WHEN SHOULD GOVERNMENT REGULATE LAWYER-CLIENT RELATIONSHIPS? THE CAMPAIGN TO PREVENT INSURERS FROM MANAGING DEFENSE COSTS

Charles Silver*

I. INTRODUCTION

I have recently undertaken to defend private interest lawyering.[1] Some may wonder why, no need being apparent. Law is the fourth largest sector of the service economy, the profession has grown dramatically, lawyers who represent private clients are highly paid, and competition for slots in prestigious law schools is fierce. The economic downturn has hurt many lawyers, but other professionals have suffered too. Why worry about lawyers who work for private clients?

One reason is that private interest lawyering is greatly under-appreciated. Although it is extremely valuable for clients, the economy, and society as a whole, its contributions are rarely recognized. Comments at the Arizona conference that preceded this symposium confirmed this opinion.[2] Many speakers maligned private interest lawyers, claiming they have lost sight of professional values, are too adversarial, and employ an outmoded paradigm.[3] An Arizona supreme court justice called the profession a "disgrace"[4] for failing to meet the legal needs of the poor. An observer might have concluded that private interest lawyers suffer serious practical and moral defects.

---

* Co-Director, Center on Lawyers, Civil Justice, and the Media, and Cecil D. Redford Professor, The University of Texas School of Law.

1. Charles Silver & Frank B. Cross, *What's Not to Like About Being a Lawyer?*, 109 YALE L.J. 1443 (2000).

2. Remarks at the Future Structure and Regulation of Law Practice Symposium at the University of Arizona James E. Rogers College of Law (Feb. 22–23, 2002). I am grateful for having had the opportunity to participate in this program.

3. In a luncheon address, James Jones, of Flywheel Communications, Inc., contended that lawyers are wedded to a paradigm of lawyering that poorly serves the needs of modern clients.

4. Although no transcript of the conference is available, I believe this is the word former Arizona Supreme Court Chief Justice Thomas Zlaket used.

In fact, the legal services sector is in excellent shape. Growing numbers and competitive pressures are encouraging lawyers to be more efficient. Even so, private interest lawyers continue to hold themselves to high standards. Consider interest conflicts, a problem that has embarrassed corporate America, brokerage houses, and the accounting profession, and that has cost investors billions of dollars. A forthcoming American Bar Foundation study states that "[w]hile other fiduciaries are strangling on their tangled loyalties, law firms may turn out to be the last fiduciary bastion where confidences are honored and uncompromising loyalty fiercely defended."[5] Private interest lawyers take conflicts seriously and handle them better than other professionals.

These lawyers also serve the public. By helping private clients operate businesses and handle personal affairs, they contribute to economic growth[6] and to a culture in which citizens use law actively.[7] They also help their communities and the poor by being civic leaders and by donating to diverse charities. *Pro bono* enthusiasts condemn the profession, but they offer no evidence that lawyers are less generous or public spirited than other people.

Another reason to focus on private interest lawyering is that state bar associations, courts, and other authorities often regulate this activity inappropriately. This is not surprising. Anyone with a background in political science, the economics of regulation, or administrative law should know that top-down regulations often misfire. Sometimes, they advantage powerful interest groups that capture regulatory bodies. Always, they reflect the views of persons far removed from local activities who possess limited information and limited rationality, who cannot respond easily to changed conditions, and who operate within the limits of language as well.[8]

Because many professional regulations are self-imposed, lawyers can enact restrictions like minimum fee schedules, advertising restrictions, and unauthorized practice of law prohibitions that benefit lawyers by constraining competition. Judges and legislators, who also regulate lawyers, have their own ideologies, agendas, and constituencies, the latter including insurance companies, product manufacturers, tort reform groups, health care providers, and lawyers. One should no more expect judges and legislators to promote the public good when regulating lawyers than when doing other things.

The risk that good intentions may backfire must also be remembered. Bar leaders restrict advertising because they want to make the public think better of

---

5. Susan Shapiro, Am. Bar Found., *Tangled Loyalties, Conflict of Interest in Legal Practice*, 13 RESEARCHING L. 1, (Winter 2002) (internal quotation marks omitted).

6. For years, tort reformers and other lawyer critics argued that the United States should model itself on Japan, which had far fewer lawyers per capita. After decades of economic stagnation, however, Japan has decided that America is rich where it is poor and is revamping its educational system to produce more American-style lawyers. Alan Brender, *Japan Tries to Reform How It Trains Lawyers*, CHRON. HIGHER EDUC., Feb. 15, 2002, at 47.

7. These points are developed more fully in Silver & Cross, *supra* note 1.

8. *See* PETER H. SCHUCK, THE LIMITS OF LAW: ESSAYS ON DEMOCRATIC GOVERNANCE 419–79 (2000) (discussing causes of failure of top-down regulations).

lawyers. Yet, television advertising correlates positively with scores in opinion polls.[9] The public might like lawyers better if lawyers had more freedom to promote themselves. Proponents of fee restrictions want to protect clients, but some scholars believe that fee rules harm clients by driving down settlements and preventing markets from pricing legal services efficiently.[10]

As a general matter, it is difficult to say whether state bar rules and other professional regulations are beneficial or detrimental. No one has studied them empirically. Our ignorance is great, even with respect to the most entrenched and significant regulations. No empirical study supports the use of unauthorized practice of law restrictions, moral fitness committees, fee rules, continuing legal education requirements, bar examinations, or bar membership requirements. For all we know, the country would be better off if all these regulations were scrapped.

This Article will use the current controversy over the professional responsibilities of insurance defense lawyers to argue that state bars and other authorities should regulate attorney-client relationships only when reliable information demonstrates the advantage of doing so. Since the mid-1990s, advisory committees and courts have issued a plethora of opinions on insurance defense practices.[11] These opinions question or prohibit long-standing practices,

---

9. Richard J. Cebula, *Does Lawyer Advertising Adversely Influence the Image of Lawyers in the United States? An Alternative Perspective and New Empirical Evidence*, 27 J. LEGAL STUD. 503 (1998); Richard J. Cebula, *Historical and Economic Perspectives on Lawyer Advertising and Lawyer Image*, 15 GA. ST. U. L. REV. 315 (1998).

10. *See, e.g.*, Rudy Santore & Alan D. Viard, *Legal Fee Restrictions, Moral Hazard, and Attorney Rents*, 44 J.L. & ECON. 549, 550 (2001) (criticizing rules that prevent lawyers from purchasing causes of action on the ground that they enable lawyers to overcharge); *id.* at 569 ("it is easy to see that [contingent] fee restrictions benefit defendants by lowering awards"); Albert Choi, *Allocating Settlement Authority Under Contingent Fee Arrangement* (Oct. 25, 2001) (unpublished working paper, on file at http://papers.ssrn.com/abstract=287925) (explaining that high percentages in contingent fee contracts can maximize plaintiffs' advantage in settlement negotiations).

11. As they say in the music business, the hits just keep on coming. After this article was substantially complete, the Utah bar issued a lengthy opinion on insurance defense ethics. Utah St. Bar Comm. on Ethics, Formal Op. 02-03 (2002). In Florida, the bar committee convened to investigate insurance defense practices and released its second report, focusing on staff counsel operations. REPORT OF THE SPECIAL COMMISSION ON INSURANCE PRACTICES II (Mar. 1, 2002), http://www.flabar.org. A new Florida rule specific to insurance defense lawyers also took effect. Joan C. Rogers, *Regulation of Bar Florida Rule Changes Feature New Form That Insurance Defense Lawyers Must Use*, 18 Laws. Man. on Prof. Conduct (ABA/BNA) 289 (May 8, 2002). In Tennessee, the supreme court issued an opinion holding that insurance companies have no legal right to control defense lawyers, but may nonetheless exercise actual control of them and may therefore be vicariously liable for defense lawyers' torts. Givens v. Mullikin *ex rel.* Estate of McElwaney, 75 S.W.3d 383 (Tenn. 2002). In Minnesota, the supreme court granted a petition to review an appellate decision holding that an insurance carrier is not a client of the lawyer retained to defend a liability suit. Pine Island Farmers Corp. v. Erstad, 636 N.W.2d 604 (Minn. Ct. App. 2001), *aff'd*, 649 N.W.2d 444 (Minn. 2002). In Texas, the state bar issued an advisory opinion on flat fee arrangements allowing defense lawyers to use them, subject to the constraint that the lawyer not be required to bear litigation expenses. Tex. Prof'l Ethics Comm., Op. 542 (2002), *available at* 2002 WL 405093. In

including the use of staff counsel, litigation management guidelines, flat fees, and fee audits. Yet, there is no evidence that these practices are harmful. Regulators sprang into action because defense lawyers asked them to, not because policyholders or insurers complained or because there was any evidence of danger to anyone. This is precisely the situation in which one should expect regulations to be counterproductive.

Several reasons support the choice of insurance defense ethics as an example. First, defending covered lawsuits is a private interest activity. The lawsuits concern mainly money sought as compensation for physical or economic injuries, and the point of the tripartite relationship is to save carriers and policyholders money by minimizing losses to claimants. Second, defense lawyering is a mainstay of litigation. Insurance companies provide lawyers in a sizeable fraction of all civil cases. The decision to subject defense lawyers to significant regulations is therefore a momentous one. Third, insurance companies are sophisticated, high volume purchasers who participate in the market for legal services over the long haul. They should develop excellent working relationships with attorneys without the help of paternalistic regulations. Fourth, there is reasonably good empirical data relating to covered claims. One can gauge some matters, such as the frequency with which policyholders incur losses above the policy limits, with precision. One can therefore evaluate empirical claims instead of taking them on faith. Fifth, defense lawyering has been a practice area for over a century, and defense lawyers have handled millions of cases. Their practices are well known, and professed needs to change their practices for ethical reasons should be easy to evaluate.

