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Insurer Guidelines and Third Party Bill Reviews: Ethical and Practical Ramifications

By:

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Introduction

Legal oversight has grown significantly in the past 40 years. With the advent of technology, billing guidelines and third party bill audits and reviews are the norm in the insurance defense business. "Managed care" has hit the arena with provision of legal services in the insurance industry.

Defense counsel hired by insurers to defend policy holders are met with billing guidelines[1] and file handling requirements, as means of cost control and effective claims management practices by insurance carriers. Sometimes, guidelines may be considered to restrict the independent exercise of professional judgment or affect the quality of an insured's representation. Additionally, many insurers utilize external billing review vendors ("fourth party" legal auditors) or computer programs, for electronic review of defense counsel's bills for determination of the reasonableness of charges for services rendered to their policyholders. In some cases, the external bill reviews can compromise the privileges shared between an attorney and their clients.

This paper explores the practical effects of these practices, and the dynamics of the impact that such practices have on the insurer-insured contractual relationship, with focus on the tripartite relationship, as well as the potential that such practice might invite extra-contractual exposure in certain instances.

I. The Nature of the Tripartite Relationship and Fourth Party Legal Audits [McIntosh]

Conceptually, every party involved in the tripartite relationship would share the same objectives and strategize accordingly. In fact, the tripartite relationship is not generally considered a conflict of interest because ideally the insured, insurer, and attorney are all working

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[1] See Appendix I, DRI, The Voice of the Defense Bar, Standard Insurer Billing Guidelines, as an example of guidelines that have been adopted on a wide scale by many insurers.

toward the common goal of defending the insured as contracted.[2] Unfortunately, reality is much more nuanced.

Each party has its own goals that influence the development of each segment of the tripartite relationship, whether it is cost efficiency, settlement, or providing quality legal representation. In order to comply with ABA Rules of Professional Conduct and to shield from malpractice, an insurance defense attorney must delineate each client's objective to ensure no conflicts of interest exist amongst them.[3]

A. Objectives of Each Party

The Insurer

The objectives of the insurer derive from its contractual obligations to the insured.[4] This contractual relationship may trigger the insurer's "duty to defend" the insured.[5] The "duty to defend" is determined by analyzing the "four corners of the complaint."[6] Any breach of this duty to defend may result in bad faith litigation; therefore, the insurer shares the common objective in providing a comprehensive and zealous defense for the insured.

The expense of the defense, however, is a different story. While the insurer is obliged to provide a defense on behalf of the insured, the insurer is under no such obligation to provide the highest quality or most expensive defense.[7] Many insurers seek to secure "panel counsel" that will provide the most cost effective legal representation for their insured. Some carriers, with use of overly restrictive billing or file handling guidelines, place burdensome restrictions on defense counsel to accommodate their expense objectives. This can effectively impact the professional, independent representation of a client.

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[2] *Am. Mut. Liab. Ins. Co. v. Super. Ct.*, 113 Cal. Rptr. 561, 571 (Cal. 3d DCA 1974) ("the attorney has two clients whose primary, overlapping and common interest is the speedy and successful resolution of the claim and litigation"); *U.S. v. Schwimmer*, 892 F.2d 237 (2d Cir. 1989) (Tripartite parties may engage in a "common legal enterprise" for the defense of the insured.)

[3] MODEL RULES OF PROF'L CONDUCT R. 1.6-1.8 and 5.4 (2015).

[4] *Allstate Ins. Co. v. RJT Enterprises, Inc.*, 692 So. 2d 142 (Fla. 1997) (the duty to defend has no roots in common law, "it is purely a contractual duty"); *Peterson v. Ohio Cas. Group*, 272 Neb. 700, 724 N.W.2d 765 (Neb. 2006); *Maxwell v. Hartford Union High Sch. Dist.*, 341 Wis. 2d 238 (Wis. 2011); *Allstate Ins. Co. v. Campbell*, 334 Md. 381 (Md. 1994).

[5] *Peterson* at 709 (In determining its duty to defend, an insurer must not only look to the petition or complaint filed against its insured).

[6] *Higgins v. State Farm Fire and Cas. Co.*, 894 So. 2d 5, 10 (Fla. 2004); *Truck Ins. Exch. v. Prairie Framing, LLC*, 162 S.W.3d 64 (Mo. W.D. 2005)("As long as the petition against the insured demonstrates the potential or possible statement of a claim within insurance coverage, even if inartfully drafted, it triggers the liability insurer's duty to defend").

[7] *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W. 2d 633 (Tex. 1998) ("some insureds who have paid for a "Chevrolet" defense are getting a "Yugo" defense").

The Insured

The insured's objectives are fairly straightforward: swift disposition of the claims against them without having to come out of pocket on any expenses. Of course, there are other more particular considerations that may vary on a case-by-case basis, such as settlement affecting the licensing of an insured or its future insurability due to loss-run history, but for the most part the insured wants the litigation to end quickly without any excess judgment exposure.

Another insured objective, which may more indirectly be sought, is the reduction of premium rates. Many advocates of the use of fourth party billing audits reason that cutting legal expenses through the use of audits reduces insured premium rates in the long run. For this reason, the insured may seek to promote its carrier scrutinizing legal costs for these more tangible benefits.

The Attorney

The defense attorney walks a narrow line in considering the interests of the insured and insurer. The attorney must provide competent representation on behalf of the insured, as his or her client, while concurrently being conscientious of the cost and expense objectives of the insurer. At the same time, defense attorneys run businesses that are for profit. The notion of what is an acceptable profit margin should be in the realm of the business owner, driven by standard free market competition. Interference by outside sources can impact a business significantly.

Some states, in order to prevent conflicts or other problems evolving from this legal balancing act, published opinions specifically finding that the attorney's client is strictly the insured and not the insurer.[8] To protect these interests, defense counsel must be aware of any arising conflicts of interest and tread carefully when planning his client's defense.

The Bill Auditor

Some courts and commentators have suggested that bill auditors or auditing computer programs endeavor to justify their existence by drastically cutting legal expenses to reduce legal costs for insurers.[9] All auditors share the same objective of cutting legal expenses.[10] However,

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[8] *See,* e.g., Fla. Bar Staff, Op, 20591 (1997) (finding that "an insurance defense lawyer's client is the insured, not the insurance company); In re Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedures, 299 Mont. 321 (Mont. 2000) (holding that the insurance defense attorney only works for the insured); Wash. State Bar Ass'n. Formal Op. 195 (1999) (stating that "legally and ethically the client of the lawyer is the insured); *Costley v. State Farm Fire and Cas. Co.,* 894 S.W.2d 380, 385 (Tex. App.--Amarillo 1994), *writ denied* (Dec. 1, 1994) (defense counsel owes "the same type of unqualified loyalty [to the insured] he would owe if originally employed by [the insured]").

[9] California has developed regulations on how a legal auditor is to be compensated as result of the concerns surrounding how legal auditors may cut costs of legal bills. Specifically, California forbids the use of any percentage based compensation scheme that may incentivize a legal auditor to reduce legal bills drastically without just cause. See Ca. Ins. Code 11580.02.

[10] 299 Mont., supra. note 8 at 333.

there are no widely utilized methods of legal auditing, most legal auditors vary widely in their background and experience, and all auditors go relatively unregulated in executing their cost cutting services. [11]

The concerns involving the use of legal bill auditors have caused more than thirty states to publish ethical opinions regarding the use of legal bill audits and billing guidelines, all of which closely examine and recognize the inherent risks of insurance companies using such services. [12] A "fourth party" to the relationship, the bill auditor has none of the obligations imposed by law or ethics on the insurer and defense counsel in the tripartite relationship. The potential for heightened risk and exposure seems poised to strike, in today's "managed care," cost control of legal services.

B. Relationships that May be Adversarial in Nature

Insurer v. Insured

In most cases, the insured and insurer's interests are aligned to provide an effective and efficient defense. However, efficiency and quality don't always go hand in hand.[13] These issues are especially apparent in analyzing the relationship between an insured and the insurer's hired bill auditor. What are the financial incentives of the insurer? What are the financial rewards for the auditor? How do these financial issues impact the insured, who is sued and needs full and complete representation?

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[11] James P. Schratz, Cross-Examining a Legal Auditor, 20 Am. J. Trial. Advoc. 91 (1996).

