. at 292, 341 S.E.2d at 521; *see* Appellee's Brief at 9.

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

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

90. *Id.* at 292-93, 341 S.E.2d at 522.

technically violate the ban on unauthorized practice by corporations.[91] Under this view, no real distinction exists between the actors; in both cases the attorney is employed by the insurance company and acts for it.[92] The American Bar Association frankly admits that the practice of permitting local counsel to represent insureds, although widely permitted, violates this ban.[93]

Similarly, in *Seawell* the court did not distinguish between the nature of the actors in announcing its prohibition.[94] This prohibition extended to the acts of local counsel and motor club employees alike.[95] The court's opinion did not restrict this ban to the collection activities at issue in the case.[96] To support its broad ban on the practice of law by corporations, the *Seawell* court relied on authorities that either forbade the collection activity of corporations through its own legal department,[97] or prohibited indirect practice by hiring outside firm attorneys.[98] Literature from the same period as the *Seawell* case supports the conclusion that the court did not necessarily contemplate a distinction between the use of house counsel and the use of outside counsel; the permissibility of a corporation hiring outside counsel to represent other persons was not resolved.[99]

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91. *See* Merrick v. American Sec. & Trust Co., 107 F.2d 271 (D.C. Cir.), *cert. denied*, 308 U.S. 625 (1940). In *Merrick* the court dismissed an argument by the Committee on Supression of Unauthorized Practice of Law of the Bar Association of the District of Columbia that a distinction exists between house counsel and local counsel. The court stated:

> Appellants ask us to draw a distinction, at least in respect to probate work, between the employment of attorney-officers and the employment of outside counsel; . . . The question whether defendant [trust company] is practicing law cannot turn upon it. Defendant is as free as any corporation to consult its own convenience in selecting and employing attorneys. What it may do through one member of the bar it may do through another, if he is not specially disqualified. The attorney's employment may be sporadic, frequent, or continuous; it may be performed in and from defendant's offices or other offices; and it may be paid for by fee or by salary. Salaried attorneys and outside counsel are subject to like motives and obligations, public and private, and to like public control. Either may be employed to perform legal services which are properly connected with their employer's business.

Id. at 277-78; *see* State Bar Ass'n v. Connecticut Bank & Trust Co., 145 Conn. 222, 229, 140 A.2d 863, 868 (1957) ("there is no valid distinction between acts performed . . . through its salaried employees and the same acts performed through independent, outside counsel"); *see also* Spencer, *supra* note 86, at 25 (briefs of Ohio State Bar Association and Illinois State Bar Association recognize that the use of independent counsel is an exception to the general rule).

92. *See* State Bar Ass'n v. Conneticut Bank & Trust Co., 145 Conn. 222, 229, 140 A.2d 863, 868 (1957); *In re* Rules Governing the Conduct of Attorneys in Florida, 220 So. 2d 6, 7 (Fla. 1969).

93. Spencer, *supra* note 86, at 24-25.

94. *See Seawell*, 209 N.C. at 632, 184 S.E. at 545.

95. The *Gardner* court acknowledged that the acts of either were prohibited. The court stated: "Petitioners quite correctly state that the Court made no distinctions between the two methods in forbidding defendants' activities." *Gardner*, 316 N.C. at 292, 341 S.E.2d at 521.

96. *See Seawell*, 299 N.C. at 632, 184 S.E. at 544-45.

97. *See, e.g.*, State v. Retail Credit Men's Ass'n, 163 Tenn. 450, 43 S.W.2d 918 (1931).

98. *See, e.g.*, State *ex rel.* Lundin v. Merchant's Protective Corp., 105 Wash. 12, 177 P. 694 (1919).