This Article will proceed as follows. Part I will provide a brief overview of recent regulatory developments relating to the practice of insurance defense. Part II will argue that these developments occurred because lawyers pressured advisory committees and other authorities to give them greater control of decisions and easier access to fees. Part III will explain the danger of waste that arises when lawyers are free to spend insurance companies' dollars. Part IV will show that no empirical evidence of harm to policyholders supports the contention that defense lawyers should have greater freedom from carriers' efforts to manage litigation. Separate sections on staff counsel operations, flat fee arrangements, litigation guidelines, and third-party fee audits will tailor this general point to the specific activities that have recently been the targets of so much regulation. Part V will draw a brief conclusion.

II. RECENT REGULATORY ACTIVITY

For most of the twentieth century, regulators had little interest in the professional responsibilities of insurance defense lawyers. A trickle of common law decisions, advisory opinions, and statutes slowly produced a pool of authority that was broad but not deep. Many states had no decided cases on fundamental

---

Hawaii, the bar issued an opinion bearing on the right of staff attorneys to use law firm names. Haw. State Bar Ass'n Disciplinary Bd., Formal Op. 42 (2002), *available at* http://hsba.hostme.com/Disc/FormalOpinion42.doc.

issues, such as the number of clients a defense lawyer represents. The attitude of regulators was one of neglect.

Despite this, or perhaps because of it, insurance carriers, policyholders, and defense lawyers went about their business with remarkably few hitches. Working hand-in-glove with insurers, defense lawyers handled millions of claims. Judging from case reports, malpractice statistics, and closed-claim studies, carriers and policyholders were happy with their work. The most controversial subject probably was the unauthorized corporate practice of law, an issue raised by independent defense lawyers who opposed insurers' staff counsel operations.[12]

In the 1990s, the trickle became a flood. Courts and advisory committees issued dozens of opinions purporting to find serious problems and ethical deficiencies of diverse kinds. In Florida, the state bar convened a special committee to investigate insurance defense practices[13] and adopted a new rule devoted exclusively to the representation of insureds.[14] In Texas, after two supreme court justices asked the legislature to intervene,[15] bills relating to litigation guidelines and third-party fee audits were passed but the governor vetoed them.[16] In Montana, the supreme court invalidated working arrangements that required lawyers to obtain prior approval of litigation activities from insurers.[17] In Kentucky, the supreme court prohibited defense lawyers from handling insurance work on a fixed fee basis and reaffirmed a standing prohibition on staff counsel operations.[18] In state after state, advisory committees sprang into action in response to defense lawyers' requests for guidance.

---

12. *See, e.g.*, ABA Comm. on Prof'l Ethics and Grievances, Formal Op. 282 (1950) (addressing staff counsel operations).

13. The Committee's reports are available online. *See* THE FLORIDA BAR, *at* http://www.flabar.org/.

14. FLA. RULES OF PROF'L CONDUCT R. 4-1.8(j) (2002) (new Florida rule on the representation of insureds).

15. State Farm Mut. Auto. Ins. Co. v. Traver, 980 S.W.2d 625, 635 (Tex. 1998) (dissenting and concurring opinion of Justices Gonzalez and Abbott).

16. *See* S.B. 1653, 2001 Leg., 77th Reg. Sess. (Tex.) (introduced Mar. 9, 2001, vetoed by governor) (regulating fee audits), *available at* http://www.capitol.state.tx.us (last visited Nov. 8, 2002); S.B. 1654A, 2001 Leg., 77th Reg. Sess. (Tex.) (introduced Mar. 9, 2001, vetoed by governor) (regulating litigation guidelines), *available at* http://www.capitol.state.tx.us (last visited Nov. 8, 2002); *see also* John Council & Brenda Sapino Jeffreys, *Winning the Battle and the War*, TEX. LAW., Feb. 25, 2002, at 37 (describing passage and vetoes of the bills).

17. *In re* Rules of Prof'l Conduct and Insurer Imposed Billing Rules and Procedures, 2 P.3d 806, 815 (Mont. 2000).

18. Am. Ins. Ass'n v. Ky. State Bar, 917 S.W.2d 568, 571 (Ky. 1996). I criticized this opinion at length in Charles Silver, *Flat Fees and Staff Attorneys: Unnecessary Casualties in the Battle over the Law Governing Insurance Defense Lawyers*, 4 CONN. INS. L.J. 205 (1998) [hereinafter Silver, *Flat Fees*]. My other writings on insurance defense ethics include: Ellen S. Pryor & Charles Silver, *Defense Lawyers' Professional Responsibilities: Part II—Contested Coverage Cases*, 15 GEO. J. LEGAL ETHICS 29 (2001) [hereinafter Pryor & Silver, *Contested Coverage Cases*]; Ellen S. Pryor & Charles Silver, *Defense Lawyers' Professional Responsibilities: Part I—Excess Exposure Cases*, 78 TEX. L. REV. 599 (2000) [hereinafter Pryor & Silver, *Excess Exposure Cases*]; Charles Silver,

Appendix 1 catalogues advisory opinions and court decisions issued between 1994 and the present. The list includes six opinions on staff counsel operations, six on flat fees, twenty-two on litigation management guidelines, and thirty-nine on fee audits. This is an extraordinary amount of authority, especially when one considers that much of it questions or condemns long-standing practices. Overall, the opinions describe flat fees and staff counsel operations as unfortunate but ethically tolerable, litigation guidelines as bad and often intolerable, and third party fee audits as an evil to be avoided at all costs.

III. THE CAUSE OF REGULATORY INTEREST: LAWYERS' DESIRE FOR CONTROL

Why did regulators suddenly show a keen interest in insurance defense arrangements? They were responding to lawyers' requests for help. All the advisory committee opinions and many of the court decisions issued, directly or indirectly, in response to requests from attorneys. In Montana, lawyers filed an unprecedented original petition in that state's supreme court. In Kentucky, the decision prohibiting flat fee arrangements was an appeal of a state bar advisory opinion that issued in response to a lawyer's request for guidance. In Texas, lawyers obtained opinions condemning litigation guidelines and fee audits from the state bar, and later lobbied the legislature to codify the results. In Florida, lawyers caused the bar to appoint the Insurance Practices Special Study Committee, which produced a report that led to a new disciplinary rule.

Why have lawyers undertaken this campaign? Their primary goal is to transform the tripartite relationship in ways that give lawyers greater control over litigation decisions and easier access to fees. Participants in the campaign have announced these objectives repeatedly. Consider attorney Donald W. Ricketts, who charged his former employer, Early, Maslach & Price, a captive law firm founded in the 1940s, with engaging in the unauthorized practice of law. Ricketts' particular gripe was that the firm allowed lay claims adjusters employed by Farmers Insurance Group to second guess lawyers' recommendations. He called for "a structural change that says, essentially, that once a case ripens to the point of

---

The Lost World: Of Politics and Getting the Law Right, 26 HOFSTRA L. REV. 773 (1998) [hereinafter Silver, *Lost World*]; Charles Silver, *Professional Liability Insurance as Insurance and as Lawyer Regulation: A Comment on Davis*, 65 FORDHAM L. REV. 233 (1996); Charles Silver & Michael Sean Quinn, *All Clients are Equal, But Some are More Equal than Others: A Reply to Morgan and Wolfram*, 6-3 COVERAGE, May-June 1996, at 47; Charles Silver & Michael Sean Quinn, *Are Liability Carriers Second-Class Clients? No, But They May Be Soon—A Call to Arms against the Restatement of the Law Governing Lawyers*, 6-2 COVERAGE, Jan.-Feb. 1996, at 21; Charles Silver & Michael Sean Quinn, *Wrong Turns on the Three Way Street: Dispelling Nonsense About Insurance Defense Lawyers*, 5 COVERAGE, Nov.-Dec.1995, at 1 [hereinafter Silver & Quinn, *Wrong Turns*]; Charles Silver and Kent D. Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 DUKE L.J. 255 (1995); Charles Silver, *Does Insurance Defense Counsel Represent the Company or the Insured?* 72 TEX. L. REV. 1583 (1994) [hereinafter Silver, *Insurance Defense*].

litigation, lawyers call the shots."[19] A California trial judge awarded Ricketts more than $2 million in damages.[20]

In Texas, the law firm of Sheinfeld, Maley & Kay sued in the name of policyholder Wicks 'n' Sticks stores to recover about $800,000 in fees. The defendants were American Motorist Insurance Co. and Juris Prudent, Inc., a fee auditing company. After the trial court judge issued a summary judgment ruling against the carrier's use of litigation management guidelines, the head of the Insurance Law Section of the State Bar of Texas was quoted as saying: "This is just another step in the direction of giving defense lawyers some latitude in representing the insurance company."[21]

In Georgia, Malcolm S. Murray Sr. filed a racketeering action against Nationwide Mutual Insurance Company, Nationwide's attorneys, and two external auditing firms after the carrier disallowed about $40,000 in legal bills. Murray accused the defendants of conspiring to "commit fraud by creating a 'burdensome scheme of denying payments.'"[22] His lawyer promised that a class action seeking "$40 million" in damages would follow on the heels of a successful individual suit.[23]

The Supreme Court of Montana and the Insurance Practices Special Study Committee of the Florida Bar also recognized these goals. The former castigated insurers for requiring defense lawyers to obtain approval of litigation activities, contending that "prior approval creates a substantial appearance of impropriety in its suggestion that it is insurers rather than defense counsel who control the day to day details of a defense."[24] The latter argued that "[t]he insurer . . . does not have the right to supervise or control the professional conduct of the attorney,"[25] expressed concern that "insurance companies . . . may exert too much control over

---

19. Gail Diane Cox, *Captive Firms of Insurers Get Stung in Court*, NAT'L L.J., May 15, 2000, at A1.

20. *Id.*; Ricketts v. Farmers Group, Inc., No. B140852, 2001 WL 1487700 (Cal. Ct. App. Nov. 26, 2001)

21. Brenda Sapino Jeffreys, *Cost of Doing Business: Insurer Can't Use Litigation Guidelines to Avoid Paying Defense Fees*, TEX. LAW., Feb. 14, 2000, at 1, *available at* http://www.law.com/servlet/ContentServer?pagename=OpenMarket/Xcelerate/View&c=LawArticle&cid=1015973959872&live=true&cst=1&pc=0&pa=0 (last visited Sept. 12, 2002).