[12] Alabama Ethics Op. RO-98-02 (1998); Alaska Bar Ass'n Ethics Comm., Ethics Op. 99-1 (1999); Arizona State Bar Comm. on the Rules of Prof'l Conduct, Formal Op. 99-08 (1999); Colorado Bar Ass'n Ethics Comm., Formal Op. 107 (1999); Connecticut Bar Ass'n Comm. on Prof'l Ethics, Informal Op. 00-20 (2000); District of Columbia Bar Legal Ethics Comm., Op. 290 (1999); Florida Bar Staff Op. 20762 (1998); Georgia State Bar Proposed Advisory Op. 99-R2 (2000); Hawaii Formal Ethics Comm., Op. 36 (1999); Idaho State Bar Formal Ethics Op. 136 (1999); Indiana State Bar Op. 4 (1998); Iowa Supreme Court Bd. of Ethics and Conduct, Op. 99-1 (1999); Kentucky Advisory Ethics Op. KBA E-404 (1998); Louisiana Bar Ethics 45 La. B.J. 438 (1998); Maine Bar Ass'n Ethics Op. 164 (1998); Maryland State Bar Ass'n Comm. on Ethics, Op. 99-7 (1998); Massachusetts Bar Ethics Op. 2000-4 (2000); Mississippi State Bar Ass'n Op. 246 (1999); Missouri Informal Op. Summary 980188 (1998); Nebraska Advisory Comm., Advisory Op. 00-1 (2000); New Hampshire Ethics Op. 2000-02/05 (2000); New Mexico State Bar Formal Advisory Op. 2000-02 (2000); New York State Bar Ass'n Comm. on Prof'l Ethics, Op. 716 (1998); North Carolina State Bar, Formal Ethics Op. 11 (2000); Ohio Supreme Court Bd. of Comm'rs on Grievances and Discipline, Op. 2000-2 (2000); Oklahoma Bar Ass'n Legal Ethics Comm., Proposed Revised Advisory Op. 1998-04 (1998); Oregon Formal Op. 1999-157 (1999); Pennsylvania Informal Op. 97-119 (1997); Rhode Island Supreme Court Ethics Advisory Panel, Op. 99-17 (1999); South Carolina Bar Ethics Advisory Op. 98-36 (1998); State Bar of South Dakota Ethics Op. 99-2 (1999); Tennessee Supreme Court Bd. of Prof'l Responsibility, Formal Ethics Op. 99-F-143 (1999); Texas Ethics Op. 532 (2000); Utah State Bar Ethics Advisory Op. Comm., Op. 98-03 (1998); Vermont Bar Ass'n Ethics Op. 98-7 (1998); Virginia Bar Legal Ethics Op. LEO 1723 (1998); Washington State Bar Ass'n Formal Op. 195 (1999); West Virginia Lawyer Disciplinary Bd., L.E.I. 99-02 (1999); Wisconsin State Bar Prof'l Ethics Comm., Ethics Op. E-99-1 (1999).

[13] 299 Mont., supra. note 8 at 333.

A common conflict of interest between insured and insurer emerges when an attorney wants take depositions of certain people in order to thoroughly develop her case.[14] Typically in order to prevent exorbitant costs, insurers "don't allow" attorneys to take the deposition of non-essential people. While this serves the insurer's interests of reducing expenses, this does not always effectuate the insured's objectives of having a quality defense and pertinent information could be lost as a result.[15] Defense counsel can also find such "restrictions" as impacting his or her exercise of independent, professional judgment in the case, as discovery needs are indentified and pursued, or not. Add to this the potential that some fourth party is going to "audit" the work, and determine if it is "essential" to the defense, and a climate is created for dispute and potential satellite litigation.

Attorney v. Bill Auditor

At least one court has noted that an insurance defense attorney stands investigatory, at best, and adversarial at worst with legal bill auditors or outside auditing companies.[16] Legal bill auditors arguably exist purely to challenge and often cut the costs that were already predetermined by the attorney to be legitimate costs incurred while serving the needs of their client. The chasm between defense counsel, and a fourth party auditor, can be enormous.

The inherent polarization between these two parties has generated tort cases between auditors and attorneys. In 2003, a California law firm sued an auditing firm for negligence and intentional tort, alleging the auditing firm caused the law firm's contract with an insurance company to end.[17] While the complaint was dismissed under California law, the case stands to illustrate the depth of the adversarial nature between a fourth-party bill auditor and insurance defense attorney.

C. Where will this go from here?

As shown above, and further explored by the co-authors of this paper hereafter, the potential for disruption of the historical tripartite relationship in the insurance defense arena, is real. The impact on privileges, and consideration of ethical issues, must be explored. Lawyers that represent insurers, directly, and those that represent policyholders, must be mindful of the effects that modern-day business practices have on the historical tripartite relationship. This is explored in more detail in the next two sections of this paper.

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[14] Amy S. Moats, A Bermuda Triangle in the Tripartite Relationship: Ethical Dilemmas Raised by Insurers' Billing and Litigation Management Guidelines, 105 W. Va. L. Rev. 525, 533 (2003).

[15] *Id.* See also 299 Mont., supra note 8 at 333.

[16] *Glenn K. Jackson Inc. v. Roe,* 273 F. 3d 1192 (9th Cir. 2001).

[17] *Glenn K. Jackson Inc.* 273 F. 3d at 1199.

II. Effect of Tripartite Relationship in Insurance Defense Cases on Attorney-Client Privilege and Work Product Privilege [Sutterfield]

A. Where does privilege exist and who forms the magic circle?

The submission of detailed attorney billings to an independent, third party billing service for review and approval of a defense attorney's services relative to an insured may not only constitute a breach of client confidentiality, but may also result in a waiver of attorney-client or work product privileges.

Because the issue of privilege is a legal issue, as opposed to exclusively a question of ethics, guidelines regarding the implications of third-party auditing of lawyers' billings and its effect on attorney-client privilege and work product privilege often fall outside the purview of many state bar advisory committees.[18]

The attorney-client privilege is the oldest privilege in the common law.[19] Its purpose is "to encourage full and frank communication between attorneys and their clients ..."[20] An offshoot of the attorney-client privilege and its legal coequal, the work product doctrine protects the materials prepared by an attorney or the attorney's agent in anticipation of litigation or for trial use.[21]

As a result of the highly protective nature of both privileges, a body of law has developed in recent years addressing the role of a third party, in relation to the basic attorney-client relationship. Examining the tripartite relationship, in the context of defense counsel (e.g. the insured-lawyer relationship, the insurer-lawyer relationship, common interests of the insurer-insured relationship, and their interplay with role of the outside auditor) makes the question even more difficult and often yields differing results.

Each of these relationships begins with a concept informally dubbed the "magic circle". As coined by the United States First Circuit Court of Appeals, the "magic circle" consists of a small circle of "others" with whom information may be shared without loss of privilege (e.g., secretaries, interpreters, counsel for a cooperating co-defendant, a

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[18] Confidentiality issues raised by the subject are often resolved by applying ABA Model Rule 1.6 - Confidentiality of Information.39 Subsection (a) of this rule states, "A lawyer shall not reveal information relating to representation of a client unless the client consents after consultation, except for disclosures that are impliedly authorized in order to carry on the representation, and except as stated in paragraph (b)." ABA Model Rules of Prof'l Conduct R. 1.6(a) (2000).

[19] *See generally* David J. Fried, Too High a Price for Truth: The Exception to the Attorney-Client Privilege for Contemplated Crimes and Frauds, 64 N.C. L. Rev. 443 (1986) (historical overview).

[20] *Upjohn Co. v. United States*, 449 U.S. 383,389 (1981).

[21] *Hickman v. Taylor*, 329 U.S. 495 (1947); *see also United States v. MIT*, 129 F.3d 681, 687 (1st Cir. 1997) ("The [attorney-client] privilege . . . is designed to protect confidentiality, so that disclosure outside the magic circle is inconsistent with the privilege; by contrast, work product protection is provided against 'adversaries,' so only disclosing material in a way inconsistent with keeping it from an adversary waives work product protection.")

parent present when a child consults a lawyer).[22]

The "magic circle" also necessarily examines the purpose of the work for which privilege is sought. Discussing a United States Second Court of Appeals addressing privilege for third-parties, one commentator summarized the case accordingly:

> In United States v. Kovel[23], this matter was considered in the case of an accountant. There, a client sent relevant paperwork to an accountant at a law firm seeking help with a matter that later came to the IRS's attention. When the IRS sought the document from the accountant, the document was considered privileged. The court found that the relevant question as to whether the information was still privileged was whether the information was given to the accountant with the purpose of gaining the accountant's advice or the attorney's. If the accountant was brought into the relationship to interpret financial documents for the attorney so that the attorney could give legal advice or counsel, the attorney-client privilege stood-whereas it would not stand if the accountant was given the information so that the accountant could give advice or if the accountant's interpretation was not necessary for the attorney.[24]

The magic circle represents a functional concern, in that the lawyer must be able to consult with others necessary for competent representation of the client.[25] However, the consult should be directly relevant.

Accordingly, considering the nature of the tripartite relationship, the privileges therein and the extension of privilege even further to communications with a third party, such as a billing company, yields a complicated path.

i. Privilege within the context of the insured- lawyer relationship.

All jurisdictions would agree that lawyer hired by an insurance company to represent its insured must represent the insured as his/her client with undivided loyalty.[26]

Some jurisdictions characterize insurance defense as a one-client situation, with

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[22] *MIT*, 129 F.3d at 684.

[23] United States v. Kovel, 296 F.2d 918 (2d Cir. 1961).

[24] Spencer Rand, Hearing Stories Already Told: Successfully Incorporating Third Party Professionals into the Attorney-Client Relationship, 80 Tenn. L. Rev. 1, 38-39 (2012)(citations omitted).

[25] *Id.*

[26] See ABA Standing Comm. on Ethics and Prof. Responsibility, Formal Op. 96-403 (1996); Florida Bar Prof. Ethics Comm. Op. 97-1 (1997).

defense counsel paid by a third party, the insurer.[27] This approach represents the minority view, but the single-client theory, under which the policyholder alone is the attorney's client, is gaining popularity.