99. *See, e.g.*, Hicks & Katz, *supra* note 54, at 93-94. Hicks and Katz noted that insurance contracts "appear to be an agreement by a corporation to furnish attorneys to third parties, a service which in other connections has been held to constitute illegal practice of the law." *Id.* at 93. After discussing the arguments for and against insurance companies that furnish attorneys, the Article speculated that courts would uphold "the contention of insurance companies that they are merely protecting their own interests when they furnish the insured with counsel." *Id.* at 93. The Article noted, however, that courts disagree over the situations in which an insurance company could furnish an attorney. *Id.* at 93-94.

The *Gardner* court's distinction between the current practice and the *Seawell* ban is, therefore, not convincing.

Second, the *Gardner* court's reasoning that the characters of the actors in each practice are distinguishable rests on the court's assumption that local counsel is an independent contractor.[100] The outside lawyer traditionally has been viewed as an independent contractor.[101] Nevertheless, the current status of the relationship between insurer and local counsel may not justify this distinction between the actors.

The *Gardner* court characterized the employment of local counsel as the fulfillment of an agreement to furnish a defense to the insured; however, the insurance contract gives the company the right to control that defense.[102] This control is of two types. First, the insurer has final authority over any settlement and can agree or refuse to settle in keeping with its interests.[103] Second, the insurer can exert control over the local counsel's trial preparation.[104] This control extends to discovery matters, including the taking of depositions.[105] One commentator has noted a current trend of insurers to "limit defense costs by exercising greater control over defense counsel's preparation and expenses."[106] In North Carolina the accepted test for determining if an employer-independent contractor relationship exists is "whether the party for whom the work is being done has the right to control the worker with respect to *the manner or method of doing work*."[107] Thus, given the established test for independent contractor status, the character of the local counsel may not be distinguishable from house counsel.

Also central to the *Gardner* court's analysis was its examination of whether section 84-5 of the North Carolina General Statutes would prohibit an appearance by the corporation through its employees.[108] Petitioners Gardner and Nationwide argued that Gardner's appearance as in-house counsel was not prohibited because the corporation would, in essence, be acting for itself.[109] This argument relied in part on the supreme court's holding in *Pledger*. As in

100. *Gardner*, 316 N.C. at 292-93, 441 S.E.2d at 522.

101. *See* W. SEAVEY, THE HANDBOOK OF THE LAW OF AGENCY § 84, at 145 (1964).

102. Traders and Gen. Ins. Co. v. Rudco Oil & Gas Co., 129 F.2d 621, 626 (10th Cir. 1942) (insurer's obligation to pay is primary and paramount; consequently its right to control the litigation is first and paramount); *see also* Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136, 1137 (1954) (most insurance policies unambiguously give the insurer the right to control defense of claims under the policy).

103. Powe v. Odell, 312 N.C. 410, 413 n.3, 322 S.E.2d 762, 764 n.3 (1984); Alford v. Textile Ins. Co., 248 N.C. 224, 229, 103 S.E.2d 8, 12 (1958).

104. Cooney, *The Perils of Defense Counsel's Relinquishment of Control Over Preparation of the Defense to Insurer*, 52 INS. COUNS. J. 259, 259 (1985). Cooney states: "Enormous pressures, either express or implied, can be exerted on defense counsel by an insurance company to forego or delay proper preparation." *Id.*; *see* Underwood, *The Doctor and His Lawyer: Conflicts of Interest*, 30 U. KAN. L. REV. 385 (1982); *Report and Recommendations for the Most Efficient Use of the Legal Effort*, 30 INS. COUNS. J. 519, 519 (1963).

105. Cooney, *supra* note 104, at 260.

106. Cooney, *supra* note 104, at 259.

107. Page v. Sloan, 12 N.C. App. 433, 439, 183 S.E.2d 813, 817 (1971) (emphasis added), *aff'd*, 281 N.C. 697, 190 S.E.2d 189 (1972).

108. *Gardner*, 316 N.C. at 290-91, 341 S.E.2d at 520-21.