22. Janet L. Conley, *Insurer's Lawyer Sues Ex-Client, Says Nonlawyers Judged Output*, FULTON COUNTY DAILY REP., Sept. 5, 2000, *available at* http://www.law.com/servlet/ContentServer?pagename=OpenMarket/Xcelerate/View&c=LawArticle&cid=1015973968351&live=true&cst=1&pc=0&pa=0.

23. *Id.* The campaign to prevent carriers from using independent fee auditors cause many carriers to sever ties with these companies. *See* Jill Schachner Chanen, *Adios, Outside Auditors: Insurance Carriers Go In-House To Check Attorney's Bills*, 86 A.B.A. J. 20 (2000).

24. *In re* Rules of Prof'l Conduct and Insurer Imposed Billing Rules and Procedures, 2 P.3d 806, 815 (Mont. 2000).

25. FLA. BAR INS. PRACTICES SPECIAL STUDY COMM., REPORT OF THE INSURANCE PRACTICES SPECIAL STUDY COMMITTEE 8 (2000) [hereinafter FLA. INS. REP.].

how a case is defended,"[26] and pointed out that "defense counsel are feeling increasingly constrained by insurance company controls."[27] The goal of the campaign is to give defense lawyers greater power over decisions, including decisions regarding services for which insurers must pay.

IV. THE "OTHER PEOPLE'S MONEY" PROBLEM

As a legal matter, both the Montana Supreme Court opinion and the Report of the Insurance Practices Special Study Committee are insupportable. Lawyers are agents, not principals, and there is no sound legal basis for giving lawyers powers that clients do not wish them to have.[28]

---

26. *Id.* at 26; *see also id.* at 8 ("The insurer . . . does not have the right to supervise or control the professional conduct of the attorney.").

27. *Id.* at 13.

28. In more articles, presentations, and amicus curiae briefs than I care to remember, I have argued (1) that attorney-client relationships are consensual, (2) that liability insurers' status as clients or third party payers therefore depends on the agreements they reach with defense lawyers, (3) that whether a carrier is a client in a particular situation is therefore a question of fact, and (4) that ordinary working arrangements establish clearly that liability carriers normally are co-clients of the lawyers they hire to defense lawsuits against insureds. No one has ever offered an alternative to this account of carrier client-hood. Nor has anyone offered an alternative that would convert the question of insurer client-hood from one of fact to one of law.

Even so, courts and advisory committees continue to deny that insurers are clients as a matter of law. The Montana Supreme Court did so in *In re Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedures*, 2 P.3d at 814, holding "that under the Rules of Professional Conduct, the insured is the *sole* client of defense counsel." This is doubly wrong. First, even in Montana, attorney-client relationships are agency relationships that arise by mutual agreement. Kaeding v. W.R. Grace & Co., 961 P.2d 1256, 1261 (Mont. 1998) ("The attorney-client relationship is an agency relationship."); Smith v. Fladstol, 807 P.2d 1361, 1362 (Mont. 1991) ("It is a well-established rule in Montana that the attorney/client relationship is one of agency"); Clinton v. Miller 226 P.2d 487, 493 (Mont. 1951) (holding the same). Consequently, even in Montana, whether a defense lawyer agreed to represent an insurer is a question of fact, not a question of law. *Fladstol*, 807 P.2d at 1362–1363 (holding that the range of tasks a client hired an attorney to perform is a question of fact). Second, because the Montana rules of professional conduct are based on the ABA's Model Rules of Professional Conduct, they do not determine client-hood. *See* Betsy Brandborg, *Changing Rules of Conduct*, 27 MONT. LAW. 6, 6 (2002) ("Montana's current Rules of Professional Conduct were adopted in 1985, using the 1983 ABA Model Rules as their guide."); MODEL RULES OF PROFESSIONAL CONDUCT pmbl., at cmt. 17 (2002) ("principles of substantive [i.e., agency] law external to these Rules determine whether a client-lawyer relationships exists.").

I spelled out the correct analysis of client-hood in an amicus curiae brief submitted to the Montana Supreme Court. Brief of Amicus Curiae Professor Charles Silver, *Pro Se, In re* Rules of Prof'l Conduct & Insurer Imposed Billing Rules & Procedures, 2 P.3d 806 (Mont. 2000) (No. 98-612), http://www.lawlibrary.state.mt.us/dscgi/ds.py/View/Collection-1831 [hereinafter Brief of Silver]. Having done so, when I came to the section of the court's opinion entitled "Whether insurers and insureds are co-clients under Montana's Rules of Professional Conduct," *In re Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedures*, 2 P.3d at 812–15, I expected to find that my account would be accepted or rejected on the merits. Instead, I found *nothing*. The opinion neither sets out my

It also is important to ask how the Montana Supreme Court and the Florida Bar Committee proposed to deal with the obvious incentive problem that arises when providers (be they lawyers, doctors, or others) are empowered to order services for which others (here, insurers) must pay. When compensated by the service or by the hour, providers make money by delivering services, not by withholding them. They profit whether or not services have value for recipients.[29] Even harmful services may be lucrative. Consequently, payers (and recipients) need security against abuse. They require assurance that providers will order services only when the benefits exceed the costs.

Insurance companies use litigation guidelines, monitoring by claims professionals, staff counsel operations, and fee audits to discourage over-spending. According to the American Insurance Association (AIA):

> A survey of its members in 1999 [showed] that, from 1996 to 1998, insurers were able to decrease average defense costs by 1%, while the U.S. inflation rate for legal services rose by 14.4% during that same time period. During the same period, the average amount AIA members paid to plaintiffs on litigated cases decreased 7.6%, providing clear evidence that insurer litigation management tactics have caused no deterioration in the quality of the defense provided to policyholders.[30]

This is some evidence that modern defense management techniques help insurers reduce costs.

If barred from using these techniques, how will insurers offset the perverse incentives created by fee-for-service arrangements and hourly rates? The Montana Supreme Court dealt with this issue in a single paragraph. After ruling that defense lawyers do not represent insurance carriers as clients,[31] the court wrote:

> We caution, however, that this holding should not be construed to mean that defense counsel have a "blank check" to escalate litigation costs nor that defense counsel need not ever consult with

---

account, nor denies the validity of any of its constituent propositions, nor attacks the soundness of my reasoning. The justices simply converted a question of fact into a question of law, apparently because they wanted to and knew that no one could stop them from doing so. This is a dismaying departure from law and reason.

29. Delivery of unnecessary, ineffective, and potentially dangerous services is a serious problem for the medical profession. *See, e.g.*, Linda A. Johnson, *Study Finds Common Knee Surgery Doesn't Work*, ASSOCIATED PRESS, July 10, 2002 (reporting that more than 300,000 Americans receive arthroscopic knee surgery for osteoarthritis annually, at a total cost of $1.5 billion, without demonstrable benefit). For other examples and a general discussion of physicians' incentives to deliver ineffective treatments, see David Hyman & Charles Silver, *You Get What You Pay For: Result-Based Compensation for Health Care*, 58 WASH. & LEE L. REV. 1427 (2002).

30. Brief of Amicus Curiae American Insurance Association at 16 n.9, *In re* Rules of Prof'l Conduct & Insurer Imposed Billing Rules & Procedures, 2 P.3d 806 (Mont. 2000) (No. 98-612), http://www.lawlibrary.state.mt.us/dscgi/ds.py/Get/File-2912/98-612(5-17-99)_Amicus_Curiae,_AIA.pdf [hereinafter Brief of Am. Ins. Ass'n].

31. For a brief criticism of this holding, see *supra* note 25.

> insurers. Under Rule 1.5, M. R. Prof. Conduct, for example, an attorney must charge reasonable fees.[32]

Evidently, the only permissible way for insurers to discourage defense lawyers from spending excessive amounts of their money is by urging them to be ethical. With billions of dollars at stake in the aggregate and thousands at issue in any given lawsuit, only a simpleton would regard this as sufficient protection.

The Florida Bar Committee expressly recognized that liability insurers have a "legitimate and understandable desire to keep costs under control."[33] One might therefore have expected the Committee to identify concrete and effective means by which insurers can police overspending. On this subject, however, the Committee's report is silent. Not a single sentence explains how the "legitimate and understandable desire to keep costs under control" may properly be advanced. The more extreme rhetoric in the report even seems to imply that no cost control measure is acceptable if it prevents a defense lawyer from exercising control: "What is clear under Florida law is that insurance provided defense counsel must be free to exercise 'completely unhampered professional judgment' for the insured client and not be swayed by *any* conflicting interests of the insurer that may be paying the bill."[34] Judging from this sentence, an insurer's desire to manage litigation costs, although "legitimate and understandable," must carry no weight with a defense lawyer at all.

When discussing principal-agent relationships, economists have emphasized the importance of the "other people's money" problem. By empowering an agent to manage an asset, a principal incurs a risk that the agent will use the right of control to enrich himself at the principal's expense. In the insurance defense context, this risk is patent. Despite this, regulators have made it harder for liability carriers to prevent waste and exploitation.

V. NO EVIDENCE DEMONSTRATES A NEED TO PROTECT POLICYHOLDERS BY PREVENTING INSURERS FROM MANAGING DEFENSE COSTS

Clearly, the policy of constraining insurers requires a solid justification. Supporters of the campaign to empower defense lawyers have sought to provide one by claiming that insurers' efforts to control defense costs endanger policyholders. They have had a hard time proving this. The AIA survey mentioned above indicates that carriers have cut costs and payments to claimants at the same time. Lawyers campaigning against insurers have no evidence to the contrary. The Florida Insurance Practices Special Study Committee admitted that "[it] uncovered little evidence of actual harm to the insured."[35]

---

32. *In re* Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedures, 2 P.3d at 814.

33. FLA. INS. REP., *supra* note 25, at 13.

34. *Id.* at 10 (emphasis added), *citing In re* Rules Governing Conduct of Attorneys in Fla., 220 So.2d 6, 7 (Fla. 1969).

35. *Id. at* 13.

