



ETHICAL CONSIDERATIONS RAISED IN INSURANCE DEFENSE PRACTICE

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Whenever an attorney takes on the defense of an insured, at the request of an insurance company, a so-called "tripartite" relationship is created. The tripartite relationship consists, at its base, of defense counsel and two clients. The primary client is the insured. The secondary, and sometimes predominant, client is the insurer. Some refer to the relationship as triangular, with the triangle being completed by the contract between insurer and insured (policy) and an implied covenant of good faith and fair dealing. This relationship can be beneficial to all involved in many respects. The insurer can closely control its risk through control of counsel and litigation, the attorneys involved are reasonably assured of payment and can develop a steady, productive source of business and income, and the insured gets a "free" defense in trial.

However, trouble often rears its ugly head in this relationship as well. Conflicts of interest are bound to arise where each party has differing goals and motivations. Increasingly, insurers are looking for ways to cut costs and become more efficient. Defense counsel seeks to provide the best possible representation to the primary client, the insured. The insured cares little about costs or strategy, they just want a defense verdict. Due to these, and other, differing motivations, conflicts arise. This article deals with but four of the many potential situations that may surface in the tripartite relationship. First, in an effort to promote efficiency, many insurers over the last five years have been turning to outside auditing agencies to review billing records of defense counsel in order to "trim the fat." This has sparked a great deal of discord among the defense bar as it raises many ethical issues.

Second, in a further effort to control legal costs, many insurers have developed outside counsel guidelines in an effort to clarify what will be paid for by the insurer and what will not, and to promote efficiency in the representation of the insured.

These two tools, in and of themselves raise many ethical issues. However, the tripartite relationship itself raises ethical conundrums as well.

The third issue addressed in this article is, what happens when defense counsel and the insurer (who is

paying the bills) disagree over case evaluations or strategy to be pursued in order to best defend the insured?

Finally, this article addresses the ethical dilemma surrounding the duty to settle within the policy limits and excess exposure.

Ethical Considerations of Submitting Detailed Billing Statements to outside Auditors

Over the past few years, insurers have been increasingly inclined to submit the billing statements of defense counsel to outside auditors for review. In this process, attorney bills are submitted directly to an independent auditing company, whose task it is to insure that the work done was within the insurer's guidelines and that the charges are not excessive. In most cases, detailed descriptions of the work done, such as parties and subject matter of phone calls or legal theories involved in research are included in the time entries. In some cases, these audit companies receive a percentage of the amount by which it reduces attorney billings. However, this practice has recently been outlawed in California. Regardless, this practice implicates many ethical considerations.

Indiana Rules of Professional Conduct 1.8 and 1.6

Indiana Rule of Professional Conduct 1.8(f) governs the tripartite relationship. It reads,

(f) A lawyer shall not accept compensation for representing a client from one other than the client unless:

- (1) the client consents after consultation;
- (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and
- (3) information relating to representation of a client is protected as required by Rule 1.6.

In the realm of independent auditing, it is part 3 of Rule 1.8(f) that creates an acute ethical dilemma. By submitting detailed billing statements to third party auditors, the attorney risks exposing, to a third party, confidential and privileged information. This implicates Rule 1.6:

(a) 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 out the representation, and except as stated in paragraph (b).

For example, suppose an insured calls up the defense counsel and they engage in a discussion which, in ordinary circumstances, would be strictly confidential, such as an insured's admission of fault or drinking. If an attorney was not very careful in crafting billing entries, this information runs the risk of being exposed to a third party not normally entitled to such information. This may be an extreme example, however there are far more subtle examples, which are far harder to escape with crafty entries. Many entries will reveal litigation strategy by identifying research topics. They can expose the

attorney's mental impressions. Most certainly, they show the nature of legal services provided to the insured.

As a result, submission of bills to outside auditors may serve to breach counsel's duty of confidentiality to the insured. Also, by exposing work product information to third parties, this may also serve to waive the work product privilege. Both of these have grave ramifications.