109. *Id.*

Pledger, Gardner and Nationwide cited the "primary interest" of the insurance company as justification for house counsel's representation of insureds.[110] The court rejected this reliance on *Pledger*[111] and pronounced that under Nationwide's proposal, the insurance company "would be appearing as an attorney for someone else" in violation of section 84-5.[112]

This conclusion merits closer examination in light of the realities of insurance defense. The *Gardner* court's narrow analysis focused on only two features of the relationship between insurer and insured. First, the court noted that the insured—not the insurance company—is the party who is named in any suit and against whom a judgment could be entered.[113] Second, the identity of the insurer and the insured are distinct because their interests do not coincide when the insured faces liability in excess of the coverage.[114] From this analysis the court surmised that the corporation would not be representing itself but rather a "person."[115] This conclusive distinction[116] between insurer and insured proves crucial because a corporation apparently would not engage in the unauthorized practice of law if it represented itself in litigation through house counsel.[117]

Other courts and commentators have advanced different and more detailed analyses of the party in interest when the insurer has a contractual duty to defend. First, actual divergence of interests between insurer and insured may be the exception rather than the rule. As a practical matter, this divergence of interest between insurer and insured due to excess exposure occurs in settlement considerations, when claims create exposure in excess of policy limits.[118] If there is exposure in excess of the insured's policy, the risk of not settling falls on the insured because "the insured will face an uninsured exposure should an effort to defend or minimize damage fail."[119] Usually, however, the goals of insurer and insured coincide because each wishes to minimize costs.[120] Furthermore, as one commentator has observed,

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110. *Id.*

111. The court's rejection of the interest argument based on *Pledger* was correct. Pledger was charged with violating N.C. GEN. STAT. § 84-4, not § 85-4. *Pledger*, 257 N.C. at 636, 127 S.E.2d at 339. The emphasis in the case concerned whether Pledger was personally liable even though he acted as an agent of the corporation. *Id.* at 637-38, 127 S.E.2d at 339-40.

112. *Gardner*, 316 N.C. at 291, 341 S.E.2d at 521.

113. *Id.*

114. *Id.*

115. *Id.* A corporation representing a person would violate the general ban announced in *Seawell*. *Seawell*, 209 N.C. at 630, 184 S.E. at 544.

116. The court apparently adopted the position of the Bar. *See* Appellant's Brief at 11. Neither the court nor the Bar cited authority on this point.

117. In its brief the Bar noted that in North Carolina no authority states that a corporation may represent itself in court through house counsel. The Bar assumed, however, that *Pledger* stands for the proposition that a corporation may represent itself. *Id.* at 14; *see also* N.C. Code of Professional Responsibility Op. 326 (1986) (the proposed practice would be unethical unless the insurance company defended a claim in its name only).

118. *See* Mallen, *supra* note 3, at 118; Cooney, *supra* note 104, at 259.

119. Mallen, *supra* note 3, at 118. The only risk-free alternative for the insured is to settle, and this option may not be financially attractive to the insurer. Mallen, *supra* note 3, at 118.

120. Cooney, *supra* note 104, at 259; Mallen, *Insurance Counsel: The Fine Line Between Professional Responsibility and Malpractice*, 45 INS. COUNS. J. 244, 252 (1978) ("Dual representation by insurance defense counsel is usually harmonious and equally beneficial to both insurer and insured since they share the same goals . . . .").