Even so, the anti-insurer campaign has persisted. The Florida Committee did not let the lack of evidence stand in its way. It explained away the absence of evidence in a footnote: "The committee is mindful of the fact that there is an inherent inequity in the ability of relatively unsophisticated insureds to present information to the committee versus the ability of the organized and informed insurance companies who were represented by experienced counsel in this process."[36] Then it propounded a lengthy and grave-sounding report and a new rule specifically for defense lawyers. It also recommended a separate investigation of staff counsel operations.

Given the speakers who communicated with the Committee and the materials it reviewed, its unwillingness to embrace the evidence is extraordinary. Many speakers could have presented evidence of harm to policyholders, including "attorneys who represent policyholders in claims against insurance companies," "general counsel for the Florida Department of Insurance," and "a professor of legal ethics," namely, me.[37] "[T]he committee also solicited and received written comments or submissions from approximately seventy individuals," including plaintiffs' attorneys.[38] The Committee further claims to have "reviewed voluminous materials, including case law from Florida and other states, unlicensed practice of law and ethics opinions from Florida and other states, scholarly articles, newspaper articles, legal memoranda and other written materials," and to have "conducted interviews with individuals who indicated a willingness to speak to the committee concerning insurance practice issues."[39] The search for signs of harm was extremely thorough.

The Committee's treatment of staff counsel operations was particularly offensive. In 1969, the Florida Supreme Court rejected a petition filed by the Florida bar that would have restricted staff counsel operations.[40] During the thirty years between the Supreme Court's decision and the Committee's creation, "the use of 'house counsel' [became] an increasingly common practice in Florida."[41] An unbiased person might have thought that the Florida bar, having lost the first battle and having failed to gather evidence of harm in the ensuing thirty years, should give staff attorneys a break. Instead, the Committee asked the Bar's Standing Committee on Unlicensed Practice of Law to review all instances in which lay employees of insurance companies stand over defense attorneys.

Another impressive broadside against modern defense cost management practices appears in *State Farm Mutual Automobile Insurance Company v. Traver*, where Texas Supreme Court Justice Raul Gonzalez filed a separate opinion railing against insurers' efforts to reduce costs.[42] Justice Gonzalez attacked captive law

---

36. *Id.* at 16 n.10.

37. *Id.* at 6–7. I received no compensation for appearing before the Committee, although an insurance company did reimburse my travel and lodging expenses.

38. *Id.* at 7.

39. *Id.*

40. *Id.* at 11.

41. *Id.* at 12.

42. State Farm Mut. Auto. Ins. Co. v. Traver, 980 S.W.2d 625, 629 (Tex. 1998) (Gonzalez, J., concurring in part and dissenting in part).

firms that have the appearances of regular firms but whose attorneys really "are the insurance company's salaried employees."[43] After "ventur[ing] to say that in most cases, the policy holder is not aware of this arrangement," Justice Gonzalez asserted that "it is probably impossible for an [employee] attorney to provide the insured [] unqualified loyalty."[44] He bemoaned the existence of "[c]ompetition for insurance work[, which] weakens the defense lawyer's hand while it allows insurance companies to demand ever-stringent cost containment measures."[45] He criticized insurance companies for allowing case administrators, "who may not even be [] lawyer[s], [to] decide[] legal strategy and tactics in the policy holder's defense."[46] He condemned "billing restrictions and . . . billing audits" and concluded by asking the legislature to intervene.[47]

Justice Gonzalez's tirade is remarkable for many reasons. First, none of the matters he addressed was at issue in *Traver*. The defense lawyer whose conduct was said to have harmed the insured did not work at a captive law firm and was not a staff attorney. There was no allegation that the policyholder suffered because the insurer improperly used a nonlawyer case administrator, subjected the defense lawyer to onerous litigation guidelines, or audited the defense lawyer's bills. Justice Gonzalez's tirade has nothing to do with the case.

Second, Justice Gonzalez offered no empirical support for his opinions. He cited no evidence that attorneys at captive law firms or staff counsel offices protect policyholders less ably than outside defense lawyers. He did not show that claims administrators, many of whom have years of experience with litigation, harm policyholders by supervising attorneys. He did not prove that competition, litigation management guidelines, billing audits, or any other cost-cutting measures are harming policyholders. He simply asserted these things and expected others to believe him.

Some have believed him. The Montana Supreme Court relied on Gonzalez's separate opinion in *In the Matter of Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedures*.[48] Certain commentators have also quoted it with approval.[49] Their veneration of shoddy authority brings to mind Bismarck's aphorism: "If you like laws and sausages, you should never watch either one being made."[50]

---

43. *Id.* at 633.
44. *Id.*
45. *Id.* at 633–34.
46. *Id.* at 634.
47. *Id.*
48. In an *amicus curiae* brief submitted to the Montana Supreme Court, I explained some of the problems with Justice Gonzalez's opinion. *See* Brief of Silver, *supra* note 28, at 11–12.
49. *See* Michael D. Morrison & James R. Old, Jr., *Economics, Exigencies and Ethics: Whose Choice? Emerging Trends and Issues in Texas Insurance Defense Practice*, 53 BAYLOR L. REV. 349 (2001) (citing Justice Gonzalez's opinion repeatedly).
50. RESPECTFULLY QUOTED: A DICTIONARY OF QUOTATIONS REQUESTED FROM THE CONGRESSIONAL RESEARCH SERVICE 190 (Suzy Platt ed., 1989).

The AIA survey mentioned above is some evidence that, despite the introduction of modern cost management techniques, policyholders continue to be well protected. Other evidence supports this impression. The American Bar Association's malpractice study found that claims against lawyers who defend personal injury cases constitute about the same percentage of all malpractice cases today as they did a decade ago.[51] An article by Stephen Daniels and Joanne Martin of the American Bar Foundation reports the impression of Texas trial lawyers that settlements payments in automobile accident cases have fallen considerably because of tort reform measures.[52] Closed claim reports prepared by the Texas Department of Insurance for the 1997–1999 period show that commercial insureds' exposure to losses above the policy limits was both small and steady.[53]

This is a small quantum of evidence, but it is fair to ask whether any advisory committee, judge, or commentator who condemns modern defense cost management techniques has countervailing evidence that outweighs it. None does. A review of the many reports, cases, advisory opinions, and law review articles produced in recent years uncovered no documented evidence of harm to policyholders.

A. Staff Counsel Operations

Staff attorneys are insurance companies' employees.[54] As I explained in 1998:

---

51. STANDING COMM. ON LAWYER'S PROF'L LIAB., ABA, PROFILE OF LEGAL MALPRACTICE CLAIMS 1996–1999 app. 1 (2000). The absolute number of claims against all lawyers, including personal injury-defense lawyers, increased over time. *Id.*

52. Stephen Daniels & Joanne Martin, *It Was the Best of Times, It Was the Worst of Times: The Precarious Nature of Plaintiffs' Practice in Texas*, 80 TEX. L. REV. 1781 (2002).

53. The following table summarizes the experience of commercial policyholders in Texas.

Year	Total Closed Claims	Number of Payments by Insureds in Excess of Policy Limits	Total Amount Paid by Insureds in Excess of Policy Limits
1997	17,173	36	$3,218,259
1998	9,354	27	$6,809,822
1999	9,131	33	$1,750,442

Sources: TEX. DEPT. OF INS., THE 1997 TEXAS LIABILITY INSURANCE CLOSED CLAIM ANNUAL REPORT 4, at fig. 3 (1999), *available at* http://www.tdi.state.tx.us/general/pdf/taccar97.pdf (last visited Aug. 16, 2002); TEX. DEPT. OF INS., The 1998 Texas Liability Insurance Closed Claim Annual Report 4, at fig. 3 (2000), *available at* http://www.tdi.state.tx.us/general/pdf/taccar98.pdf (last visited Aug. 16, 2002); TEX. DEPT. OF INS., The 1999 Texas Liability Insurance Closed Claim Annual Report 4, at fig. 3 (2001), *available at* http://www.tdi.state.tx.us/general/pdf/taccar99.pdf (last visited Aug. 16, 2002).

54. Companies in other lines of business also use in-house legal counsel and are routing more work to these lawyers to reduce costs. *See U.S. Corporations Aim to Rein in Spending for Outside Lawyers*, BLOOMBERG NEWS, Jan. 4, 2002 (discussing results of survey predicting that overall corporate spending on outside legal services will decline in 2002 because of corporate cost-cutting plans that "include routing more legal work to in-house lawyers"), http://www.nera.com/_template.cfm?c=6168&o=4821.

> Most staff attorneys are former outside defense lawyers with years of experience trying and settling liability cases. They receive regular performance reviews, participate in bar associations and other professional groups, take continuing legal education courses, do pro bono work, receive malpractice coverage, enjoy paid vacations, and have health insurance plans and pensions. Most staff counsel offices are indistinguishable in basic respects from outside law firms. They have libraries, computers, paralegals, secretaries, procedure manuals, conflict-checking systems, continuing legal education programs, retreats, letterhead, receptionists, and business cards. Some staff counsel offices even use surveys to gauge policyholder satisfaction with services they provide. And unlike many outside lawyers, most staff attorneys are specialists who handle large numbers of similar cases. As specialists, they should be able to defend lawsuits better than many outside defense lawyers who, being generalists, know less about the particular subject areas in which cases arise.[55]

The New Jersey Supreme Court was right when it stated that staff attorneys "are not second-class lawyers; [they] are first-class lawyers who are delivering legal services in an evolving format."[56]

Staff counsel operations have existed since the late 1800s. Most large carriers have them, and some assign them more than half their cases.[57] A study of large claims that closed in 1990 and 1991 found that in-house lawyers handled twenty-two percent of all litigated claims.[58] Given the volume of claims they handle, it is to be expected that many staff counsel offices are sizeable. Some carriers employ more than 500 staff attorneys. Whether measured in terms of attorney numbers, claims handled, or operating budgets, the importance of staff counsel operations is great and growing.

Judging from the length of time staff counsel operations have existed, their size, and the number of lawsuits they have defended, one must conclude that insurance companies are confident in their ability to deliver quality services at reasonable cost.[59] Closed-claim studies support this contention.

