Keeping Policyholder Firms Off Panel Counsel Lists: Are There Disclosure Obligations?

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For Presentation at the Annual Meeting of the ACCEC
Chicago, May 5-6, 2016

This paper addresses the frustrating circumstances experienced by policyholder counsel in large law firms with a diverse litigation practice, including securities litigation defense, when confronted with an insurer's practice of placing restrictions upon law firms as a condition of being listed as "panel counsel" on their D&O insurance policy forms. These restrictions may broadly include a prohibition against any lawyer in that law firm representing any client in any matter adverse to the insurer, even if completely unrelated to matters covered by the D&O policy form. The insurer then rigidly enforces the D&O policy requirement that policyholders use only listed "panel counsel," declining to consent to a policyholder's request to engage non-panel counsel law firms, even where such counsel have existing, longstanding relationships with the policyholder.

A typical D&O policy "panel counsel" provision is something like this:

> Affixed as Appendix A hereto and made a part of this D&O Coverage Section is a list of Panel Counsel law firms ("Panel Counsel Firms") from which a selection of legal counsel shall be made to conduct the defense of any Securities Claim against an Insured pursuant to the terms set forth in this Clause. In the event the Insurer has assumed the defense, then the Insurer shall select a Panel Counsel Firm to defend the Insureds. In the event the Insureds are already defending a Securities Claim, then the Insureds shall select a Panel Counsel Firm to defend the Insureds.

The insurer requires law firm management to make a choice: Either agree that no lawyer in the firm will represent any client in any matter adverse to the insurer, or else understand that the firm will not be listed as panel counsel and will not be able to obtain the insurer's consent to serve as securities defense counsel even if requested by long standing firm clients. This strategy has the intended effect of pitting law firm securities litigation and insurance coverage litigation practice leaders and groups against each other in anticipatory fashion, even when there are no existing client conflicts.

Many large U.S. law firms have outstanding securities litigation defense practices offered at competitive rates to clients. Similarly, many of these same law firms have outstanding policyholder side insurance coverage litigation practices. Securities litigation practice leaders in these firms are understandably upset if they are excluded from an insurer's D&O panel counsel list, especially if that insurer has a substantial share of the D&O insurance market for public companies. They are even more upset if and when a longstanding firm client wants to engage them as securities litigation defense counsel, but the insurer refuses to give consent, instead requiring the engagement of "panel counsel." Similarly, policyholder side insurance coverage practice leaders are understandably upset if their firm agrees to the restrictions required by the insurer to be listed as "panel counsel," thereby foreclosing them from representing any existing

or future clients with interests adverse to the insurer, even though the insurer is not a firm client and regardless of what line of insurance may be involved.

It is an understatement to say that this "panel counsel" practice threatens the ability of securities litigation and policyholder side insurance practices to function side by side together in large law firms and to compete with other law firms having no such restrictions. These are very serious, very difficult law firm issues often leading to the effective marginalization of one or the other of these practices. Accordingly, it should be unsurprising to anyone when questions arise concerning what, if anything, can be done to stop or otherwise ameliorate what appears to be an insurer's punitive practice directed at law firms with policyholder side insurance practices.

Having been privy to a great many conversations among policyholder side insurance counsel hypothesizing one theory or another about why this practice should be "illegal" (antitrust, group boycott, unfair competition, interference with contract, etc.), this paper will eschew all of them for the time being in favor of considering a market based inquiry focused upon both (a) the kind of full disclosure an insurer should make to customers at the time of sale of D&O insurance policies with "panel counsel" provisions; and (b) the duties law firms listed as "panel counsel" on these D&O policies may have to assure full disclosure is made by the insurer to customers at the time of sale.

Hypothetical

Assume as follows:

1. An insurer offers a D&O insurance policy ("Policy") which indemnifies the policyholder as an entity for "loss" defined to include the cost of defense in excess of a $1,000,000 retention for securities claims.
2. The Policy provides: "The insureds shall defend and contest any claim made against them. The insurer does not assume any duty to defend or investigate."
3. The Policy requires the policyholder to use specifically listed law firms and individual lawyers ("panel counsel") as a condition of coverage.
4. To be listed in the Policy, all panel counsel have been required by the insurer to orally agree (a) that no lawyer in their firm will represent any client in any coverage matter adverse to the insurer; or (b) that no lawyer in their firm will represent any client asserting a bad faith claim against the insurer, even if completely unrelated to matters covered by the Policy ("non-adversity agreements").
5. Prior to sale and issuance of the Policy, the insurer does not disclose to its policyholder customers the non-adversity agreements it has required from listed panel counsel.

Questions

1. Has the insurer breached any duty of disclosure owed to its policyholder customers prior to the sale and issuance of the Policy?
2. If so, are panel counsel complicit in this breach by acceding to being listed by the insurer without disclosure to policyholder customers of their non-adversity agreement?
3. Are there any other legal or ethical issues implicated?

Potential Conflicts

Once claims are asserted, it is commonly understood that there are at least three areas where the interests of the policyholder and the insurer potentially diverge:

1. The policyholder is interested in having all asserted claims completely covered, whereas the insurer may contest coverage or reserve its rights regarding a denial or allocation of coverage for some or all of the claims alleged.
2. The policyholder is interested in having all claims resolved within the limits of the Policy, whereas the insurer may resist settlement of claims for amounts it deems unreasonable within Policy limits.
3. The policyholder may want to defend against baseless claims for reputational or other business reasons rather than settle them, whereas the insurer may insist upon settlement within the self insured retention.

Should any one or more of these areas be implicated, a tension arises in which it would be seemingly impossible for defense counsel not to "take sides" in some respect.