> the reality of the excess exposure resides only in the imagination of the pleader. It is almost unheard of for a personal injury claimant to plead a sum constituting the damages which corresponds to the actual loss or that sum truly desired for settlement. Too often the damage claims are so inflated as to be ludicrous.[121]

Finally, even when the insured risks excess exposure, the interposition of the insurance company's interest will guarantee a vigorous defense.[122]

Second, some courts and the American Bar Association approach the issue of the interests of the parties from a functional perspective. Under this analysis of the undertakings of insured, insurer, and attorney, a recognizable community of interest characterizes the relationship.[123] Viewed in this manner, "the company and the insured are virtually one in their common interest."[124]

Third, several courts have noted that although the insurance company is not technically a party to the suit, the insurer's interest and the nature of the contractual duty to defend place the practice proposed by Nationwide and other insurers outside of the ban on unauthorized practice.[125] Under this analysis, the financial state of the insurance company and the burden of carrying defense costs entitles it to defend using its own attorney.[126] The ban is not violated because the insurance company fulfills a contractual obligation, as opposed to conducting a general law practice[127] or furnishing legal services to a member of its organization.[128]

The *Gardner* court's simple statutory analysis, although technically correct, summarily dismissed petitioners' argument and ignored numerous instances in which the insurer alone bears the costs of defense and any loss.[129] The court quite correctly noted that section 84-5 differs from statutes found in many jurisdictions that permit house counsel to defend insureds.[130] The absence of a statutory exception, however, did not prohibit the court from defining the interests of

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121. Mallen, *supra* note 3, at 118; *see, e.g.*, Parker v. Agricultural Ins. Co., 109 Misc. 2d 678, 440 N.Y.S.2d 964 (1981) (punitive damage claims routinely tacked on to *ad damnum* clauses).

122. O' Morrow v. Borad, 27 Cal. 2d 794, 799, 167 P.2d 483, 486 (1946).

123. ABA Comm. on Professional Ethics, Formal Op. 282 (1950). The ABA Ethics Committee stated: "[I]t is evident at the outset that a community of interest exists between the company and the insured growing out of the contract of insurance . . . ." *See also* American Mut. Liab. Ins. Co. v. Superior Court, 38 Cal. App. 3d 579, 592, 113 Cal. Rptr. 561, 571 (1974) (insurer, insured, and attorney may be viewed as loose partnership, alliance, or coalition sharing a common purpose).

124. ABA Comm. on Professional Ethics, Formal Op. 282 (1950). Based on this common interest analysis, the ABA Committee on Professional Ethics ruled that an attorney, employed by an insurance company on a salaried basis, may defend lawsuits against insureds on behalf of the insurance company. *Id.* Although noting that the ABA opinion was "entitled to respect," the Gardner court declined to follow it. *Gardner*, 316 N.C. at 293-94, 341 S.E.2d at 522-23.

125. *In re* Rules Governing the Conduct of Attorneys in Florida, 220 So. 2d 6, 8 (Fla. 1969); Coscia v. Cunningham, 250 Ga. 521, 524, 299 S.E.2d 880, 882-83 (1983).

126. *In re* Rules Governing the Conduct of Attorneys in Florida, 220 So. 2d 6, 8 (Fla. 1969).

127. *Coscia*, 250 Ga. at 524, 299 S.E.2d at 883.

128. *Id.* The Georgia Supreme Court, therefore, would distinguish between Nationwide's proposed practice and the fact pattern of *Seawell* in which the general ban on unauthorized practice was announced.

129. Unless the insurer asserts a reason to deny coverage, if the *ad damnum* clause is equal to or below the policy limit the risk will be the insurer's alone. *See* Appellant's Brief at 17-18.

130. *Gardner*, 316 N.C. at 293, 341 S.E.2d at 522.

the insured and insurer as identical, especially in those cases in which the insured risks no excess exposure problem.[131] The court's literal definition of the represented interest oversimplifies a complex problem that deserves more careful attention.

The ethical issues that the court declined to address could provide a more plausible, although inconclusive, basis for distinguishing the use of local counsel from house counsel.[132] Attempts to distinguish the types of representation involve the ability of house counsel to ethically represent an insured[133] in the face of conflicts of interest endemic to insurance defense.[134] These conflicts of interest were catalogued in CPR 326,[135] but are typified by conflicts surrounding settlement in instances of possible liability beyond policy limits[136] and by coverage issues.[137] Although the Bar recognized that these conflicts apply to local counsel as well as house counsel,[138] it claimed that house counsel may occupy a position in which it cannot behave ethically.