> The Insurance Services Office has conducted three closed-claim surveys in which the relative efficiency of staff counsel operations

---

55. Silver, *Flat Fees*, *supra* note 18, at 248–49 (footnotes omitted).

56. *In re* Weiss, Healey & Rea, 536 A.2d 266 (N.J. 1988). Many staff attorneys are active participants in debates about legal ethics and professionalism. *See, e.g.*, John Conlon, *Insurer Litigation Guidelines: Attorney Ethical Considerations*, 42 RES GESTAE 11 (1998).

57. James Howland & Michael Pritula, *Legal Costs: Can the Flow Be Slowed?*, BEST'S REV. PROP. & CAS. INS. ED., Feb. 1991, at 14, 16 (stating that "[c]arriers like Allstate and The Travelers report that staff counsel handles well over half of their litigated cases").

58. *See* INS. SERVS. OFFICE, INC., ISO INSURANCE ISSUES SERIES, LEGAL DEFENSE: A LARGE AND STILL GROWING INSURANCE COST 14–15 (1992).

59. The magnitude of the savings is described in Silver, *Flat Fees*, *supra* note 18, at 241–42.

> was assessed. All three surveys "have shown that the ratio of paid-to-date ALAE [allocated loss adjustment expenses] to paid loss is higher for claims in which insurers use only outside counsel to defend their insureds than the ratio is for claims in which insurers use only in-house counsel." In the most recent study, the ratio for outside counsel was almost twice as large as that for in-house counsel, even when severity of injury alleged by the claimant was controlled.[60]

There is no obvious reason to doubt that insurance companies save money by using staff attorneys. If staff counsel operations were losing propositions, insurers would have every reason to close them and farm out the work.

Opponents of staff counsel operations deny neither that insurers like them nor that they save insurers money. They contend that by using staff attorneys, insurance carriers engage in the unauthorized practice of law and subject insureds to dangerous interest conflicts. The latter allegation gives the former its appeal.[61] If everyone admitted that staff attorneys benefit policyholders by defending them ably and reducing insurance costs, law firms' efforts to invoke unauthorized practice prohibitions would appear to be naked acts of self-interest. Their object would be to prevent employed attorneys from siphoning cases and fees away from independents. Only the appearance of protecting policyholders gives outside defense lawyers a claim to the high ground.

Yet, if harm to policyholders is the issue, it is reasonable to ask opponents of staff counsel operations for evidence supporting their charge. Given the length of time staff counsel operations have existed and the number of cases they have handled, evidence should be easy to find. For example, one might compile a record of complaints filed with state bar associations in which staff attorneys were disciplined. One might cite reported opinions holding staff attorneys or their employers liable for disloyalty or malpractice. One might produce complaints that policyholders lodged with state insurance regulators, attorneys general, or consumer protection agencies. Citing closed claim studies, one might show that trial losses or settlement payments are higher in cases handled by staff attorneys than when outside lawyers are engaged. One might use the same studies to show that outside lawyers resolve excess exposure cases within the policy limits more often than staff attorneys do.

Writing in 1998, I explained that no one had offered any evidence showing that carriers endanger policyholders by referring cases to staff attorneys. I also offered evidence that staff attorneys serve policyholders as well as outside lawyers do. For example, I explained that although there were many reported cases involving misdeeds by outside defense lawyers, neither my WESTLAW research nor my review of the literature on staff counsel operations turned up a single instance in which an adjudicated breach of duty by a staff attorney saddled a

---

60. *Id.* at 242.

61. Most jurisdictions that have addressed the issue have refused to find that staff counsel operations violate unauthorized practice of law restrictions. *See* Leo J. Jordan & Hilde E. Kahn, *Ethical Issues Relating to Staff Counsel Representation of Insureds*, 30 TORT & INS. L.J. 25 (1994).

policyholder with harm.[62] A review that I personally conducted of a staff counsel operation in Texas found no record of disciplinary action or malpractice complaints and only one grievance. The "staff attorneys compared well to the average member of the Texas bar in terms of credentials, years of experience, salary, and other characteristics."[63] I also observed that "[w]hen the Florida bar reviewed staff counsel operations in that state, the insurance commissioner reported that his office had received no complaints about staff attorneys."[64]

There are even reasons for thinking that staff attorneys are likely to outperform other defense lawyers. They may be more independent minded because they are better protected against wrongful discharge and because they stand to lose less by violating insurers' instructions. They may be more careful because they are supervised more closely and because their employers are vicariously liable for their mistakes. Insurance carriers want staff lawyers to be careful and ethical. They know that shoddy conduct would jeopardize the existence of staff counsel operations.

In 1998, I asked for empirical evidence of harm to policyholders, and I criticized the Kentucky Bar Association for giving staff attorneys an undeserved "slap in the face."[65] Since then, the campaign against staff counsel operations has continued. Advisory committees received several requests from lawyers for opinions and responded with grave warnings that staff attorneys must make complete disclosures.[66] Michael D. Morrison and James R. Old, Jr. contended in a law review article that Texas ethics opinions "compel the conclusion" that liability insurers' use of house counsel "involves the unauthorized practice of law."[67] Yet the truth continues to be that opponents of staff counsel operations have offered no evidence of harm to insureds.

Consider the law review article. Morrison and Old accuse staff attorneys of "violat[ing] prohibitions against the corporate practice of law, conflicts of interest rules barring even the appearance of impropriety, and prohibitions against partnerships where lawyers share legal fees with nonlawyers."[68] Given the number of charges, their seriousness, the length of time staff counsel offices have existed, and the number of cases staff attorneys have handled, the authors should have no difficulty proving that insureds have suffered. Yet, they offer no evidence. When discussing unauthorized practice restrictions,[69] they cite a raft of cases and

---

62. The only published opinion listed in the 1996 edition of LEGAL MALPRACTICE was *Bevevino v. Sydjari*, 76 F.R.D. 88 (S.D.N.Y. 1977) (cited in RONALD E. MALLEN & JEFFREY M. SMITH, LEGAL MALPRACTICE § 28.5, at 498 n.3 (4th ed. 1996)). In *Bevevino*, the policyholder escaped injury because the staff lawyer's negligence "[fell] exclusively upon the [insurance] carrier." *Id.* at 94.

63. Silver, *Flat Fees*, *supra* note 18, at 248.

64. *Id.*

65. *Id.*

66. *See* Appendix 1 for authorities.

67. Morrison & Old, *supra* note 49, at 401.

68. *Id.* at 401.

69. *Id.* at 400–01.

advisory opinions,[70] but they fail to identify even a single policyholder who was harmed. When discussing interest conflicts[71] they write, "the use of house counsel takes a situation ... fraught with conflicts and economic tension, and adds even greater opportunity for mischief."[72] Yet they again offer no evidence of harm to an insured. When discussing rules regarding law firm names, they accuse insurers of engaging in conduct that "is at best misleading and at times fraudulent" and that "raises serious ethical and consumer protection issues."[73] Again, though, their commentary is long on law but decidedly short on examples of harm.[74] Judging from the article, one would have to conclude that staff attorneys violated important ethics rules thousands or millions of times *to the demonstrable detriment of no one.*

Morrison and Old seem to think they can prove that a particular practice endangers policyholders by finding a legal authority that says so. This belief reflects a deep misunderstanding as to where one must look to find relevant facts.[75] Policyholders experience the effects of insurance defense practices in the physical world, not in the minds of judges and lawyers who write legal opinions applying state bar rules. One must therefore examine the world to discover how well or badly insurance defense practices work. Dire assertions in reported cases and advisory opinions that have no empirical foundation are worthless when it comes to establishing facts.

Fortunately, advisory committees have had better sense than to outlaw staff counsel operations on the basis of unsupported allegations and fears. Recent

---

70. Morrison & Old, *supra* note 49, at 412. Morrison and Old frequently rely on *American Insurance Association v. Kentucky State Bar*, 917 S.W.2d 568 (Ky. 1996), the case I dubbed the "Worst Opinion On A Professional Responsibility Topic in 1996." Silver, *Flat Fees*, *supra* note 18, at 207. They also rely heavily on the Montana opinion, *In re* Rules of Prof'l Conduct and Insurer Imposed Billing Rules and Procedures, 2 P.3d 806, 815 (Mont. 2000), my candidate for "Worst Opinion On A Professional Responsibility Topic In 2000."

71. Morrison & Old, *supra* note 49, at 405–08.

72. *Id.* at 407.

73. *Id.* at 408.

74. Morrison & Old have a point when they contend that insurance companies should stop beating around the bush when advertising staff counsel operations. *Id.* at 408–09. I have previously advised insurers to advertise staff counsel offices forthrightly, and I am pleased that some are now doing so. Insurers should be proud of staff attorneys' accomplishments, and staff attorneys should be too.

75. It also demonstrates Morrison and Old's willingness to use authorities selectively. When condemning flat fee arrangements, they rely heavily on Douglas R. Richmond, *The Business and Ethics of Liability Insurers' Efforts to Manage Legal Care*, 28 U. MEM. L. REV. 57 (1997). Yet, when discussing staff counsel operations, they ignore many statements by Richmond that wholly undercut their position. *See, e.g.*, *id.* at 112 ("There is no reason to believe that insurance company staff counsel uniformly offer insureds a less competent defense."); *id.* at 113 ("For professional responsibility purposes then there is little difference between many attorneys in private practice and staff counsel."); *id.* ("The problem with staff counsel representation of insureds is largely one of perception."); *id.* ("It is difficult to evaluate the validity or accuracy of this perception [that staff attorneys are more loyal to carriers than private practitioners], for it is unsupported by any sort of evidence.").

opinions allow staff counsel offices to continue in operation. Yet, these opinions also convey a sense of unease. For example, in 1996 the New Jersey Committee on the Unauthorized Practice of Law supplemented its original opinion affirming the permissibility of staff counsel operations because "the Committee was troubled by a number of ethical issues raised not only by the inquirer, but by many of the commentators as well."[76] One such issue was the use of nonlawyer claims managers to supervise defense lawyers. Another concerned a practice of renting out staff attorneys to self-insured companies at a profitable hourly rate. A third related to the disclosures staff attorneys made to policyholders about their employment status.