The majority of jurisdictions prefer a joint client approach, meaning that the lawyer represents both the insured and the insurer.[28] In these cases, the defense lawyer has two clients--the insurer and the insured.[29] This is the well-known "dual client doctrine," under which the defense lawyer owes fiduciary duties to both the insurer and insured.[30] However, there is a general perception that the defense attorney will show ultimate alliance to the business practicalities of courting the insurer.[31]

The benefits and complications of the dual client doctrine were explained by one commentator accordingly:

> This joint client construct solves some problems and creates others. It gives the insurance company financing the engagement more clout with the lawyer; some would say too much clout. It also cements claims of privilege for communications with the insurance company. On the other hand, if it is a joint representation, the lawyer, from the beginning, has to worry about conflicts between the insurance company and the insured. As a result, some of these proposed joint representations will be non-starters because issues relating to coverage are already present. And if those conflict issues are not apparent in the beginning they can develop at any time. In addition, the joint representation model means that issues relating to the confidentiality of information must be addressed. When the lawyer could learn from the insured client confidential information that could provide a policy defense (such as intentional misconduct or lack of cooperation), the lawyer is barred from sharing that information with the co-client insurance company.[32]

To that extent, an attorney is not free to disclose potential coverage issues that may exist and impact the insured's status with insurer. For example, in a Massachusetts case, defense counsel was charged with malpractice for disclosing intentional acts by

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[27] See Wolpaw v. Gen. Accident Ins. Co., 639 A.2d 338, 340 (N.J. Super. Ct. App. Div. 1994). (See also, footnote 8, supra.)

[28] Restatement (Third) of the Law Governing Lawyers at §134 cmt. f. (2000).

[29] Jerry & Richmond, supra note 17, § 114, at 887 (describing this view as the majority rule).

[30] Id. (quoting Nat'l Union Fire Ins. Co. v. Stites Prof'l Law Corp., 1 Cal. Rptr. 2d 570, 575 (Ct. App. 1991)).

[31] Purdy v. Pacific Auto. Ins. Co., 203 Cal. Rrptr. 524, 533-34 (ct. App. 1984) ("As a practical matter, however, there has been recognition that, in reality, the insurer's attorneys may have closer ties with the insurer and a more compelling interest in protecting the insurer's position, whether or not it coincides with what is best for the insured").

[32] Susan R. Martyn, Accidental Clients, 33 Hofstra L. Rev. 913, 937 (2005).

insured to insurer.[33]

For this reason, regardless of the single or dual-client approach, some jurisdictions advocate the appointment of separate independent counsel to avoid a conflict of interest. According to one court, "[c]onflict of interest between jointly represented clients occurs whenever their common lawyer's representation of the one is rendered less effective by reason of his representation of the other."[34] Ultimately, it falls to counsel to recognize when a conflict develops. In some jurisdictions, where a conflict of interest arises between a liability insurer and its insured because the insurer provides a defense under a reservation of rights, the insurer has a duty to provide its insured with independent counsel of the insured's choosing, or "Cumis counsel."[35] In others, such as my home state of Louisiana, the insurer can appoint separate counsel for the insured so long as the counsel can defend the insured without doing so in a way that may affect the coverage issues.[36] However, there is case law in Louisiana that should the insurer deny coverage but decide to defend the case, the insurer is responsible for the reasonable costs of the insured's independent counsel.[37]

ii. Privilege within the insurer-insured relationship.

There is no recognized insured-insurer privilege that, in of itself, protects communications between an insured and the insurer.[38] As a result, the only privilege that can arise between the insured and the insurer is that which arises from the attorney-client privilege of the insured-lawyer relationship.

In order to perfect attorney-client privilege, there are two views as to the mechanism giving rise to attorney-client privilege for communications between an insured and its insurer, dubbed the broad view and the narrow view.

Under the broad view, an insured's communication to its liability or indemnity insurer as to an incident possibly giving rise to liability covered by the policy is protected

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[33] Massachusetts Elec. Co. v. Fletcher, Tilton & Whipple, P.C., 394 Mass. 265 (Mass. 1985).
[34] Spindle v. Chubb/Pacific Indem. Group, 89 Cal.App.3d 706, 713, 152 Cal.Rptr. 776, 780-81 (1979).

[35] West's Ann.Cal.Civ.Code § 2860. Compulink Management Center, Inc. v. St. Paul Fire and Marine Ins. Co., 169 Cal. App. 4th 289, 87 Cal. Rptr. 3d 72 (2d Dist. 2008).

[36] See Storm Drilling Co. v. Atl. Richfield Corp., 386 F.Supp. 830, 832 (E.D. La.1974).

[37] Belanger v. Gabriel Chemicals, Inc., 2000-0747 (La.App. 1 Cir. 5/23/01, 7); 787 So.2d 559, 565 writ denied, 802 So.2d 612 (La.2001)

[38] Some states have chosen to adopt bright line rules, acknowledging that all parties to the tripartite relationship enjoy a degree of attorney-client privilege. See Bank of Am., N.A. v. Superior Court of Orange Cnty., 151 Cal. Rptr.3d 526 (2013) ("confidential communications between either the insurer or the insured and counsel are protected by the attorney-client privilege, and both the insurer and insured are holders of the privilege."); see also Ratcliff v. Sprint Missouri, Inc., 261 S.W.3d 534, 548 (Mo. Ct. App. 2008).

from disclosure by the attorney-client privilege.[39] From a practical standpoint, it is understood that such insured-insurer communications are made for the purpose of the insured's reporting responsibilities, as well as triggering the insured's duty to defend.[40]

Even under the broad view, the assumption of privilege is not without limitation. For example, under an Illinois state ruling, there was no attorney-client privilege protecting an insured's communications to an independent insurance adjuster, retained by the insurer to investigate the accident.[41] Likewise, the Iowa Supreme Court found there was no privilege for communications unrelated to the defense of the claim.[42]

Under the narrow view, there is no per se attorney-client privilege in insured-insurer communications. Rather, the attorney-client privilege applies only to communications made for the dominant purpose of the insured's defense by the insurer-appointed attorney and under circumstances in which the insured has a reasonable expectation of confidentiality. This test, while stricter, often results in a privilege being extended to communications between an insured and its insurer-appointed attorney.

Regardless of the broad or the narrow view, an attorney-client privilege extending to communications between an insured and its liability or indemnity insurer may be waived by the insured's voluntary disclosure of the communication to a third person. Voluntary disclosure may constitute a waiver of both the attorney-client privilege and work product protection and each requires a separate analysis for waiver.

iii. Privilege arising from a common interest.

Under the common interest privilege (or "joint defense privilege") the attorney client privilege is extended to protect communications that are "part of an on-going and joint effort to set up a common defense strategy."[43] Under the common interest doctrine, privilege may extend to information shared with third parties when "the parties engage in a common legal enterprise and the communications are a part of an ongoing and joint effort to set up a common defense strategy."[44]

In order to establish the existence of a joint defense privilege, the party asserting the privilege must show that (1) the communications were made in the course of a joint

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[39] See e.g. Finegold v Lewis (1965, 2d Dept) 22 App Div 2d 447, 256 NYS2d 358 (a statement made by an insured to his insurer, before commencement of the suit, was held not available for discovery).

[40] See e.g. White v. City of Ladue, 422 S.W.3d 439 (Mo. Ct. App. E.D. 2013), reh'g and/or transfer denied, (Jan. 30, 2014) and transfer denied, (Mar. 25, 2014) (privilege covers, and excludes from discovery, any communication between insured and insurer which relates to the former's duty to report incidents and the latter's duty to defend and to indemnify).

[41] See e.g. Shere v Marshall Field & Co. (1974, 1st Dept) 26 Ill App 3d 728, 327 NE2d 92.

[42] See in Re Munsell's Guardianship (1948) 239 Iowa 307, 31 NW2d 360.

[43] Weinstein v. Eisenberg, 474 U.S. 946, 106 S.Ct. 342, 88 L.Ed.2d 290 (1985).

[44] US v. Schwimmer, 892 F.2d 237, 243 (2d Cir. 1989).

defense effort, (2) the statements were designed to further the joint effort, and (3) the privilege has not been waived.[45] Where a "joint defense effort or strategy has been decided upon and undertaken by the parties and their respective counsel," communications may be deemed privileged whether litigation has been commenced against both parties or not.[46]

Interpreting a broad cooperation clause, the Illinois Supreme Court applied the common interest doctrine, when it found that the insured and insurers shared a common interest in defeating or settling a plaintiff's underlying claims, despite the fact that coverage was in dispute as well. The court rejected the insured's claims of attorney-client privilege (for independently retained counsel) and permitted discovery by insurers. The court also found the work product doctrine inapplicable because the materials sought were prepared for the benefit of both the insurer and insured in the underlying action, not in anticipation of the coverage litigation.[47]

The benefit of a "common interest" defense, like that in *Waste Management*, is that communications between insured and insurer fall within the protection of the attorney-client privilege with respect to underlying plaintiffs and other third parties. Accordingly, while perhaps limiting the independence of the insured or insurer, the Illinois viewpoint promotes insured/insurer cooperation, while protecting communications from discovery by third parties.