These issues of ethical behavior arise under two ethical canons,[139] Canon 5[140] and Canon 4 of the Code of Professional Responsibility.[141] Canon 5 prescribes as follows: "A Lawyer Should Exercise Independent Judgement on

131. Although the Bar's authority to establish rules of professional conduct and ethics is said to be co-extensive and co-equal with the supreme court's power to regulate its attorneys, *see supra* note 21, the possibility remains that the court has retained sufficient authority to rule on the permissibility of representation by house counsel. In *Gardner* the court was careful to note that the general assembly had expressly stated in N.C. GEN. STAT. § 84-36 that by empowering the Bar it did not intend to abridge or disable the court's "inherent power to deal with its attorneys." *Gardner*, 316 N.C. at 287-88, 341 S.E.2d at 519. Additionally, the court noted that this case was "of sufficient importance" to warrant consideration. *Id.* at 288, 341 S.E.2d at 519. Thus, the court's rationale for the holding, deference to the legislature, seems disingenuous. After examining the substantive issues involved, the court could have chosen to uphold the superior court or modify the ruling to strike a compromise.

One possible solution appears in ABA Comm. on Professional Ethics, Formal Op. 282 (1950). Under this opinion house counsel can represent the insured when the *ad damnum* is within the policy limit. *Id.*; *see also* Locke & Austin, *Handling the Excess Coverage Situation for the Insurer*, 36 INS. COUNS. J. 60 (1969) (advocating the use of independent counsel in situations when the claim exceeds the policy limit).

132. Most of the attention in both appellant's and appellee's briefs was devoted to the conflicts of interest issue.

133. *Gardner*, 316 N.C. at 288-89, 341 S.E.2d at 519.

134. Appellant's Brief at 16.

135. "These conflicts include areas of case liability, evaluation, compulsory counterclaims by the insured, economics of the defense of the case and policy coverage and confidential disclosures." N.C. Code of Professional Responsibility Op. 326 (1980).

136. Appellant's Brief at 17; *see* Locke & Austin, *supra* note 131, at 64; Note, *Conflicts of Interest*, 13 GA. L. REV. 973, 987 (1979).

137. Appellant's Brief at 17; *see* Note, *supra* note 136, at 1007.

138. *See* Appellant's Brief at 16-17; Mallen, *supra* note 120, at 244-45.

139. Subsequent to arguments before the North Carolina Supreme Court, the N.C. Bar Council adopted the NORTH CAROLINA RULES OF PROFESSIONAL CONDUCT (1985) [hereinafter RULES OF CONDUCT]. The RULES OF CONDUCT superceded the NORTH CAROLINA CODE OF PROFESSIONAL RESPONSIBILITY (1981) [hereinafter N.C. CODE], which was based on the ABA MODEL CODE OF PROFESSIONAL RESPONSIBILITY. Because *Gardner* was briefed and argued before the Bar Council adopted the RULES OF CONDUCT, this Note refers to the N.C. CODE in its discussion of ethical opinions. Canons IV and V of the RULES OF CONDUCT embody the same standards for professional conduct as the Canons, Ethical Considerations, and Disciplinary Rules discussed in this Note.

140. Cooney, *supra* note 104, at 262.

141. Amicus Brief for the North Carolina Bar Association at 25, *Gardner*; Note, *supra* note 136, at 1010.

Behalf of a Client."[142] This canon and its disciplinary rules require a lawyer to exercise professional judgment solely for the client and free of compromising influences.[143] If this is not possible a lawyer must decline[144] or discontinue employment.[145] Most important for insurance defense, a lawyer may represent multiple clients if the lawyer "can adequately represent the interests of each and if each consents to the representation after full disclosure."[146] Settlement considerations in situations of possible excess exposure create conflicts that require defense counsel to balance the rights and liabilities of both the insurer and the insured.[147]