Approaches to the Problem

Indiana

In Ethics Opinion 4 of 1998, the Legal Ethics Committee of the Indiana State Bar addressed these issues. The Committee found that

The submission of statements containing confidential information to an independent auditor, without the express consent of the insured after consultation, is a breach of the attorney's ethical obligation to maintain confidentiality of information. It may further constitute unethical conduct with respect to privileged information contained in the statement, if a waiver of privilege is caused by such submission to independent auditors, and if such waiver is detrimental to the insured's cause.

The Committee conceded that defense counsel may provide such information to the insurer, who has the duty to defend without waiving

any privilege.

However, the Committee held that since the auditing company had no contractual relationship with the insured, and the provision of such information is not necessary to carry out the representation of the insured, the disclosure to the auditing company violated Indiana ethics rules. Further, the committee held that disclosure of this information could serve to waive the work product or attorney client privilege, thus implicating Indiana Rule of Conduct 1.1 (Incompetency of counsel) and others.

The committee held that any such disclosure was not permitted without the express written consent of the client.

Other Jurisdictions and "MIT"

This "informed consent" rule is by far the most common approach among the States.

Most of these opinions (including Indiana) have at least cited, if not relied upon, *United States v. Massachusetts Institute of Technology*, 129 F.3d 681 (1st cir. 1991). The "MIT" case, as it is known, involved a demand by the Internal Revenue Service (IRS) to review attorney bills and other work product to determine whether MIT qualified for tax exempt status. MIT had provided the bills to a third party auditing agency at the behest of the Department of Defense to review the reasonable nature of the charges made under MIT's contract with the Department.

The IRS contended this constituted a waiver of the attorney client privilege and the work product privilege. The Court agreed. The Court further held that there was no protection from the mere expectation that the agency would not reveal the information. The Court held this was a "foreseeable

gamble."

After a review of the MIT case and the myriad of state ethics opinions, one may be lulled into thinking the only option is to get the informed consent of the insured before sending these bills to an outside auditor. However, this is not necessarily the right assumption.

Counterpoint

All the State ethics opinions listed herein rely on forms of Rule 1.6, which emphasizes the representation of the "client."

However, what about the tripartite relationship? Is the insurer not a client as well under that theory? Nearly all the State ethics opinions ignore this. These bills contain confidential information from both the insured and insurer. The opinions have treated the insurer as a third party payor under Rule 5.4. However, even Indiana cases like *Richey v. Chappell*, and others, cast doubt on that assumption. It seems quite odd that a third party stranger would be afforded the attorney client and work product privileges. If the insurer is treated as a third party payor, the disclosure to the auditor will always be improper.

Further, great weight is put into the MIT case, but as Mallen and others (even noted ethics expert Geoffrey Hazard), MIT is not on point when it comes to insurance companies. MIT concerned an action by the direct client, not its lawyers. MIT held that MIT, as the client, waived the privilege. MIT did not decide whether unauthorized acts by the lawyer were improper. Further, the disclosure came after counsel had exited the case and the submission could no longer have been within the realm of being "necessary to representation." Further, as Geoffrey Hazard notes, the MIT Court held that if the disclosure is made for the purpose of facilitating the representation, the privilege is not waived. The Court cited several exceptions, including secretaries, interpreters, and parents present when children consult lawyers.

Further, what happens if the client does not consent? Most of the opinions lead to the conclusion that the lawyer cannot then comply with the insurer's request. The lawyer must withdraw or get assurances from the insurer that bills will not be sent to the auditor. This clearly creates a great conundrum. Apart from rewriting policies to include a consent to auditing of any defense bills (which may be of arguable effect), the insurers, "clients" under the tripartite theory, are relegated to third party strangers under these state opinions. This, according to some, is not their proper role.

Solutions?

Until there is a judicial resolution, there appear to be only two safe courses for defense counsel. The first is for insurers to

discontinue the use of outside auditors. The second is for defense counsel to obtain the informed, preferably written consent of each insured to the risks of transmitting confidential information to an outside auditor. Neither course seems to satisfy the needs of defense counsel, the insureds, or the insurers wanting to use outside auditors.