Customer Expectations

Absent some warning or disclosure to the contrary, a policyholder would normally expect that defense counsel selected from the panel counsel list would have the conventional ethically imposed duty of undivided loyalty. A policyholder would have no reason to suspect that its counsel would be inhibited in any way from providing a comprehensively zealous representation of all its interests. Here, however, panel counsel with undisclosed non-adversity agreements would be impaired from providing the policyholder with undivided loyalty and a comprehensively zealous representation of all the policyholder's interests, including the three areas listed above where the interests of the policyholder and the insurer might diverge.

Furthermore, here the policyholder is being contractually required to pay its own money to conflicted panel counsel firms for the first $1,000,000 of legal expense within the Policy's self insured retention. The Policy imposes an affirmative duty upon the policyholder to defend itself using panel counsel, whereas the insurer has no contractual duty to provide a defense. ("The insureds shall defend and contest any claim made against them. The insurer does not assume any duty to defend or investigate.") However, without complete advance disclosure of the full details of the non-adversity agreements reached between panel counsel and the insurer, the policyholder has no way of knowing the full extent of undisclosed conflicts. Indeed, the relatively unlimited duty of loyalty secretly pledged by panel counsel to the insurer extends far more broadly than just one case, whereas the loyalty provided by panel counsel to the policyholder is materially limited.

Surely any policyholder would want to know these facts before paying the premium for a D&O policy with baked in conflicts for the panel counsel it will be required to retain and pay with up to $1,000,000 of its own money. These would certainly be material facts affecting any purchase decision. The failure of an insurer to disclose these material facts, about which it is fully informed while a prospective customer is completely ignorant, should be subject to the same

scrutiny as in any commercial transaction. Ordinarily, a seller would have a duty to disclose all material facts to a buyer. By not disclosing these material facts, the insurer is foreclosing the policyholder from making a fully informed decision about whether to purchase this Policy or a different one from a competing insurer on the open market not having such restrictions upon defense counsel.

Full Disclosure in Marketing

It is the central premise of this paper that the attorney-client relationship is among the most sacrosanct of all in our state and federal legal systems. Long ago, the U.S. Supreme Court stated:

> There are few of the business relations of life involving a higher trust and confidence than that of attorney and client, or, generally speaking, one more honorably and faithfully discharged; few more anxiously guarded by the law, or governed by sterner principles of morality and justice; and it is the duty of the court to administer them in a corresponding spirit, and to be watchful and industrious, to see that confidence thus reposed shall not be used to the detriment or prejudice of the rights of the party bestowing it. *Stockton v. Ford*, 52 U.S. (11 How.) 232 (1850).

Nearly forty years ago, the Idaho Supreme Court put it this way:

> The relationship of client and attorney is one of trust, binding an attorney to the utmost good faith in dealing with his client. In the discharge of that trust, an attorney must act with complete fairness, honor, honesty, loyalty, and fidelity in all his dealings with his client. An attorney is held to strict accountability for the performance and observance of those professional duties and for a breach or violation thereof, the client may hold the attorney liable or accountable. *Beal v. Mars Larsen Ranch Corp., Inc.*, 99 Idaho 662, 667-668, 586 P.2d 1378, 1383-1384 (1978) (citation omitted).

The rules of professional responsibility for every state address conflicts of interest and the duty of undivided loyalty owed by attorneys to their clients. For example, Rule 1.7 of the Illinois Rules of Professional Conduct provides:

> CONFLICT OF INTEREST: CURRENT CLIENTS
>
> (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client; or

(2) ***there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to*** another client, a former client or ***a third person*** or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) ***each affected client gives informed consent***.

(emphasis added).

Comment 9 to Rule 1.7 of the Illinois Rules of Professional Conduct elaborates:

Lawyer's Responsibilities to Former Clients and Other Third Persons:

[9] In addition to conflicts with other current clients***, a lawyer's duties of loyalty and independence may be materially limited*** by responsibilities to former clients under Rule 1.9 or ***by the lawyer's responsibilities to other persons***, such as fiduciary duties arising from a lawyer's service as a trustee, executor or corporate director.

A fair reading of this Rule 1.7 would seem to require at a minimum that, prior to engagement as defense counsel, panel counsel must both (a) make full disclosure of any oral or written agreement they have made with an insurer which might in any way materially limit their duty of loyalty and independence to the policyholder; and (b) obtain the policyholder's informed consent, which may be reasonably withheld.

It stands to reason that an insurer similarly should make full advance disclosure to prospective policyholder customers of whatever oral or written agreements they have made with panel counsel which might in any way materially limit their duty of loyalty and independence to the policyholder. If an insurer is not making such full disclosure, and if listed panel counsel are aware that no such disclosure is being made to prospective policyholder customers, then a further question (unanswered by this paper) arises concerning the level of complicity and exposure panel

counsel may have for whatever complaints policyholder customers might assert against insurers for non-disclosure of such obviously material facts in marketing.

Conclusion

This paper is not intended to be a comprehensive legal analysis of the "panel counsel" practices of any insurer. The questions raised herein are simply intended to shed daylight on the underwriting, marketing, and claims handling practices of insurers using "panel counsel" lists to punish law firms with policyholder side practices. A fully informed and free market place should be allowed to determine in the first instance whether policyholder customers have any appetite for "panel counsel" policies with baked in non-adversity agreements. If not, then the issue is moot. If so, however, then further inquiry into the legality of these contractual trade restraints, including the full scope of oral agreements between panel counsel and insurers, can follow.

At a bare minimum, no policyholder should ever have the experience of learning for the first time, after a securities claim has already been filed against it, that the "panel counsel" law firm it is being contractually compelled by its D&O insurer to retain has material limitations upon its duties of loyalty and independence.