In terms of third party protections under the common interest doctrine, in Bellmann v. County of Arapahoe, 531 P.2d 632 (Colo. 1975), the district attorney in a criminal matter sought discovery of statements made by an insured to an investigator hired by defense counsel in a civil matter. The Colorado Supreme Court held that statements made to a third party (investigator) fell under the ambit of attorney-client relationship and was therefore privileged.

However, the minority viewpoint held by some states indicates that they are reluctant to extend attorney-client privilege so far. In Langdon v. Champion, 752 P.2d 1004 (Alaska 1988), the Alaska Supreme Court held that the insured's communications to a third party (the insurance adjuster) would only qualify as attorney-client privilege if it can be shown that "the adjustor received the communication at the express direction of counsel for the insured".

B. The Auditor, a common interest, and the "magic circle".

In United States v. MIT, a First Circuit Court of Appeals case decided in 1997,

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[45] Matter of Bevill, Bresler & Schulman Asset Management Corp., 805 F.2d 120, 126 (3rd Cir. 1986) (citations omitted).

[46] Schwimmer, 892 F.2d at 244.

[47] Waste Management, Inc. v. International Surplus Lines Ins. Co., 144 Ill. 2d 178 (Ill. 1991).

the court held that privileged information disclosed to an outside government auditing service was discoverable.[48] The court found that MIT waived the attorney-client privilege when it disclosed documents to government auditors, which the court considered outside the "magic circle".[49] In MIT, the IRS requested billing statements from law firms for MIT. Pursuant to a defense contract requirement, MIT had already disclosed the very same billing statements to the auditing agency.[50] MIT provided the billings to the IRS, but redacted portions claiming attorney-client privilege, the work product doctrine, or both.[51] The district court ruled that MIT's disclosure of legal bills to the audit agency forfeited its attorney-client privilege.[52]

This opinion was echoed by the Montana Supreme Court, when they rejected the notion that third-party billing auditors are part of a privileged community or the "magic circle" within which confidential information may be shared without waiver of attorney-client or work product privilege.[53]

The MIT court also rejected the idea that a common interest concept applied to an audit agency, because their interests are not common:

> In a rather abstract sense, MIT and the audit agency do have a 'common interest' in the proper performance of MIT's defense contracts and the proper auditing and payment of MIT's bills. But this is not the kind of common interest to which the cases refer in recognizing that allied lawyers and clients—who are working together in prosecuting or defending a lawsuit or in certain other legal transactions—can exchange information among themselves without loss of the privilege. To extend the notion of MIT's relationship with the audit agency, which on another level is easily characterized as adversarial, would be to dissolve the boundary almost entirely.[54]

However, it should be noted that in MIT, the court did note that a strong policy argument could be made for protecting against disclosure of the mental

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[48] U.S. v. Massachusetts Institute of Technology, 129 F.3d 681, 48 Fed. R. Evid. Serv. 66, 39 Fed. R. Serv. 3d 4 (1st Cir. 1997).
[49] Id.
[50] Id.
[51] Id.
[52] Id.
[53] In re Rules of Prof'l Conduct & Insurer Imposed Billing Rules & Procedures, 299 Mont. 321, 340, 2 P.3d 806, 818 (2000); *see also* U.S. v. South Chicago Bank, 1998 WL 774001, *2, 3 (N.D. Ill. 1998) ("[A]uditors are not generally part of the circle of persons, including secretaries and interpreters, for example, with whom confidential information may be shared without destroying the privilege. ... Here, the banks' year-end audit team—as opposed to the fraud audit team—was outside the circle of persons with whom confidential information could be shared because they were performing work in the ordinary course of business, not for the sake of legal advice. By voluntarily disclosing the minutes from the meetings of the boards of directors and special fraud committees to the year-end auditors in full and to their insurance company in part, the banks have relinquished the right to assert the privilege now against the government.").
[54] 129 F.3d at 686.

impressions and legal theories of an attorney.[55] The court refused to consider the issue because it was not raised or briefed for the court's review.[56] Therefore, to the extent that detailed attorney billings are submitted to external billing auditors, they still may represent work product subject to privilege.

Nonetheless, some commentators are reluctant to extend the First Circuit's rationale concerning auditor to the defense billing context, arguing that the insured, insurer, and auditor interests are aligned because the auditor promotes fiscal efficiency, resulting in lower premiums, and promotes an incentive for counsel to "take the most direct route to resolution", ostensibly encouraging litigators not to drag their feet in order to pad billing.[57]

C. Conclusion

Arguably, it is questionable if third party billing services retained by insurance companies could fall within the ambit of "others" within the "magic circle" with which information may be shared without loss of privilege. While argument may exist to paint the role as adversarial and umbrella it under a larger policy concern advocating speedy resolution of litigation, the issue is nonetheless clouded by uncertain and contradictory case law.

Unlike purely ethical considerations, such as client confidentiality, because the issue of privilege is a legal issue, practicing attorneys must wait for the issue to be ripe within the courts, as opposed to adopting state bar sanctioned guidelines for third-party auditing of lawyers' billings. In light of increasingly complex and intrusive billing management requirements, defense attorneys are left with an open question of "how much is too much?" in order to breach attorney-client privilege, and "how much is just enough?" to preserve work product privilege.

III. Ethical Issues Raised by Billing Guidelines and Legal Fee Audits in Tripartite Relationships [Posner]

A. Billing Auditors and the Attorney-Client Privilege and Work-Product Doctrine

The following issues are implicated when an insurer uses outside billing auditors to review the bills submitted by defense counsel:

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[55] Id. at 688.

[56] Id.

[57] *See* John P. Killacky, Expanding the Tripartite Relationship: Extending Evidentiary Privilege to Fourth-Party Legal Audits, 2000 U. Ill. L. Rev. 1339, 1357 (2000); Kent D. Syverud, The Ethics of Insurer Litigation Management Guidelines and Legal Audits, 21 No. 7 Ins. Litig. Rep. 180, 192 (1990)("the MIT decision actually supports insurers' use of outside auditors, because disclosure of billing information is necessary to facilitate the insured's representation and because the insurer and insured have a common interest in efficient, cost-effective and appropriate representations.")

- The Attorney-Client Privilege
- The Attorney-Work Product Doctrine
- ABA Model Rule of Professional Conduct 1.2 (Scope of Representation and Allocation of Authority between Client and Lawyer)[58]
- M.R. 1.4 (Communication)
- M.R. 1.6 (Confidentiality of Information)
- M.R. 1.7 (Conflict of Interest: Current Clients)
- M.R. 1.8(f) (Conflict of Interest: Current Clients: Specific Rules, particularly with respect to where the fees are being paid by someone other than the client)
- M.R. 5.4 (Professional Independence of a Lawyer)
- M.R. 5.5 (Unauthorized Practice of Law)
- M.R. 5.7 (Responsibilities Regarding Law-Related Services)
- M.R. 8.4 (Misconduct)

Any lawyer defending an insured cannot ignore these rules and doctrines, lest she put herself at significant professional and disciplinary risk.

Insurers also should be mindful of these concerns. While no one can argue that insurers have a right to manage their costs, insisting on the use of outside billing auditors in connection with the defense of an insured has some potential to result in claims against insurers for breach of contract, professional negligence, and bad faith, which in turn could lead to liability for extracontractual damages and regulatory proceedings.

1. Risks

Billing auditors have been described as the "fourth party" in the tripartite relationship.[59] While many jurisdictions have recognized that communications among the client, defense counsel, and the insurance company paying for such counsel, are or should be protected from disclosure to plaintiffs by the attorney-client privilege and/or the work-product doctrine,[60] as is more fully discussed below, many jurisdictions also have declined to extend those protections when such information is shared with the "fourth party."

Similarly, some jurisdictions also have expressed concerns about the limitations imposed on defense counsel by so-called "billing and litigation guidelines." The use of such guidelines and of outside billing auditors have been contributing to an atmosphere of tension, distrust, and

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[58] Hereinafter the ABA Model Rules of Professional Conduct will be abbreviated to "M.R." For the complete text of and comments to the Model Rules, as well as annotations to them, *see* E.J. BENNETT, E.J. COHEN & H.W. GUNNARSSON, ABA ANNOTATED MODEL RULES OF PROFESSIONAL CONDUCT (8th ed. 2015) (hereinafter ANNOT. M.R.). The reader also is invited to consult the applicable Rules in all jurisdictions in which the reader is licensed and or is otherwise admitted to practice.

[59] *See, e.g.*, John P. Killacky, *Expanding the Tripartite Relationship: Extending Evidentiary Privilege to Fourth-Party Legal Audits*, 2000 U. ILL. L. REV. 1339 n. d1.

[60] *See, e.g.*, Stephen Gillers, *Ethical Issues in Monitoring Insurance Defense Fees: Confidentiality, Privilege and Billing Guidelines*, monograph furnished to Law Audit Services, Inc. (1998). For an expanded discussion of this topic, *see* Amber Czarnecki, *Ethical Considerations Within the Tripartite Relationship of Insurance Law—Who is the Real Client?*, 74 DEF. COUN. J. 172 (April 2007).

concern for quite some time, contributing to the rise of an adversarial relationship between insurers and defense counsel.[61] But while cost control is a legitimate business concern, from the point of view of the insured, as well as insured's defense counsel, there's also the ethical and evidentiary concerns regarding privilege.