In Indiana, the only sure fire way to protect oneself, from an attorney's point of view, is to get the full, informed consent of the client prior to submitting bills to an outside auditing agency. Although not all firms in this state believe this is necessary, according the Indiana State Bar Ethics Committee, this is the

proper method.

Insurance Litigation Guidelines: When Conflicts Arise Between Counsel and Insurers

As a further result of insurers' increasing focus on containing costs and promoting efficiency in the defense of insured, many insurers have developed formal outside counsel litigation guidelines to govern the relationship between the insurer and counsel. These guidelines mandate and regulate activities such as reports to claims representatives, what personnel can draft discovery, prior approval for travel, allowable legal research, budgeting requirements, and staffing guidelines.

These guidelines ostensibly serve many purposes, such as facilitation of communication between counsel and insurer, control of litigation costs by the insurer, and general efficiency. However, in reality, they also serve as a means of discipline, similar to that of audits.

Although insurers surely do not intend to inhibit defense counsel or create ethical problems, these guidelines carry with them many inherent potential ethical traps.

Further, at least one court has noted the possibility that rigid adherence to restrictive guidelines may well violate the insurer's duty to defend, as well as the attorney's ethical obligations.

Indiana Rules of Professional Conduct Implicated by Insurer Guidelines

Insurer litigation guidelines implicate several ethical rules. The rule most directly implicated is Rule 1.8 (f)(2), which mandates that "a lawyer shall not accept compensation for representing a client from one other than the client unless . . . there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship." Some feel that these guidelines serve to restrict the defense counsel's independent judgment as to how the matter should best be handled. This independent judgment requirement continues, even though client consent has been obtained.

Many times, agreements may arise between insurer and defense counsel over the proper strategy to be pursued. Often, these can be worked out through timely communication to the insurer. However, if these are not resolved, defense counsel is placed in a predicament between following the guidelines and following their own professional judgment, and possibly doing work the insurer will not pay for in the end.

Other rules pose similar problems. Indiana Rule of Professional Conduct 1.1 mandates, "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation." In some instances, insurer guidelines will not allow activities counsel believes is necessary for the competent pursuit of the defense. Again, when this occurs, the attorney is placed in the difficult position of following the guidelines of the insurer or, in his or her judgment, pursuing a competent defense of the insured.

Indiana Rule 1.3 states, A lawyer shall act with reasonable diligence and promptness in representing a client. Although on its face, this rule seems to refer to negligent or untimely actions, this rule directly applies to insurer guidelines. Defense counsel who delays activities because of guidelines, or who fails to perform them altogether because they require prior approval from the insurer or are not allowed by the guidelines run the risk of violating Rule 1.3.

Rule 1.7(b) is very important in this context as well. " A lawyer shall not represent a client if the

representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless the lawyer reasonably believes the representation will not be adversely affected; and the client consents after consultation." The "other client or third person" is the insurance company paying the bills.

Further, some commentators note that defense counsel may be under a duty to inform the insured of the existence of the guidelines under Rule 1.4 (Communication with the insured). Further, if defense counsel's representation of the insured is limited in any way, Rule 1.2 is implicated and counsel must get the informed consent of the client.

Various Approaches: Where does the ultimate duty lie?

In near unanimity, authorities, including the Indiana Supreme Court have held that the ultimate loyalty lies with the insured client. Ethics Opinion 3 of 1998, the Legal Ethics Committee of the Indiana State Bar stated "the Indiana lawyer can have no doubt in light of Siebert Oxidermo that the insured is the primary client to whom all ethical duties are owed." As a result, it seems as though Indiana views the tripartite relationship a having one client, the insured, and one "quasi-client," the insurer. Further, after a reading of Indiana Supreme Court's decision in Richey v. Chapell, the insurer may almost be seen as a partner or "agent" of the attorney.

Solution: Independent Judgment Cannot be Compromised, but the problem can be.

As noble as the approach demanding ultimate loyalty to the insured sounds, the solution is not that simple. Lawyers and law firms must work in the real world, one filled with the realities of business. Defense counsel depend on insurance companies for business and income. As a result, defense counsel must be extremely cautious when dealing with guidelines that have the potential to restrict counsel's judgement, independence, and duty to the insured. Counsel should always work to reach an informal solution to any conflicts that arise in this arena.