The Committee handled the third issue well. After observing that no one presented evidence that failure to disclose employment status "resulted in harm to the insureds," it expressed reluctance to require disclosure.[77] Yet, the Committee spoke out against the first two policies even though, insofar as one can tell, no evidence of harm was submitted regarding them either. Absent such evidence, neither policy should have raised hackles. Nonlawyers have supervised defense attorneys for decades. The arrangement is entirely proper. Any corporate client can engage a nonlawyer agent for the purpose of monitoring a lawyer. The practice of renting out staff attorneys is new, but not obviously dangerous.[78] The self-insured companies that want to hire staff attorneys are sophisticated clients who know that these lawyers are carriers' employees. The risk of deception is minimal and the hourly rates are attractive, whether or not insurers profit from them.

The Alaska Bar Association Ethics Committee also treated several issues sensibly.[79] It declined to find either that staff counsel offices violate unauthorized practice prohibitions or that conflict rules establish per se prohibitions on joint representations by staff attorneys of carriers and insureds. On a third issue, however, the Committee's opinion can be quarreled with. According to the Committee, an actual and unwaivable conflict of interests exists when a claimant submits a settlement demand "at or within policy limits where there is a substantial likelihood of an excess judgment."[80] Again in the Committee's view,

---

76. N.J. Comm. on Unauthorized Practice, Op. 23 (1996), *available at* 1996 WL 520891.

77. *Id.* The Committee on Professional Ethics of the New York State Bar Association was less restrained. Despite having no evidence that existing practices were confusing insureds, it required various disclosures. *See* N.Y. Bar Ass'n Comm on Prof'l Ethics, Op. 726 (2000), *available at* 2000 WL 567960. Other states have done the same. *See, e.g.*, Or. State Bar Ass'n Bd. of Governors, Formal Op. 1998-153 (1998) (requiring disclosure in letterhead), *available at* 1998 WL 717727; W. Va. Lawyer Disciplinary Bd., Op. 99-01 (advising that captive law firms disclose their affiliations with insurance companies on "their letterhead, business cards, phone book identification, phone answering method, office entrances and pleadings and ... explain [the affiliation] to each client").

78. Many companies charge the cost of in-house legal operations separately to their subsidiaries. *See* Tex. Comm. on Prof'l Ethics, Op. 531 (1999) (discussing propriety of billing subsidiaries at market rates rather than actual cost for in-house legal services), *available at* http://www.txethics.org/reference_opinions.asp?opinionnum=531.

79. Alaska Bar Ass'n Ethics Comm., Op. 99-3 (1999), *available at* 1999 WL 1494993.

80. *Id.*

"representation by salaried staff counsel is prohibited" in this situation "since counsel could not reasonably believe" that the representation of both clients would be unimpaired.[81]

For reasons I have explained at length elsewhere,[82] the Committee's conclusion that a policy limits settlement demand creates a fatal conflict is far too quick. First, the Committee assumes that the carrier and the policyholder will hold different opinions. This need not be true. Both may want to accept the demand or to reject it. Second, if a disagreement exists, one client may change its mind upon learning how the other feels or upon hearing the reasons supporting the other's opinion. A lawyer can properly help the clients discuss the expected costs and benefits of trying the case in the hope of enabling them to resolve their disagreement. Third, if disagreement persists, the carrier may waive the conflict in hopes of avoiding a bad faith lawsuit by the insured, or the insured may do so in the hope of avoiding a coverage denial. Informed clients can waive nearly all conflicts under prevailing ethics rules. They should be free to waive this one too.

The Alaska Committee can also be faulted for failing to demand evidence that policyholders represented by staff attorneys are at particular risk of harm when claimants offer to settle at or within policy limits. The assertion that they are at risk is just a specific application of the general charge that staff attorneys put carriers' interests ahead of insureds' when the two clients' interests conflict. Because no evidence supports the general allegation, none supports the specific allegation either. Nor did the Alaska Ethics Committee offer any evidence. It merely posited an unwaivable conflict, thereby continuing the tradition of impeding clients' freedom to structure attorney-client relationships as they wish even when there is no factual basis for fearing that consensual arrangements are especially dangerous.

B. Flat Fee Arrangements

Seeking to manage defense costs while motivating defense lawyers to use resources wisely, liability insurers have recently turned to flat fees. In my 1998 article, I described how some of these arrangements work and explained the relevant economics. My conclusion was:

> Flat fees are . . . flexible arrangements that, when handled thoughtfully, offer some important advantages to institutional purchasers of legal services who are dissatisfied with hourly rates. They also have advantages for lawyers. They give lawyers access to reliable work flows, predictable profits, regular employment, training opportunities for associates and paralegals, and opportunities to build strong relationships with commercial clients who are potential sources of unbundled matters for which firms will be paid higher fees.[83]

I also critiqued the arguments supporting the Kentucky Supreme Court's conclusion that by working for flat fees defense lawyers would violate their

---

81. *Id.*
82. Pryor & Silver, *Excess Exposure Cases*, *supra* note 18, at 651–63.
83. Silver, *Flat Fees*, *supra* note 18, at 221.

professional responsibilities. No rule cited by the court supports this view. The court's conclusion rests on a series of confusions.

Several commentators have defended the Kentucky Supreme Court against my accusations. For example, although Nancy Moore agreed with me that "the Kentucky court's opinion is remarkably unpersuasive," she thought its position on flat fees "not nearly as indefensible" as I contended.[84] She based this statement partly on the existence of a small number of advisory opinions expressing views like those espoused by the Kentucky Supreme Court.[85] Even though she candidly admitted that "none" of these opinions "satisfactorily addresse[d] the questions" I raised, she correctly pointed out that there was more legal authority for the court's decision than I acknowledged.[86] Moore also argued that the possibility that "bundled flat fee arrangements do pose additional dangers" should not be foreclosed summarily, while "tak[ing] no position on whether these additional dangers do or do not exist."[87] I agree that one should always be willing to consider new evidence.

Factually, then, Moore's position is close to my own. She agrees that "[g]iven the lack of empirical evidence, an absolute prohibition on the practice [of using bundled flat fees] seems harsh and unwarranted."[88] Philosophically, though, we are far apart. Despite the lack of evidence of harm to policyholders, Moore does not oppose a prophylactic prohibition: "[G]iven the extent to which the tripartite relationship already seems to favor the insurer over the insured," she writes, "it may not be unreasonable to want to avoid any new [fee] arrangements that further undermine an attorney's loyalty to the insured."[89] This circumlocution troubles me. Rather than have regulators erect barriers that "may not be unreasonable," I would have them do nothing unless and until the need for barriers is proved. I am more strongly committed to philosophical liberalism than Moore.

Morrison and Old also wish to rescue the Kentucky Supreme Court, but they proceed in the oddest way. Although they draw upon my 1998 article when discussing staff counsel operations, they neither mention it nor respond to my critique of the Kentucky Supreme Court's opinion when taking up flat fees. Insofar as I know, mine is the only law review article that both attacks the *AIA* decision and defends flat fees. Without seeming too self-important, I hope I can say that Morrison and Old should have addressed my arguments or at least dropped a footnote acknowledging my article as expressing an opposing view.[90]

---

84. Nancy J. Moore, *The Ethical Duties of Insurance Defense Lawyers: Are Special Solutions Required?*, 4 CONN. INS. L.J. 259, 286–87 (1998).

85. *Id.*

86. *Id.* at 288–89.

87. *Id.* at 291.

88. *Id.* at 292.

89. *Id.*

90. Speaking of opposing views, James R. Old, Jr. has repeatedly asserted that "the 'client' of defense counsel is the insured, not the insurance carrier." James R. Old, Jr., *Walking the Ethical Tightrope: An Insurance Defense Laywer's Perspective on Third Party Audits and Billing Guidelines*, 64 TEX. B. J. 61, 62 (2001); *see also* Morrison & Old, *supra* note 49, at 356–57. As authority, Old cites Employers Cas. Co. v. Tilley, 496 S.W.2d 552

Morrison and Old also embrace the discredited view that disciplinary rules requiring reasonable fees are supposed to protect lawyers from fees that are unreasonably *low*.[91] They repeatedly voice the fear that powerful insurers will drive down payments to the point where lawyers working for fixed fees will incur losses.[92] This is a surprising gambit. In *Goldfarb v. Virginia State Bar*, the U.S. Supreme Court condemned the Bar for enforcing minimum fee schedules on the ground that this made the Bar complicit in "what [was] essentially a private anticompetitive activity."[93] Morrison and Old renew the idea that bar associations should maintain fees at high levels by prohibiting lawyers from accepting flat fees from insurers.[94] Yet, they do not mention *Goldfarb*. The omission is troubling. In her comment on my 1998 article, Nancy Moore observed that "[t]he Kentucky Supreme Court did not even mention" the "reasonable fee" rule in *AIA*, possibly because it "agreed that *Goldfarb* prohibits the regulation of unreasonably low fees."[95] Morrison and Old should have addressed Moore's point.

Sidestepping Morrison and Old's legal arguments, a common failing of their factual claims is their failure to provide any supporting evidence. Morrison and Old contend that lawyers cannot make decent profits from flat fees, that ignorance prevents lawyers from setting flat fees appropriately, that flat fees cause lawyers to ignore their responsibilities and to defend policyholders inadequately, and that flat fees deny policyholders the benefit of their insurance bargains. Again,

---

(Tex. 1973). I have repeatedly shown that this reading of *Tilley* is mistaken. Justice Samuel Johnson regarded the insurer as a third party payer, but no other justice joined his *Tilley* concurrence. *Id.* at 561. The rest of the court decided the case under the conflict rules that apply to lawyers with multiple clients. *See, e.g.*, Silver & Quinn, *Wrong Turns*, *supra* note 18. This analysis of *Tilley* recently persuaded the Texas Supreme Court to withdraw its original opinion in *State Farm Mutual Automobile Insurance Company v. Traver*, 980 S.W.2d 625 (Tex. 1998), which treated a defending carrier as a third party payer.