First is the question of whether documents shared with outside billing auditors may be discovered by plaintiffs in the underlying action. Second is the question of whether documents *mentioned* in documents that are shared with outside billing auditors may be discoverable. Put another way, does sharing such information with outside billing auditors waive the attorney-client privilege, the protections of the work-product doctrine, or both? A somewhat extensive selection from a leading law-review article on this subject may be helpful at this juncture:

> The waiver argument advanced by the insurance defense bar is meritorious. This claim has found acceptance among state bar associations, many of which have issued ethics opinions forbidding the disclosure of information to fourth-party auditors. [Citation to Michael Booth, *State Ethics Bans on Outside Fee Audits Mounting*, 154 N.J. L.J. 93, 93 (1998).] However, the issue is far from settled. At least one state bar has held that such disclosures are permissible. [*Id.*] Additionally, legal auditors feel that violation of confidentiality arguments against fourth-party auditing "are too often shills for defense attorneys who don't want their bills audited . . . . Insurance companies have always audited bills . . . . All they are doing now is outsourcing this function." [*Id.* (quoting Ted Ringle, auditor at Law Audit Services).]
>
> Recently, the courts have added to the controversy. In 1997, the First Circuit Court of Appeals decided United States v. Massachusetts Institute of Technology (*MIT*) [129 F.3d 681 (1st Cit. 1997)], which addresses waiver of attorney-client privilege by disclosure of documents to auditors outside the insurance context. The *MIT* decision is often cited by the insurance defense bar to support their view that disclosure of billing statements to auditors waives any privilege. [Citation to Claire Hamner Matturro, *Auditing Attorneys' Bills: Legal and Ethical Pitfalls of a Growing Trend*, FLA. B.J., May 1999, at 22, 24.] In *In re Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedures (In re Rules Case)* [2 P.3d 806 (Mont. 2000)], the Montana Supreme Court directly applied *MIT* to answer the question of whether disclosure of billing statements to insurer-hired auditors violates client confidentiality. [*Id.* at 818-20.] The court concluded fourth-party auditors do not fall within the "magic circle" of persons covered by the attorney-client privilege. [*Id.* at 820-21.] Additionally, a number of other suits have been filed by insurance defense lawyers seeking restrictions on the ability of insurers to review and control bills. [Citations to Anne Berryman, *Suits Challenge Audits of Insurance Defense Bills*, FULTON CO. DAILY REP. Mar. 8, 1999, at 7; *Smith v. Law Audit Servs.*, No. 164549 (San

[61] *See, e.g.*, Chris S. Stacy, *Life of the Triparty: Why Flat-Fee Independent Counsel Might Just Make Everyone (More or Less) Happy*, 19 REV. LITIG. 323, 325 (Spring 2000).

Francisco Super. Ct., filed Feb. 11, 1999); *Smith v. Legalgard*, No. 164548 (San Francisco Super. Ct., filed Feb. 11, 1999).][62]

While this commentator advocates for an extension of the privilege to fourth-party auditors, his advocacy necessarily must acknowledge that the privilege, in most situations, does *not* extend to fourth-party auditors. Accordingly, a review of potential preventive measures follows.

2. Prophylactic Measures

(a) Stop Using Billing Auditors

While defense counsel likely will not want to hear this, it is not unreasonable for an insurance company to want to exercise some control over the amount of money spent on defending insureds. If the function could be brought in-house, then the issue essentially evaporates.

This may be a difficult concept to sell to insurance companies because there likely are significant cost savings and benefits associated with outsourcing this function. Those benefits, however, need to be weighed against the risks discussed above.

(b) Obtain Informed Consent of Insured Before Disclosing Detailed Bills to Billing Auditors

M.R. 1.6(a) provides in pertinent part that "[a] lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent . . . ."[63] M.R. 1.0(e) defines "informed consent" to denote "the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct."[64]

While the definition of "informed consent" is arrestingly brief, the comments to that definition disclose how serious this concept is to the drafters:

> [6] Many of the Rules of Professional Conduct require the lawyer to obtain the informed consent of a client or other person (e.g., a former client or, under certain circumstances, a prospective client) before accepting or continuing representation or pursuing a course of conduct. See, e.g., Rules 1.2(c), 1.6(a) and 1.7(b). The communication necessary to obtain such consent will vary according to the Rule involved and the circumstances giving rise to the need to obtain information consent. The lawyer must make reasonable efforts to ensure that the client or other person possesses information reasonably adequate to make an informed decision. Ordinarily, this will require communication that includes a

[62] John P. Killacky, *Expanding the Tripartite Relationship: Extending Evidentiary Privilege to Fourth-Party Legal Audits*, 2000 U. ILL. L. REV. 1339, 1340-41.

[63] ANNOT. M.R. 101.

[64] ANNOT. M.R. 15.

disclosure of the facts and circumstances giving rise to the situation, any explanation reasonably necessary to inform the client or other person of the material advantages and disadvantages of the proposed course of conduct and a discussion of the client's or other person's options and alternatives. In some circumstances, it may be appropriate for a lawyer to advise a client or other person to seek the advice of other counsel. A lawyer need not inform a client or other person of facts or implications already known to the client or other person; nevertheless, a lawyer who does not personally inform the client or other person assumes the risk that the client or other person is inadequately informed and the consent is invalid. In determining whether the information and explanation provided are reasonably adequate, relevant factors include whether the client or other person is experienced in legal matters generally and in making decisions of the type involved, and whether the client or other person is independently represented by other counsel in giving the consent. Normally, such persons need less information and explanation than others, and generally a client or other person who is independently represented by other counsel in giving the consent should be assumed to have given informed consent.

[7] Obtaining informed consent will usually require an affirmative response by the client or other person. In general, a lawyer may not assume consent from a client's or other person's silence. Consent may be inferred, however, from the conduct of a client or other person who has reasonably adequate information about the matter. A number of Rules require that a person's consent be confirmed in writing. See Rules 1.7(b) and 1.9(a). For a definition of "writing" and "confirmed in writing," see paragraphs (n) and (b). Other Rules require that a client's consent be obtained in a writing signed by the client. See, e.g., Rules 1.8(a) and (g). For a definition of "signed," see paragraph (n).[65]

The "Financial and Billing Information" annotation to M.R. 1.6(a) addresses this issue more directly:

> The rule also prohibits a lawyer from revealing a client's financial or billing information without the client's consent. *See, e.g.*, R.I. Ethics Op. 2002-02 (2002) (lawyer for municipal council may not comply with individual council member's request for unredacted itemized billing statement unless council consents). The issue arises often in the context of insurance representation, when a lawyer hired by an insurance company to represent an insured is asked to submit information supporting the lawyer's bills to the insurer or a third-party auditor hired by the insurer . . . . Ethics committees commonly find that a lawyer is impliedly authorized to give billing information to an insurer if it will not adversely affect the interests of the insured, but not to submit this information to a third-party auditor without the informed consent of the insured. *See, e.g.*, ABA Formal Ethics Op. 01-421 (2001); *accord In re Rules of Prof'l Conduct*, 2 P.3d 806 (Mont. 2000) (insurance defense counsel may not give detailed description of legal services to third-party auditors absent fully informed consent of insureds);

[65] ANNOT. M.R. 17-18.

Alaska Ethics Op. 2006-3 (2006) (insurance defense counsel may not give confidential bills to noninsurer contractors for electronic or computerized screening); *see also* Conn. Informal Ethics Op. 2011-7 (2011); Fla. Ethics Op. 12-04 (2013); Mass. Ethics Op. 2000-4 (2000); Neb. Ethics Op. 2000-1 (2000); N.H. Ethics Op. 2000-01/05 (2000); N.Y. State Ethics Op. 987 (2013); Pa. Ethics Op. 01-200 (2001); S.C. Ethics Op. 12-08 (2012). *But see* D.C. Ethics Op. 290 (1999) (lawyer may not provide client billing information to insurer or insurer's auditing agency without client's informed consent).

On the other hand, billing information and fee agreements are generally not protected by either confidentiality or the evidentiary attorney-client privilege unless disclosure would reveal the substance of confidential communications between a lawyer and a client. *See, e.g., DiBella v. Hopkins*, 403 F.3d 102 (2d Cir. 2005) (time records and billing statements not privileged when they do not contain detailed accounts of legal services rendered); *United States v. Naegele*, 468 F. Supp. 2d 165 (D.D.C.. 2007) (lawyer's billing statements that were general and did not reveal any litigation strategy or other specifics of representation not protected by attorney-client privilege); *Att'y Grievance Comm'n v. Zdravkovich*, 852 A.2d 82 (Md. 2004) (lawyer's bank statements not attorney-client communications and neither confidential nor privileged); *Hewes v. Langston*, 853 So. 2d 1237 (Miss. 2003) (simple invoice normally not protected by attorney-client privilege, but "itemized legal bills necessarily reveal confidential information and thus fall within the privilege"); *In re Dyer*, 817 N.W.2d 351 (N.D. 2012) (lawyers' bank trust account records not confidential).[66]

This is a minefield, to say the least. Is the information that the insurer requests from defense counsel confidential? What is contained in it? What analysis of these documents must be undertaken in order to determine whether the information contained therein is confidential? Who will undertake that analysis? Should the defense lawyer do it? Is it a conflict of interest for her to do it? Should the insured hire independent counsel to do it? Who would pay for that?