Fortunately, most insurance guidelines do not contain items that unduly restrict counsel's activities. Most of the guidelines merely set out limits on how much counsel can charge for certain types of work, mostly in terms of the time allowed for certain tasks. Further, many insurance company representatives are very cooperative and flexible when it comes to these guidelines. After all, the main goals of these guidelines are efficiency and communication—not penny-pinching at all costs. In most cases, the interest of the insured and insurer run together. In those cases, proper communication and discussion with the insurer will solve most problems.

Claims representatives are usually more than willing to work within the facts of each particular case to develop a case strategy with counsel. In fact, it is not unheard of for insurance representatives to flat out tell counsel how to tailor billing entries and such so that they can get paid and still be able to perform certain tasks (rather than paralegals, for example) or spend proper time on a particular issue. Claims representative are usually open to allowing counsel to pursue the defense as they see fit.

As a result, counsel should strive to keep the lines of communication open. Discussing the situation with the insurer will resolve the problem nearly every time. If the insurer still refuses to authorize a particular task or strategy, counsel should fully inform the insured of the situation, and, if necessary, inform the insured that they may wish to retain independent counsel.

The bottom line remains, as the California court put it best, "Under no circumstances can such

guidelines be permitted to impede the attorney's own professional judgment about how best to competently represent the insureds. If the attorney's representation is to be limited in any way that unreasonably interferes with the defense, it is the insured, not the insurer, who should make that decision."

III. Disagreements over case evaluations—What do you do? Settling within Limits/ Excess Exposure to Client

Insurer guidelines have the potential to create ethical conflicts. Fortunately, more often than not, the guidelines cause few problems. However, what should one do when problems arise due to the nature of the tripartite relationship itself? This article addresses this issue by use of an example. Suppose the insurer and defense counsel disagree over the evaluation of the value of a certain case. The attorney values the case as worth much more than the insurer. Whose valuation controls the course of the defense, and how do you proceed if (although unlikely) the insurer and counsel cannot agree? Or, go one step further and assume the attorney feels there is a danger of excess exposure and the insurer wishes to try the case anyway? These are two situations that may arise as a result of guidelines, yet they can just as easily arise wholly apart from any insurer guidelines.

A. Where does ultimate responsibility for the client's representation lie?

In addressing this issue, counsel should be clear that ultimate responsibility for the representation of the insured lies with the attorney, and not the insurer. Indiana Rule of Professional Conduct 5.4(c) states, "A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services." This unequivocally mandates that the insurer, as a third party payor, cannot ultimately exercise final judgment for handling the defense. Although many insurance policies give insurers the right to "control" the defense, "the ethical standard . . . does not allow an insurer . . . as a third party payor, to ultimately exercise the judgment for handling the insured's defense." The attorney cannot abdicate the duty and responsibility to the insured. "The 'privilege' to err in judgment is for the lawyer, not the insurer." After all, counsel, and not the insurer, is liable for any negligent errors or omissions in the conduct of the defense.

When this situation arises in the context of insurer guidelines, the problem is where the guidelines do not provide that the ultimate responsibility lies with the attorney. Without such an escape valve, at the very least, a dangerous appearance of impropriety arises. Fortunately, most insurer guidelines allow for this, at least impliedly. For example, rarely is there a strict requirement of "prior approval." Only "prior consultation" is required. Again, this fosters the goals of communication and efficiency, without compromising the lawyer's ethical obligations, and the insurers realize the importance of this. Counsel and insurer, under these guidelines, discuss the situation and agree on how to proceed. The insurer is informed at all times and can inform counsel of the insurer's concerns. However, in the rare event that there is a disagreement, as stated above, the primary duty is to the insured and the ultimate responsibility is with counsel.

Further, some commentators have noted that the right of the insurer to make reasonable decisions to control the defense is not present where the insurer will not be liable for any judgment. This is particularly applicable in reservation of rights situations and situations where coverage is an issue.

However, none of this is to say that counsel should not accept limitations. Counsel should be willing to accept limitations that minimize the financial burden on the insurer and still allow effective and competent representation of the insured. These limitations hurt no one and improve the tripartite

relationship, whatever its form.