Canon 4 states that a lawyer should preserve the confidences and secrets of a client.[148] Under Ethical Consideration 4-5, a lawyer may not "use information acquired in the course of representation of a client to the disadvantage of a client."[149] Furthermore, the lawyer cannot knowingly reveal a confidence.[150] Ethical conflicts can arise when the attorney learns information from the insured "that indicates that the policy does not cover the claim or that a policy defense exists that the insurer could use to avoid coverage."[151]

Following CPR 326 the Bar argued that house counsel could not act ethically in the face of these conflicts for two reasons. First, due to house counsel's position as employee of the insurance company, counsel could not exercise the independent judgment necessary to identify potential or actual conflicts and responsibly manage them.[152] Second, as an agent of the company, house counsel could not maintain the confidentiality of an insured, especially in coverage issues.[153]

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142. N.C. CODE OF PROFESSIONAL RESPONSIBILITY Canon 5 (1981).

143. *Id.* EC 5-1.

144. *Id.* DR 5-105(A).

145. *Id.* DR 5-105(B).

146. *Id.* DR 5-105(C).

147. Locke & Austin, *supra* note 131, at 61.

148. N.C. CODE OF PROFESSIONAL RESPONSIBILITY EC 4 (1981).

149. *Id.* EC 4-5.

150. *Id.* DR 4-101(B).

151. Note, *supra* note 136, at 1007. These situations will be referred to collectively as "coverage issues." "The *Code of Professional Responsibility* imposes a broad fiduciary duty upon an attorney not to use information acquired in the course of representation to the disadvantage of his client." Note, *supra* note 136, at 1006. If the insured divulges confidential information to the attorney which indicates that the policy may not cover the claim, the attorney may not disclose the privileged information to the insurer. Note, *supra* note 136, at 1007-08.

152. Appellant's Brief at 16; *see* N.C. Code of Professional Responsibility Op. 326 (1986).

153. Appellant's Brief at 16. A typical coverage issue would arise when the insured relates facts to the attorney that would allow the insurer to deny coverage under the terms of the policy. Mallen describes the duty of counsel when given confidential information concerning a possible coverage issue:

> Where the attorney selected by the company to defend a claim or suit becomes aware of facts or information, imparted to him by the insured under circumstances indicating the insured's belief that such disclosure would not be revealed to the insurance company but would be treated as a confidential communication to the attorney, which indicated to the attorney a lack of coverage, then as to such matters, disclosures made directly to the attorney, should not be revealed to the company by the attorney nor should the attorney discuss with the insured the legal significance of the disclosure or the nature of the coverage question.

Mallen, *supra* note 120, at 247.

Commentators have noted the problems that arise when house counsel attempts to manage conflicts of interest. Responsibilities placed on house counsel to properly respond to the needs of employer and insured have been described as onerous.[154] Difficulty recognizing conflicts of interest may result from a subjective bias in favor of the insurer.[155] Control of insurance defense ultimately lies with a house counsel's superiors, who may pressure the attorney to act in the company's interest.[156] Furthermore, house counsel may be concerned that the insurer will be dissatisfied if he or she employs a course of action detrimental to the company's economic interests because of perceived ethical obligations.[157] Although these conflicts present serious ethical problems for local counsel as well,[158] the rationale underlying CPR 326 is that the employee relationship of house counsel creates such a tremendous risk that a prophylactic rule is justified.[159]

Not all courts and commentators agree with this ethical analysis, which characterizes house counsel as a corporate agent caught in a situation that prevents ethical behavior. The Florida Supreme Court rejected a nearly identical proposal to CPR 326[160] on the grounds that it "merely discriminates against a