And to the question of informed consent, who should make the request to the insured? How likely is it that the insured will understand the importance of the question? Will an insured—who likely is much more concerned about having been sued and about being defended and, hopefully, exonerated—going to go to the trouble and expense of hiring an independent lawyer to review the request? And how many independent lawyers will advise the insured to give such consent?

While it always is a mistake to use the word "clearly" in legal writing, it appears clear to this author that the likelihood is quite small that any consent obtained from an insured under the condition of being a defendant in a lawsuit would be deemed "informed."

(c) Give Insured Option to Choose In-House Auditor versus Outside Auditor, Subject to Higher Premium

[66] ANNOT. M.R. 111-12.

This self-explanatory option calls into question whether an insured that selects the less-costly option has been provided with sufficient information to make an informed decision to take that option. This raises the question of whether "consent in advance" ever can be effective. *See, e.g.*, *In re Rules Case*, in which the Montana supreme court held that, "under Rule 1.6, [Mont.] R. Prof. Conduct, for an insured to make a fully informed consent to disclosure of detailed professional billing statements, the consent must be contemporaneous with the facts and circumstances of which the insured should be aware."[67] Thus, where an insured chooses the less-costly option (a likely scenario), the problem does not go away.

(d) Go to Fixed-Fee Arrangements

In a case where the insurer is defending without a reservation of rights, then a flat-fee or fixed-fee arrangement certainly would solve the problem for there would be nothing to audit.

In the frequent case, however, where the defense is being provided subject to a reservation of rights that gives rise to the insured's right to independent counsel, this becomes a more challenging issue. One commentator, however, has offered the following food for thought:

> The arguments for independent counsel are easy to conceptualize, but there remain practical problems that prevent independent counsel from being a panacea for the problems of conflicting interests. The primary problem is that by vesting policyholders with the right of independent counsel without saddling them with the costs of independent counsel, inefficient defenses are likely to result.[68] These inefficiencies are manifested both by the policyholder's choice of a defense counsel who charges high hourly rates and by the policyholder's incentive to maximize the number of hours that are spent defending the claim. [Citation to Jeffrey B. Ellis, *Revisiting the "Cumis" Rule*, 11 CAL. LAW. 55, 55-56 (1991) (discussing problems arising from a statute requiring use of independent defense counsel when a conflict of interest exists between the insurer and the insured).]
>
> Utilizing flat-fee arrangements for compensating the defense attorney can solve the second problem of over-working a claim and thereby remove the need for oversight by billing auditors. By separating the attorney's compensation from the amount of time spent working on the defense, the attorney has incentives to suggest efficient defense strategies. But this still leaves the question of who gets to set the flat-fee sum. The insurer will still want to select the cheapest, the policyholder will still want to select the most expensive, and the attorney will still want to make sure that he can make money on the defense.
>
> There are many possible solutions to the question of who gets to set the level of compensation for independent counsel. To name a few, the choice could be regulated by the state or vested in either the policyholder or the insurer. The problem is in keeping the chooser honest, so that he has to internalize the costs as well as the benefits of the choice. This situation parallels the classic "I cut, you

[67] *In re Rules Case*, 2 P.3d 806, 822 (Mont. 2000).

[68] Author's comment: Many independent defense lawyers would take issue with this statement!

choose" situation familiar to many parents who have been required to moderate a dispute between two children fighting over the last remnants of a birthday cake. The problem is solved by vesting the right to divvy the resource in one child, while vesting the right of first choice between the divvied pieces in the other child. The cutter is kept honest by the prospect that he will be left to suffer the consequences of an unfair allocation. The solution would be only slightly more complicated in a tripartite relationship utilizing a flat-fee agreement.

One possible solution could involve giving defense attorneys the right to cut by submitting flat-fee bids for bundles of independent counsel cases to an independent defense referral service. Defense counsel could be given first bite at the apple by agreeing to continue the representation as independent counsel for a fee amount equal to that of the bid that is closest to, but less than, the mean bid. If counsel declines, then the attorney that submitted the just-below-the-mean bid would be given the opportunity to represent the policyholder. Using the bid that is closest to, but below, the mean as the benchmark would exert downward pressure on the market flat-fee rate while preventing insurers and unscrupulous defense attorneys from setting a rate that is too low to provide a reasonably effective defense. At the same time policyholders would be precluded from demanding rates that are higher than what is justified by the value of the claim. To ensure the consensual basis of the attorney-client relationship, policyholders could be given the right to choose a higher bidder and pay for the difference or to bargain for any extra services not contemplated in the attorney's bid.

* * *

By allowing for independent counsel after a reservation of rights is issued by the insurer, the likely expectations of the policyholder are most fully realized. The policyholder is provided with unconflicted representation, and insurers are precluded from obtaining back-door disclosure of information that could be used against the insured. An independent counsel system relying on a competitive, flat-fee bid process and administered through an independent referral service accounts for the market imperfections inherent in the insurer-insured relationship, while providing for some measure of cost control. Furthermore, the system rescues insurance defense attorneys from the thorny situation of having to serve two masters with divergent interests.

All of this is achieved in a way that avoids the pitfalls of trying to fit the square peg of insurer-insured relations into the round hole of professional responsibility law. Instead of trying to formulate a rule that works in both conflicted and unconflicted situations, and which depends on the designation of the insurer as either a client or a third-party payor, the solution recognizes that the

three parties' posture relative to one another is more important than the titles they hold.[69]

This commentator's suggestion is worth further consideration and discussion among those of us who practice in the insurance-coverage area. While this suggestion, as written, may not comport completely with the law in some jurisdictions that give insureds close-to-unfettered rights with respect to the selection of independent counsel in a reservation-of-rights situation, creative coverage practitioners on both sides of the insurer-insured divide, acting in good faith, should be capable of coming up with variations on this theme that may not require a revision of applicable law. Such a solution, if one could be agreed upon, would eliminate the need for outside billing auditors, which in turn would reduce the risks of waiver of the attorney-client privilege and the protections of the work-product doctrine. And it also might make insurers' billing guidelines somewhat less onerous for defense attorneys to comply with.

3. And if the Insured Refuses to Consent to Outside Billing Review?

If the insured refuses to give its informed consent for defense counsel to share documents with outside billing auditors, then defense counsel may not do so. The Florida Bar has addressed this question, stating:

> Given the requirements of Rule 4-1.6 [Florida's equivalent to M.R. 1.6 (Confidentiality)], Florida Ethics Opinion 93-5, and other applicable precedent, the inquiring [defense] attorney cannot allow the insurer or third party auditing companies to audit and review detailed billing statements and/or files of his clients who are insured by this insurance company without first obtaining permission from his clients. Whether the insurance contract between insurer and insured grants such permission to the insurer is a legal question upon which Bar ethics counsel cannot provide an opinion.[70]

An answer to the closing question in the above-quoted passage may be found in *In re Rules Case*, as discussed above, wherein the Montana supreme court held that "for an insured to make a fully informed consent to disclosure of detailed professional billing statements, the consent must be contemporaneous with the facts and circumstances of which the insured should be aware."[71] In other words, it is quite foreseeable that some courts will decline to enforce a provision in an insurance contract that could be construed as an "advance consent."

In any event, if defense counsel does not obtain his client's informed consent, but the insurer insists on having the documents anyway, then defense counsel has no choice but to withdraw. And that could lead to bad-faith litigation. That is an untenable situation for everyone.

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[69] Chris S. Stacy, *Life of the Triparty: Why Flat-Fee Independent Counsel Might Just Make Everyone (More or Less) Happy*, 19 REV. LITIG.323, 352-54 (Spring 2000).

[70] Claire Hamner Matturro, *Auditing Attorneys' Bills: Legal and Ethical Pitfalls of a Growing Trend*, FLA. B.J., May 1999, at 22, 24, citing FLA. B. ETHICS COUNS. ADV. OP. 20762 (Mar. 9, 1998).

[71] In re Rules Case, 2 P.3d 806, 822 (Mont. 2000).

B. Auditor Playing the Role of Lawyer: Effect of Auditing on the Quality of Representation

Some courts have turned a gimlet eye toward billing guidelines. One such case is *Frederick v. Unum Life Insurance Company of America.*[72] In *Frederick*, the parties moved to vacate the scheduled trial date because "discovery issues 'have arisen which have significantly delayed discovery in this matter which will prevent the parties from being prepared to proceed to trial . . . as presently scheduled.'"[73] The judge declined the motion.