Disagreements Over Evaluations and Excess Exposure

Occasionally, cases arise where defense counsel and insurer differ on the evaluation of a case or how to proceed in the face of possible excess exposure. Ethical duties are put to the test in these instances.

It is well settled that insurers have a duty to accept reasonable settlement offers within the policy limits. It is also well settled that under most policies the insurer has the right to settle matters without the consent of the insured. Pursuant to such, defense counsel is often provided with a file from the insurer and asked to evaluate the case (this is usually in the guidelines submitted). Usually, insurer and counsel can come to an agreement on valuation of the case. However, disagreements to arise.

As a result, defense counsel should keep in mind that the insurer really does have the last say on evaluation of cases. Counsel must fully inform both the insurer and insured of counsel's stance on the issue if they disagree. In the end, however, the decision is the insurer's.

Excess Exposure

The case of excess exposure poses a special problem. In this case, if the insurer insists on taking the case to trial, the insured will be directly exposed to personal liability. As a result, counsel has special duties in this situation. There is a duty to keep the insured apprised of settlement negotiations and the risk of a potential for excess exposure.

Where there is potential excess exposure, "an immediate conflict of interest arises between the insurer and the insured. The insured, usually, though not always, will want the case settled, the insurer, for reasons of its own may wish to take the case to trial." This is especially true with a reservation of rights.

Defense counsel must make the insured aware of this conflict of interest and advise the insured to consult with independent counsel regarding the potential exposure. Counsel must also tell the insurer of the potential. Thereafter, both sides can take precautions to protect their interests.

New Trend

Recently, some insurers have been taking a slightly different approach. Several have incorporated a program which specifically asks attorneys NOT to evaluate cases. This poses an acute problem in excess situations. Due to the duty of counsel to the insured, there is no question that counsel must inform the insurer of the possibility of excess liability in this situation and the necessity of protecting the insured's interests (as well as informing the insured).

In order to protect the insured's interest, some companies utilize an "assurance letter," which is sent to the insured which states that if the insurance company decides to try a case in the face of excess exposure to the insured, the insurer will cover any excess verdict, thus preventing any personal liability on the part of the insured. This, on its face, diminishes or dispels any inherent conflict of interest. Regardless, even in this situation, counsel has a duty to keep the insured informed (preferably in writing) of their rights and options.

CONCLUSION-DIALOGUE IS CRUCIAL

As the Indiana State Bar Association Ethics Committee's Opinion 3 of 1998 put so well,

To the extent that litigation guidelines merely define the financial relationship between an insurance carrier and its defense counsel, including communications between them, such parties enjoy the freedom to contract for whatever economic terms they wish, and no ethical considerations are ordinarily raised. But if the negotiated financial terms result in a material disincentive to perform those tasks which, in the lawyer's professional judgment, are reasonable and necessary to the defense of the insured, such provisions are ethically unacceptable.

Billing audits and litigation guidelines are but two areas of potential ethical pitfalls that face insurance defense attorneys every day. However, it is important, in any potential ethical dilemma, to keep in mind that counsel's conduct is governed by the Rules of Professional Conduct and not any insurance policy or litigations guidelines. Fortunately, most insurers realize this and are willing to work with counsel in productive ways to make sure potential ethical conflicts do not arise, and if they do, to deal with them promptly and effectively.

The attorney must always be mindful, no matter what view of the tripartite relation one has, that the attorney's ultimate responsibility and duty is to the insured. Full information to the insured and the exercise independent judgment by the attorney are essential. This may even result in the attorney performing work that does not get paid for, or withdrawal.

Unfortunately, try as we may, there is no one approach that is appropriate for all situations. As one commentator accurately noted, "the simplistic admonition that defense counsel must 'always put the insured's interest in front of the insurer's' is not sufficient ethical direction in modern insurance defense practice." All cases are different and new factual situations develop every day that no one had even dreamed of before.

However, with proper dialogue among insurer, insured, and counsel, most any potential pitfall can be avoided and/or dealt with effectively.

ENDNOTES

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