Old has never responded to my reading of *Tilley*. Nor has he come to terms with the Texas Supreme Court's action in *Traver*. These are important failings.

91. Morrison and Old also repeatedly invoke the "appearance of impropriety" when arguing against flat fees. *See, e.g.*, Morrison & Old, *supra* note 49, at 416 (asserting that "flat fee agreements may create an appearance of impropriety"). This objection also has outlived its useful life. When an appearance of impropriety bears no connection to an actual violation, the appropriate course is to educate the public about the permissibility of the conduct, not to ban it.

92. *See* Morrison & Old, *supra* note 49, at 411 ("At a normal price of between $3,500 and $5,000 per file, the margin for the defense firm is so slight that any untoward event, no matter how slight, could put the firm at a loss on the whole program. The economic pressure is enormous."); *id.* at 413 (arguing that flat fees will force lawyers to choose "between taking a financial loss—possibly even missing a draw or payroll—and overlooking the interests of a client," by which they mean a policyholder).

93. 421 U.S. 773, 774, 792 (1975).

94. Advisory committees have written similar statements. *See, e.g.*, Ohio Bd. of Comm'rs on Grievances & Discipline, Advisory Op. 97–7 (1997) ("The more pertinent concern is that the flat fee agreements between an attorney or law firm and a liability insurer will provide insufficient and inadequate compensation to the attorney or law firm. When a flat fee agreement . . . provides insufficient compensation in regards to the time and effort spent on the representation, ethical problems emerge."), *available at* 1997 WL 782951.

95. Moore, *supra* note 84, at 289.

given the seriousness of the complaints and the certainty with which Morrison and Old express them, one would expect them to offer examples in which dire consequences occurred and empirical studies demonstrating the systemic nature of the effects. They offer neither. Morrison and Old do not cite a single case or empirical study showing that a policyholder was harmed. Nor do they show that an inadequate flat fee arrangement ever caused a defense lawyer to declare bankruptcy or to give a policyholder short shrift.

Given the frequency with which lawyers receive flat fees in criminal cases, matrimonial matters, and other representations, the failure to cite cases requires some explanation. There must be hundreds of malpractice cases involving lawyers who worked for fixed fees. Why did Morrison and Old not cite them? An important possibility is that citations would have undermined their position. After all, neither courts, nor advisory committees, nor state bar associations have seen fit to prohibit flat fees in other contexts, despite the frequency of malpractice. Citations to other cases would have caused readers to wonder why a special prohibition should apply to insurance defense lawyers, especially when other lawyers have track records that are demonstrably worse.

Other problems also plague Morrison and Old's factual claims. For example, it seems obvious that lawyers who find flat fees unprofitable will refuse to accept them. Nothing prevents defense lawyers from moving into more lucrative practice areas. Consequently, insurers will have to offer flat fees that are high enough to convince defense lawyers to handle their work. The market should therefore keep flat fees from falling to unacceptable levels. The market should handle the problem of ignorance the same way. Ignorance implies that lawyers' estimates of case costs will have high associated variances. Insurers will have to deal with this problem by offering lawyers risk premiums, by using techniques like case bundling to boost lawyers' confidence in cost estimates, or by tying increases in flat fees to litigation events that drive up costs.

Finally, the charge that flat fees put insurers in breach of their contracts with insureds founders on two grounds. First, in most cases only carriers' dollars are at stake.[96] By being excessively parsimonious with their attorneys, insurance companies would harm mainly themselves. Second, policyholders' attorneys are ready, willing, and able to bring bad faith actions when insureds are disserved. The threat of liability should give carriers an additional reason to see that policyholders are defended zealously.

Morrison and Old drew most of their objections to flat fees from a 1997 article by Douglas R. Richmond.[97] Richmond is a prolific insurance lawyer who, despite devoting an enormous amount of time to writing and public speaking, keeps his clients extremely happy. A 1999 survey ranked him first among lawyers

96. In the closed claim reports prepared by the Texas Department of Insurance, the ratio of payments by insurers to excess payments by policyholders varied from a low of 141 to 1 in 1998 to a high of 957 to 1 in 1999. *See supra* note 53. Carriers have far larger financial stakes in covered lawsuits than policyholders.

97. Richmond, *supra* note 75.

most admired by industry insiders "for providing excellent service—and better results—to insurance companies."[98]

Richmond rejects my argument that insurers would harm mainly themselves by offering inadequate fixed fees. "This pro-insurer argument," Richmond contends:

> while theoretically sound, often fails in practice. Insurers seldom appreciate the potential for increased indemnity obligations when looking for ways to cut defense costs. Defense expenditures are concrete and predictable, while the potential for increased future indemnity payments is speculative and incapable of measure. Insurance company claims managers focus on trimming defense costs because they can and because their ability to control defense costs is one of the factors by which their job performance is evaluated. The indemnity side of insurance claims management is too often discounted or discarded, even though both insurers and insureds may suffer as a result.[99]

Although the attack on modern cost reducing techniques consists mainly of lawyers accusing liability carriers of stinginess, Richmond believes that liability insurers are not really good at saving money.

In keeping with the spirit of this essay, I begin my critique of Richmond's point by noting that he offers insufficient evidence for it. Clearly, some evidence is required. Insurance companies understand that defense outlays affect indemnity losses. This is why they defend many lawsuits instead of settling them or allowing default judgments to be entered. Insurance companies also monitor claim-related losses and seek to maximize profits by keeping these losses down. When total losses grow, insurers have incentives to figure out why. One should not expect significant false economies to persist over time.

Even if Richmond has identified a problem, then, its magnitude may be small. Should claims managers be one percent more generous than they are? Ten percent? Fifty percent? Richmond does not answer this question, and without an answer the desirability of regulation remains unclear.

Some flat fee arrangements are designed to avoid the problem that bothers Richmond. As I explained in 1998, a carrier can use a variety of methods to monitor the impact of flat fees on indemnity losses and to encourage lawyers to minimize payouts:

> [An insurer] can [] compare judgment and settlement costs incurred in the block of cases handled by the firm with costs incurred in similar matters handled by other lawyers, including staff attorneys, and with its own historical payouts on closed claims. To make even better comparisons, a large insurer could divide cases into two or three blocks, sending the blocks to different firms and letting each firm know that its performance will be measured against the others'.

---

98. Lori Tripoli, *Among the Best . . . No Bad Rap for These Insurance Defense Lawyers*, 18 COUNSEL 1, 1 (1999).

99. Richmond, *supra* note 75, at 114–15.

> Short of this, the carrier could establish targets for a firm based on the firm's or the carrier's historical loss experience. It could then give the firm a preference on future work assignments if the targets are met, taking advantage of the firm's desire to keep the insurer's business. To further encourage optimal effort, the insurer could offer the firm a bonus inversely proportionate to the insurer's loss experience across the bundle. The smaller the carrier's payout on judgments and settlements, the larger the bonus to the firm.[100]

Neither Richmond nor Morrison and Old show that these monitoring devices and incentive arrangements are inadequate.

Still, no one is perfect, and managers of companies never have ideal motives, incentives, information, or judgment. Some claims managers probably are as short sighted as Richmond contends. Even admitting this, however, one must still ask why it is right to use state bar disciplinary rules to police mistaken judgments made by claims managers. State bar rules govern neither insurance carriers nor their lay employees. Even conceding that Richmond spotted a problem, it is not one that state bar rules exist to correct.

A prohibition on fixed fees would not correct the problem anyway. If claims managers are willing to slash defense outlays even when doing so generates larger indemnity losses, then they will abuse *any* fee arrangement. They will slash hourly rates, refuse to pay for legal research, and disallow expenses. They will set reverse contingencies too low. They will substitute less experienced and less able attorneys for better ones who demand higher fees.[101] To prevent claims managers from being too stingy requires a prohibition against parsimony that applies to all defense-related decisions carriers make. By itself, the ban on flat fees will only divert cost-obsessed managers to other opportunities to save defense dollars.

The ban on flat fees may also have counterproductive effects. First, it may prevent well-managed insurers from demonstrating their superiority by using fixed fee arrangements just when these are economically superior to other forms of compensation. Second, it may insulate inefficient lawyers from competition. Lawyers who are able to deliver quality legal services while shouldering the risks that fixed fees entail will be denied the opportunity to attract business away from those who cannot.[102]

This last point bears emphasis. Richmond complains that fixed fees are creating an "underclass" of defense firms that deliver services of rock-bottom

---

100. Silver, *Flat Fees*, *supra* note 18, at 218–19.

101. The REPORT OF THE INSURANCE PRACTICES SPECIAL STUDY COMMITTEE suggests that insurers are unduly parsimonious in an extraordinary variety of ways. *See, e.g.*, FLA. INS. REP., *supra* note 25, at 14 (noting that insurer refused to pay lawyer for more than one draft of appellate brief); *id.* (noting "[i]nstances where only paralegal rates would be paid for certain services even where the attorneys felt the work should be done by lawyers"); *id.* at 15 (reporting "insurance company limitations on the number of depositions that could be taken, . . . the number of hours . . . for trial preparation [and] . . . trial time").

102. I have no empirical data to support these assertions. I wish I did. Fortunately, I am arguing against regulation, not for it. In a liberal society, those who support regulations carry the burden of proof.

quality at rock-bottom prices.[103] This is a pejorative description of a development that may be desirable from the joint perspective of policyholders and insurers. On the plaintiffs' side, market forces long ago produced law firms, colloquially referred to as "mills," that churn out cases in volume, settling most and investing significant resources in few. Mills have large staff to lawyer ratios, enormous case portfolios, and the bare minimum of overhead. For these reasons, they are not prestigious places for lawyers to work, but their existence is good for small claimants. By keeping costs down, mills provide plaintiffs with small injuries a realistic shot at recovering.