After "commending" counsel for both sides for cooperating in discovery, the judge stated that he was "troubled by exhibit 6 supporting the motion, ('*Unum Life Insurance Company of America* GUIDE FOR OUTSIDE COUNSEL, December 1995') and the potential role it might have in these proceedings to date, and in the problems experienced by counsel of record."[74] Judge Molloy stated further:

> **A. The defendant's apparent litigation policy**
>
> UNUM, not its local counsel, has formulated a business plan for dealing with litigation. That business plan is bottom line oriented on its face. For instance, consider the following points:
>
> - No legal services should be provided unless authorized in advance.
> - We expect to be informed before you make any commitments on UNUM's behalf, and as developments occur.
> - Unless you are otherwise advised, a UNUM attorney or *paralegal* must review all briefs, motions, substantive pleadings, *discovery responses* and settlement offers.
> - **UNUM will not pay for the following:** any legal work which is not required by the litigation or which does not "advance the ball"
> - **UNUM will not pay for the following:** forwarding documents to UNUM
> - **UNUM will not pay for the following *unless approved in advance by UNUM:*** Work which could have more cost-effectively been performed by UNUM.
>
> **B. The obligation of local counsel**
>
> By contrast the local rules provide the duties and responsibilities of the Montana lawyer representing the out of state party.

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[72] 180 F.R.D. 384 (D. Mont. 1998).
[73] *Id.* at 385.
[74] *Id.* (italics and all-caps in original).

> "The attorney shall also designate in the application a member of the Bar of this Court with whom the Court and opposing counsel may readily communicate regarding the conduct of the case and upon whom papers shall be served." **Local rule 110-1(f).**

While the rule is couched in light of the *pro hac vice* procedure, it provides a suitable analogy here where the GUIDE FOR OUTSIDE COUNSEL suggests that "inside counsel" will control UNUM's "case leadership."

> "UNUM's Philosophy (sic) is to actively co-counsel with Outside Counsel, working as a team. This may mean that UNUM's inside counsel will provide case leadership. In some case, Outside Counsel will provide that leadership." (Ex. 6 pg. 2, U-007481).

The problem as I see it is that UNUM's bottomline GUIDE is in conflict, not only with the local rules of practice, but also with the Federal Rules of Civil Procedure. The GUIDE hamstrings the lawyer charged with defending the claim. The GUIDE seems to be based on the erroneous presumption that litigation is like chess, the object is to win by anticipating the opponents moves to the point that the opponent has no place to turn and must then concede.

C. Rule 1, F.R.Civ.P.

Litigation is not a game in which counsel are paid only where they "advance the ball." The rules of discovery and the rules of procedure serve one salutary purpose: "They shall be construed and administered to secure the just, speedy, and inexpensive determination of every action." Rule 1, F.R.Civ.P. * * *

The Rules of Civil Procedure, the public interest and the interests of both parties to this litigation, demand a seemly and efficient use of judicial resources to achieve the goals articulated in Rule 1. [Citation omitted.] As I read the materials before me two things are clear. Counsel of record are vigorously representing their respective clients while simultaneously making an effort to comport with the rules. The problem on the horizon stems from UNUM's apparent bottomline based litigation policy.[75]

Other jurisdictions are in accord. For example, it is the opinion of the Iowa Supreme Court Board of Professional Ethics and Conduct that: "1) it would be improper for an Iowa lawyer to agree to, accept or follow Guidelines which seek to direct, control or regulate the lawyer's professional judgment or details of the lawyer's performance; dictate the strategy or tactics to be employed; or limit the professional discretion and control of the lawyer" and "2) it would be improper for an Iowa lawyer to agree to, accept or follow such proposed service-log requirements in any form that causes the attorney-client privilege to be placed in jeopardy, if the service-log is sent to a third party. An Insurer may require a lawyer to identify the services rendered and time spent, so long as it does not control the lawyer's professional judgment or

[75] *Id.* at 385-86 (italics, boldface, and all-caps in original).

undermine the attorney-client privilege."[76] As to the more specific question of outside auditors, the Iowa Board stated: "A lawyer is required to protect the confidences and secrets of a client and they may not generally be revealed without the client's consent, after full disclosure. DR 4-101. Any requirement that the lawyer obtain the insured's consent to such a disclosure creates an ethical dilemma for the lawyer. As the Washington State Bar Association has stated, 'This is because it is almost inconceivable that it would ever be in the client's best interests to disclose confidences or secrets to a third party.' WSBA Formal Opinion 195, 6/24/99. 'If there is the slightest risk of embarrassment to the client or waiver of privileged information, independent counsel could have an affirmative duty to recommend against disclosure.' Id."[77]

Tennessee has issued similar guidance. In Tenn. Ethics Op. 99-F-143,[78] the Board of Professional Responsibility of the Supreme Court of Tennessee stated that prior to allowing auditors to review attorney's bills and case files, client consent must be given, and also stated that attorneys are not allowed to enter into any agreement to represent an insured whereby the insurance company has the power to direct the manner of the attorney's representation.[79] In response to a request for clarification of that Ethics Opinion, the Board was asked whether an attorney may comply with that opinion simply by "redacting" the confidences and secrets from the clients' files and bills prior to submitting them to the auditors.[80] The Board answered "no," stating:

> It should be reiterated that if a client consents, there is no problem submitting any file to an auditor. DR 4-101(a) requires a lawyer to keep not only information protected by the attorney/client privilege confidential, but also any "secret". "Secrets" include "other information gained in the professional relationship that the client has requested to be held inviolate or the disclosure which would be embarrassing or would likely to be detrimental to the client." "A secret" can therefore be almost anything the client does not wish to be disclosed. For instance, in Board of Professional Responsibility Formal Opinion No. 82-F-25 (February 22, 1982), the Board noted that even zip codes, birth dates, race, sources of referral, etc., may be considered "secrets". It is not up to the attorney to determine what the client wishes to keep confidential or secret. Thus an attorney cannot unilaterally make redactions based on his/her personal judgment as to the confidentiality of certain information in his/her file. Client consent remains necessary for any disclosure.[81]

The Board also was asked whether the attorney complies with the requirements by sending the bill not directly to the audit service, but to the insurance company with the knowledge that the insurance company may forward the bill to the auditor.[82] The Board's answer to this question also was "no," stating: "DR 1-102(a) states that lawyer 'shall not circumvent the disciplinary rules through actions of another.' Therefore, a lawyer cannot evade the requirements

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[76] IOWA S. CT. BD. OF PROF. ETHICS & CONDUCT OP. No. 99-01 (Sept. 8, 1999).
[77] *Id.* (underscore in original).
[78] 1999 WL 406886 (June 14, 1999).
[79] *Id.* at *3-4.
[80] TENN. ETHICS OP. 99-F-143(a), 1999 WL 961452, *1 (Sept. 10, 1999).
[81] *Id.* (underscore in original).
[82] *Id.*

of the aforesaid opinion by participating in a scheme whereby the insurance company forwards the bill to the auditor."[83]

The third question relates to a proposed insurance company requirement that an attorney who feels he/she cannot provide competent representation to a client under the insurer's litigation guidelines, must first discuss the situation with the insurance company.[84] The answer to this question is yes on the condition that "confidential communications or information cannot be disclosed without the client's consent. If after the discussion the attorney and the insurance company continue in disagreement as to specific aspects of the attorney's representation, Opinion No. 99-F-143 requires the attorney to disregard the insurance company's directives and to proceed in the direction he/she believes to be in the best interest of his/her client."[85]

C. Conclusion

No reasonable person can argue that: (1) insurance companies should be allowed to control their costs; (2) insureds are entitled to defense counsel that is diligent, competent, and conducts herself in conformity with the applicable rules of professional conduct and the rules of court; and (3) that defense counsel has an ethical obligation to conduct the defense without outside parties interfering with counsel's independent professional judgment.

It is becoming increasingly well settled that efforts on the part of insurance companies to dictate how defense counsel is to conduct the defense, through such documents as "billing and litigation guidelines," may and often do interfere with the independent professional judgment of defense counsel. And it also is becoming increasingly well settled that the use of outside billing auditors raises serious concerns about loss or waiver of the attorney-client privilege and/or the protection of the work-product doctrine.

It is the view of this author that coverage counsel from both sides of the insurer-insured divide should work together to acknowledge that these problems exist and to devise solutions that benefit all three parties to the tripartite relationship.

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[83] *Id.*
[84] *Id.*
[85] *Id.*

APPENDIX I

DEFENSE RESEARCH INSTITUTE
RECOMMENDED CASE HANDLING GUIDELINES FOR INSURERS

DEFENSE RESEARCH INSTITUTE
RECOMMENDED CASE HANDLING GUIDELINES FOR INSURERS

I. PREFACE

Philosophy

[Insurer] expects to work with the Firm and the insured to achieve the best result for the insured in an efficient and cost-conscious manner consistent with the Firm's ethical obligations. Nothing contained herein is intended to nor shall restrict Counsel's independent exercise of professional judgment in rendering legal services for the Insured or otherwise interfere with any ethical directive governing the conduct of counsel.

II. CASE DEVELOPMENT

An effective and strategically sound legal defense is the responsibility of counsel and [insurer] and should be developed in a timely manner.

A. A goal is to identify, timely, those claims for which there is liability, and to discuss settlement opportunities early. The activities necessary to defend a given claim and bring it to appropriate resolution should be addressed early and the steps necessary to achieve that resolution should be jointly agreed upon as between the [Insurer] and defense counsel.