154. Coscia v. Cunningham, 250 Ga. 521, 524, 299 S.E.2d 880, 883 (1983).

155. Mallen, *supra* note 3, at 109. Mallen notes that conflicts of interest have both objective and subjective components. Favoritism to the interests of an insurer, whether deliberate or subconscious, constitutes a breach of ethical rules and fiduciary obligations. *Id.* at 109-110. The pressure that an insurance company can exert on house counsel was illustrated by an article in the National Law Journal on November 26, 1984. This article reported a California case in which house counsel filed suit against an insurance company claiming he was wrongfully discharged for refusing to participate in the company's "aggressive policy of unethical claims practices." The attorney alleged he was fired after he disobeyed the company's orders not to tell two policyholders that plaintiffs had made settlement offers within the policy limits. The jury awarded house counsel $250,000. Galante, *In-House Attorney Wins $250,000 for Wrongful Discharge*, Nat'l L.J., Nov. 26, 1984, at 8. Although this case could be viewed as evidence of the onerous pressure on house counsel to favor their employers, an alternative conclusion is possible. Such cases may serve as notice to insurance companies desiring the economic advantages of house counsel representation that they must allow house counsel to behave ethically or face possible civil penalties from the employee as well as from the insured.

156. This argument ignores, however, the duty imposed on the insurer to carry out the insurance contract in good faith. Alford v. Textile Ins. Co., 248 N.C. 224, 229, 103 S.E.2d 8, 12 (1958) ("[C]ourts have consistently held that an insurer owes a duty to its insured to act deligently [sic] and in good faith in effecting settlements within policy limits . . . ."). If insurance companies pressure house counsel to behave unethically, they risk assertions of bad faith by the insured.

157. Mallen, *supra* note 3, at 111. In response to petitioner's argument that house counsel would behave ethically by adherence to the Code of Professional Responsibility, the Bar stated:

> Such an assumption ignores the fact that such conflicts, particularly in the area of defense economics, are often difficult to perceive. This difficulty would doubtless be exaggerated for an attorney with a long-term institutional bias in favor of his corporate employer, which happens to be potentially adverse to his primary client.

Appellant's Brief at 24.

158. *In re* Rules Governing the Conduct of Attorneys in Florida, 220 So. 2d 6, 7 (Fla. 1969); *see supra* note 32.

159. Amicus Brief for the North Carolina Bar Association at 32.

160. *In re* Rules Governing the Conduct of Attorneys in Florida, 220 So. 2d 6 (Fla. 1969). The Florida Bar proposed an addition to their rules aimed primarily at "the practice of certain major insurance companies to maintain full time employed counsel who also represent policy holders." *Id.* at 7. The Florida Bar noted possible conflicts between insurer and insured when claims exceeded coverage and in compromise settlement negotiations. The Bar insisted that the "pressure of retaining one's full time means of livelihood" precluded the possibility that house counsel could give unadulterated devotion to divergent interests. *Id.* The Florida court rejected the proposal that only local counsel could handle these situations and upheld the use of house counsel. *Id.*

class with no reasonable basis for distinction."[161] The court reasoned that the ethical problem might well arise regardless of the nature of the employment between the insurance company and the lawyer.[162] Courts that find house counsel to be equally loyal to clients perceive these attorneys as members of the bar governed as all others by the Code of Professional Responsibility.[163] Differential treatment between the two types of counsel may serve to establish a "double standard of ethics"[164] between two groups within the same bar. This situation is troubling because all members of the bar are subjected to the same background scrutiny and examination concerning professional responsibility.[165]

The Code of Professional Responsibility offers guidance to attorneys who handle conflicts of interest as they arise in a typical insurance case. When the interests of insurer and the insured diverge after a lawyer has undertaken representation, such as in the context of a settlement negotiation, the attorney must disclose these conflicts to the insured and advise the insured of his or her ability to obtain independent counsel.[166] Local counsel has used this disclosure requirement as a method for maintaining ethical behavior. It appears that disclosure and advice of rights requirements would similarly protect the interests of insureds who are represented by house counsel. Such an assumption rests, however, on a belief that house counsel would not be unduly influenced by subjective biases arising from the employment situation itself.