B. An early resolution of lawsuits is desirable and the use of alternative dispute resolution is encouraged.

C. If defense counsel is involved in settlement negotiations, settlement authority must be obtained from [Insurer] and requests for authority should be made timely.

III. STAFFING PHILOSOPHY

Your firm should designate one attorney to have primary responsibility for each case on which your services are requested. The case should be staffed economically and effectively. Obviously, a balance must be struck between the efficiency a more experienced lawyer at your firm brings to a given task and the advantages of having the task performed by a junior lawyer or a paralegal. Duplication of effort within the firm should be avoided.

To achieve the best efficiency and value, the role and responsibilities of the staff members should be clearly defined and appropriate to each individual's qualifications, level of experience and billing rate. Defense counsel should delegate work to subordinates wherever possible to achieve efficiency and cost-effectiveness without compromising quality.

IV. REPORTING REQUIREMENTS

A. Reports

Unless otherwise requested, reporting is required for three events: Acknowledgment, Initial Evaluation, and Significant Developments. Reports should be provided to both [insurer] and [insured].

1. Acknowledgment:

Upon receipt of a new case, counsel should send an acknowledgment letter regarding receipt of the file and designating the legal team assigned to the case. Any matters of immediate concern or information that may result in early resolution of the case should be addressed in the acknowledgment letter.

2. Initial Report:

Within _____ days after receipt of the assignment, counsel should send an initial report with the following information:

a. A summary of the allegations in the complaint, the factual basis for the litigation, a summary of the information developed during the preliminary investigation and a preliminary evaluation of liability and damages.

b. A Litigation Plan providing the following:

1. Identify each significant activity counsel proposes to initiate. (e.g., investigation, motion, discovery, legal research, etc.).

2. Identify discovery and motions which have been or are likely to be initiated by other parties.

3. Estimate the completion date for each activity.

4. State the estimated expenses of each activity.

c. Discussion of the potential for early disposition of the case by settlement, and recommendations with respect to arbitration, mediation or direct settlement negotiations.

d. Discussion of the potential success of dispositive motions prior to, or after, the commencement of discovery and when motions to dismiss or for summary judgment are appropriate.

e. An estimate of the probable trial date.

3. Significant Development Report:

Defense counsel should communicate and apprise of significant developments as soon as practical. This will include reports on summaries of depositions, and pre-trial reports, and if applicable:

a. Settlement options and/or dispositive motions.

b. Updated evaluation of the client's liability and damages.

c. An updated Litigation Plan.

d. Trial Report: If it is anticipated the case will proceed to trial, 30 days before the scheduled trial date, a detailed report should be submitted, detailing the issues and an analysis of same and any other information requested by [Insurer].

B. Documentation

Reporting shall not include copies of the following documents, unless specifically requested:

1. Research Memorandum, Motion Papers and Legal Briefs;

2. Deposition Transcripts;

3. Expert Reports;

4. Medical Reports.

Counsel should provide copies of all pleadings and amended pleadings filed by or against the party whom you are defending and Releases and Orders of Dismissal for Final Judgments. Counsel will consult with [Insurer] on the appropriate means of communication, whether by e-mail, fax or regular mail to avoid duplication.

Counsel should comply with all reasonable requests for information and documents, provided however, that any documents or information that are privileged or intended by the insured to be confidential shall not be disclosed, absent consent from the Insured.

C. Consultation

After submission of the Initial Report, counsel welcomes discussion with and input and comment from the insurer. Counsel and [Insurer] will endeavor to agree on the proposed activities outlined in the Litigation Plan. However, in the event of disagreement, the final decision will remain the independent professional judgment of defense counsel.

V. BILLING

A. Billing Procedure

1. Frequency of Billing

a. Bills should be issued at intervals to be agreed upon by counsel and [Insurer].

2. Billing Format

a. Heading. The first page of the bill must state: (a) the firm's IRS number; (b) the caption of the case; (c) the name of the insured; and (d) the claim number.

b. Body. The bill must be prepared with daily entries showing: (a) the date the work was performed; (b) the initials of the person providing the service; (c) a description of the work performed (single activities); and (d) the actual time in tenths of an hour.

c. End of Bill Summary. The bill must include: (a) the full name of each attorney/paralegal; (b) the status of each timekeeper (i.e., partner, associate, paralegal); (c) the hourly rate of each timekeeper; and (d) the total hours and total amount charged for each timekeeper during the billing period.

d. Task Codes. Task coding is not required, unless requested. Where requested, the uniform billing codes as currently endorsed by the American Bar Association shall be used.

B. Charges for Service

1. Time Charges. Actual Time in One-Tenth Increments. All charges for services by attorneys and paralegals must be recorded daily based upon their actual time in one-tenth hour increments.

2. Single Entry Timekeeping. Unless otherwise directed, the time for each activity should be separately stated. Grouping multiple activities under a single time charge greater than one-tenth of an hour ("block billing") is not acceptable, absent authorization from the [Insurer].

3. Information Descriptions of Services. Descriptions of services should inform of the nature, purpose or subject of the work performed, and the specific activity or project to which it relates.

4. Compensation. Counsel should consult with [Insurer] regarding any increase in the rate of compensation.

5. In-Firm Conferences. Where counsel consults with another attorney in the firm to obtain specific advise or counsel on substantive or procedural aspects of the case that result in a more effective defense, said reasonable and necessary conference time will be reimbursed, provided that sufficient detail of the subject of the communication is set forth to demonstrate its relevance and value.

6. Multiple Attendance. Counsel should consult with insurer where it is anticipated that more than one attorney's attendance is necessary at trial, court appearances, meetings, depositions, witness interviews, inspections and other functions.

7. Depositions. Counsel should consult with [Insurer] before initiating depositions other than that of the plaintiff(s), the insured, and other depositions already approved in the initial Litigation Plan or supplement thereto and shall advise the [Insurer] of upcoming depositions initiated by other parties that Counsel plans to attend.

8. Legal Research. Counsel should consult with Insurer before undertaking a legal research project requiring over three hours of research. Copies of all research memoranda shall be provided to [Insurer] upon request.

9. Motions. Counsel should consult with [Insurer] before filing any motions not previously identified and approved in the initial Litigation Plan or supplement thereto.

10. Revising Standardized Forms/Pleadings. Only the actual time spent in personalizing standardized pleadings, documents, or discovery responses or requests to the case at hand should be billed, rather than the time originally spent drafting standard language.

C. Disbursement

1. Internal Expenses. [Insurer] shall advise counsel of its guidelines as to reimbursement of internal expenses.

2. External Expenses. Charges for service by outside vendors will be reimbursed at their actual cost. Expenses over $_____ may be forwarded to [Insurer] for payment. Disbursements should be itemized on the law firm's statement with the following information, unless back-up documentation is provided: (a) the name of the vendor; (b) the date incurred; and (c) a specific description of the expense. Where back-up documentation is provided, the law firm statement need only set forth a description of the expense and amount incurred.

3. Travel Expenses. Counsel should consult with [Insurer] prior to incurring travel expenses. [Insurer] will reimburse defense counsel for reasonable travel expenses. All expenditures of $25 or more must be supported with receipts attached to the law firm's statement.

4. Professional Services. Counsel should consult with [Insurer] prior to incurring expenses for experts, consultants, investigators, temporary attorneys or outside paralegals, or other professional services.

5. Secretarial and clerical activities. Secretarial and clerical work is not billable to [Insurer]. As examples and not as a complete list, secretarial and clerical work includes receipt and distribution of mail, new file set up, maintenance of office and attorney calendars, transcribing, copying, posting, faxing, e-mailing, inserting documents into and retrieving documents from the file, maintaining order in the file, stamping documents, tabbing sub-files and assembling materials.

VI. BILL AND FILE REVIEW

[Insurer] reserves the right to review all charges for services and disbursements pertaining to litigation, including without limitation all charges paid by the insured with respect to such litigation, whether pursuant to self-insured retentions or deductibles under [Insurer's] insurance policies or otherwise. [Insurer] reserves the right to conduct audits and to review the defense file and/or defense bills, consistent with the defense attorney's ethical obligations, and in a manner that will not compromise the attorney-client or work product protection accorded material in the file or communications by and between counsel, the client and [Insurer] or otherwise interfere with any ethical directive governing the conduct of counsel. Counsel agrees to comply with all reasonable requests for information and documents, provided that such documents or information are not privileged or intended by the insured to be confidential. In such instance, the [Insurer] must obtain the consent of the Insured. [Insurer] fully reserves all rights to decline to pay or to seek reductions and/or refunds with respect to charges that fail to comply with the requirements set forth herein, and which are not fully explained or documented by the firm after reasonable inquiry. The [Insurer] shall allow the law firm to appeal any declination of payment by [Insurer]. [Insurer] agrees to pay the undisputed portion of bills received from Counsel Counsel within _____days.

This is an example of case handling guidelines which promotes uniformity in reporting and billing and effective and efficient case management, consistent with the defense attorney's professional responsibilities. Nothing contained herein constitutes or shall be construed as a standard of care.