Coverage issues present more complex and troubling questions concerning the possible limitations on the ability of house counsel to handle ethical problems. In conflicts surrounding coverage issues, the insured's counsel possesses confidential information that may be adverse to the interests of both insurer and insured.[167] When this situation arises the only acceptable solution is for the attorney who possesses the harmful information to withdraw from the case.[168] Even assuming that house counsel could behave ethically in most other situations, it would be a formidable task for counsel either to withdraw from the case or to refrain from divulging information to his or her employer.[169]

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161. *Id.*

162. *Id.* The court stated: "The ultimate problem is the same. There may come a time when the lawyer must decide which of two masters he will continue to serve . . . ." *Id.*; *see also* Murach v. Massachusetts Bonding & Ins. Co., 339 Mass. 184, 189, 158 N.E.2d 338, 342 (1959) (because of the interest of the insurance company in the outcome, local counsel is no more removed than house counsel).

163. *See* Merrick v. American Sec. & Trust Co., 107 F.2d 271 (D.C. Cir. 1939), *cert. denied*, 308 U.S. 625 (1940); Coscia v. Cunningham, 250 Ga. 521, 299 S.E.2d 880 (1983); Allstate Ins. Co. v. Keller, 17 Ill. App. 2d 44, 149 N.E.2d 482 (1958).

164. *In re* Rules Governing the Conduct of Attorneys in Florida, 220 So. 2d 6, 8-9 (Fla. 1969).

165. THE BOARD OF LAW EXAMINERS OF THE NORTH CAROLINA STATE BAR, RULES GOVERNING ADMISSION TO THE PRACTICE OF LAW IN THE STATE OF NORTH CAROLINA §§ .0600, .0900 (Sept. 19, 1985).

166. *See* N.C. CODE OF PROFESSIONAL RESPONSIBILITY EC 5-16 (1981). When an attorney is initially hired by an insurance company to represent an insured, it is the duty of the company to advise insureds of their right to obtain their own counsel. *Id.*

167. *See* Mallen, *supra* note 3, at 108, 112; Note, *supra* note 136, at 1005.

168. *See* Note, *supra* note 136, at 1005.

169. A suggestion has been made, however, that a properly planned legal department could insulate an attorney from these forces. Mallen, *supra* note 3, at 111. Mallen suggests, for example, that a staff counsel department could be "designated to achieve an independence comparable to that

Analysis of the ethical issues surrounding the use of house counsel suggests a more substantive process for determining the validity of CPR 326 than the strict statutory analysis test on which the *Gardner* court relied. Although the court alluded to possible conflicts of interest issues in its decision, by basing its decision entirely on statutory grounds the court engaged in a superficial assessment of the question before it. A thorough assessment of the Bar's claim of the need for a prophylactic rule would have obliged the court to identify and balance the interests of insurance companies, the public, and the Bar. Through this balancing the court could have determined whether a limited exception to the unauthorized practice ban would benefit the public or constitute a reasonable practice by insurance companies.

Even assuming that a strict statutory analysis is a reasonable basis for deciding this case, the court's superficial treatment of the challenge to CPR 326 fails to address satisfactorily the lower court's finding that this ethics opinion draws an arbitrary distinction between local and house counsel. The *Gardner* decision comes during a time of growing concern over the costs of liability insurance. The court's failure to justify the Bar's ruling on more plausible grounds leaves both the court and the Bar open to inferences that they exalted interests of one segment of the Bar over the public interest.

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of outside counsel." *Id.* at 112. This department would be totally separate "with lines of supervision and control [originating with] senior lawyers, not claims persons." *Id.* at 112. The responsibility for employment review and promotion should be maintained within the department. In short, "the exercise of professional judgment must remain with the staff counsel, not the company." *Id.* at 112.