To date, staff counsel operations have been insurance carriers' best responses to plaintiffs' mills. However, there is no reason to prevent independent practitioners from showing that they too can be low-cost operators. Many carriers experience too few claims to support staff counsel offices in all areas where they do business. Low-cost independent providers may offer them an opportunity to compete with plaintiffs' mills on an equal footing. Because positive defense costs increase the settlement value of many marginal claims, the option of using low-cost defense lawyers may be an important way of reducing liability costs.

Because the factual objections to flat fee arrangements are unproven and doubtful, it is reassuring that few advisory committees have seen fit to follow the Supreme Court of Kentucky's lead. The consensus thus far is that flat fees are permissible as long as the terms of the fee arrangement are disclosed to the insured.[104] However, as Nancy Moore observed, even the disclosure requirement is a departure from tradition. "[V]irtually all fee arrangements pose conflicts between lawyers and clients, yet there is no support for any routinely required disclosure to clients of these types of risks."[105] Disclosure may be a minor nuisance or a major one, but in the absence of evidence that policyholders are exposed to unique risks, why impose special requirements on insurance defense lawyers who work for flat fees? Lawyers who represent criminal defendants in death cases receive grossly inadequate flat fees from public coffers and have much worse incentives,[106] yet there is no ethical requirement that they make fee-related disclosures and no nationwide campaign to create one.

Some advisory committees have also endorsed the argument that flat fees are permissible as long as they are high enough to provide compensation that is reasonable in light of the time and effort cases require.[107] This argument also smacks of hypocrisy. If applied across the board, it would prevent lawyers for capital defendants from accepting the meager wages states dole out. And what of

---

103. Richmond, *supra* note 75, at 84.

104. *See, e.g.*, Fla. State Bar Ass'n Comm. on Prof'l Ethics, Op. 98-2 (1998) (reviewing prior opinions and stating that attorneys' obligations include "disclosure to the insured of the fee arrangement between the insurer and the attorney"), *available at* 1998 WL 796691.

105. Moore, *supra* note 84, at 289.

106. *Id.* at 290 (stating that "in criminal defense work, flat fees are common for lawyers representing indigent defendants, and the rates are outrageously low, especially in death penalty cases").

107. Ohio Bd. of Comm'rs on Grievances & Discipline, Advisory Op. 97-7 (1997), *available at* 1997 WL 782951.

pro bono representations? Apparently, a fixed fee of zero dollars is always proper but a flat payment of five thousand dollars may be ethically suspect. There also is *Goldfarb* to consider.[108] By insisting that insurers set fees high enough to compensate lawyers handsomely, advisory committees are taking us back to the days before minimum fee schedules were barred.

No one has ever suggested that state bar rules place lower bounds on the hourly rates insurance companies may offer defense lawyers or the number of hours they must allow defense lawyers to bill. No one has ever suggested that defense lawyers must disclose hourly rate compensation arrangements to insureds, even though these too are rife with conflicts. Yet, these ideas and a slew of others are taken seriously when insurers offer flat fees. The explanation is simply that flat fees are more effective than hourly rates at reducing defense costs.

C. Litigation Management Guidelines and External Fee Audits

My 1998 article mentioned litigation guidelines and fee audits but did not focus on them. The Kentucky Supreme Court had not addressed these cost control methods in *AIA*, the opinion I was critiquing, and I did not foresee how controversial they would become.

I now wish I had discussed guidelines and audits at length. As Appendix 1 shows, they have received the bulk of the attention of state bar committees. Already, the advisory opinions are too numerous to examine individually. The opinions also are decidedly hostile. Because of them, many insurance companies no longer employ fee auditors, and an industry-wide effort has been made to craft guidelines that advisory committees will approve.[109] Both developments were needless.[110] Defense lawyers can adhere to litigation guidelines and submit invoices for review by fee auditors without violating any disciplinary rules. Other academics share this view.[111]

---

108. *See supra* notes 93–95 and accompanying text (discussing *Goldfarb*).

109. *See* Lloyd H. Milliken, Jr., *DRI Promulgates Case Handling Guidelines*, FOR DEF., Apr. 2000, at 2.

110. The latter also appears to have been unsuccessful. The General Counsel of the Alabama State Bar has stated that the guidelines prepared by the Defense Research Institute present many of "the same concerns and problems" that led the Alabama Disciplinary Commission to prohibit compliance with guidelines. *See* Ala. State Bar Ass'n, Formal Op. RO-98-02, *available at* http://www.thefederation.org/Public/DCI-Relations/alabama.htm (last visited Oct. 5, 2002).

111. Several opinion letters by law professors were appended to the opinion Geoffrey Hazard submitted in *In re Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedures*, 2 P.3d 806 app. (Mont. 2000). *See* Appendix to Opinion of Geoffrey C. Hazard, Jr., http://www.lawlibrary.state.mt.us/dscgi/ds.py/Get/File-2908/98-612(4-16-99)_Appendix_to_Opinion_of_Geoffrey_C._Hazard_.pdf.

Lawyers at franchise law firms that provide low cost services to individual clients also follow guidelines, though guidelines that are self-imposed. By offering standardized services and devolving tasks to secretaries and paralegals, they reach people whose legal needs would otherwise go unmet. JERRY VAN HOY, FRANCHISE LAW FIRMS AND THE TRANSFORMATION OF PERSONAL LEGAL SERVICES 21 (1997).

The positive account of insurance carriers' right to insist on guidelines and audits is straightforward.[112] Ordinarily, liability carriers are co-clients of the lawyers they retain to defend liability suits against policyholders. As clients, they may manage legal fees and control lawyers' actions by any means to which they and their attorneys agree. They may carve up tasks among attorneys, paralegals, and secretaries, and they may assign different billing rates (including rates of zero dollars) to these providers. They may agree that the lawyer will obtain prior approval from the client before taking particular actions, such as hiring an expert witness or incurring travel costs. They may use lay claims managers to instruct lawyers and to monitor lawyers' conduct. They may even agree that certain legal services will be omitted.[113] And, obviously, they may review lawyers' bills themselves or hire specialized legal auditors for this task. Clients have been doing all these things for years without causing lawyers to run afoul of state bar rules.

Sometimes, insurance carriers are third party payers, not clients. Whether they hold one status or the other is governed by agreement.[114] As a third party

---

112. For descriptions of the content of litigation management guidelines used by insurers and other corporations, see Susan Randall, *Managed Litigation and the Professional Obligations of Insurance Defense Lawyers*, 51 SYRACUSE L. REV. 1, 7-8 (2001); Brief of Am. Ins. Ass'n, *supra* note 30.

113. For a debate over the ethics of unbundling legal services, see David A. Hyman & Charles Silver, *And Such Small Portions: Limited Performance Agreements and the Cost-Quality/Access Trade-Off*, 11 GEO. J. LEGAL ETHICS 959 (1998); Fred C. Zacharias, *Limited Performance Agreements: Should Clients Get What They Pay For?*, 11 GEO. J. LEGAL ETHICS 915 (1998); Fred C. Zacharias, *Reply to Hyman and Silver: Clients Should Not Get Less Than They Deserve*, 11 GEO. J. LEGAL ETHICS 981 (1998).

114. Some people who agree that carriers usually are clients continue to get this point wrong. For example, Susan Randall writes that "the typical insurance defense is a joint defense in which both the policyholder and the company are clients." Randall, *supra* note 112, at 3. However, she attributes the carrier's status to the harmony of interest it shares with its policyholder, rather than to the agreement between the carrier and the defense lawyer. *Id.* at 13. This is incorrect. You and I may have common interests after being injured in a traffic accident, but to become co-clients we must hire the same attorney pursuant to an appropriate agreement. Moreover, we may become co-clients by hiring the same attorney even if our interests conflict. Our status depends solely on our agreement with our lawyer. The compatibility of our interests bears not on client-hood but on whether the conflict rules are triggered.

Randall also makes another errant assertion. Writing in 2001, she contends that the "crucial distinction between insurer as client or nonclient has been largely overlooked in the debate over managed litigation." *Id.* at 3. Having defended the two-client view against one-client thinkers hundreds of times, I can say with authority that the carrier's status has been hotly debated, not "overlooked." It was the focus of my first article on insurance defense ethics, *Does Insurance Defense Counsel Represent the Company or the Insured?*, published in 1994. *See* Silver, *Insurance Defense*, *supra* note 18. It also was an important issue in my debate with Thomas Morgan and Charles Wolfram over the treatment of insurers in the RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS. I repeatedly tried to convince them that there is a "world of difference between being a client and not being one." Silver, *Lost World*, *supra* note 18, at 781. Stephen Gillers' memorandum also expressly divides the analysis on the alternative assumptions that the carrier is or is not a defense lawyer's client. *See* Stephen Gillers, *Ethical Issues in Monitoring Insurance Defense Fees: Confidentiality, Privilege and Billing Guidelines* (1998), *at* http://tarlton.law.utexas.edu/silver/gil.htm.

payer, an insurer may neither tell a defense lawyer what to do nor reasonably expect a defense lawyer to protect its interests, except as they happen to coincide with an insured's. Because the duties of obedience and loyalty run only to clients, only policyholders may give lawyers instructions and demand their fidelity when liability carriers are third party payers.

Yet, even as a third party payer, a carrier may have rights against a defense attorney. Usually, these too are determined contractually.[115] By agreement with a defense lawyer, a carrier may set the lawyer's billing rate, the format in which bills are to be submitted, the information the carrier is to receive, and the services for which the carrier will pay.[116] An agreement may also indicate the insurer's unwillingness to compensate the lawyer for the insured's coverage work, for time spent on the insured's affirmative claims, for attempting to settle the claim on behalf of the insured, for work that is not properly documented, or for work that is not reasonably needed to defend the liability suit. Insurers need rights like these to ensure that they pay only for services their policies obligate them to cover and to enable them to evaluate settlement opportunities intelligently. No state bar rule prohibits a carrier that is a third party payer from coming to terms with a defense attorney that protect these important interests. Such terms may include, for example, portions of litigation guidelines relating to billing and the use of fee auditors.

Why, then, do so many advisory committees and commentators reach the opposite conclusion? Starting with guidelines, "[t]he primary ethical concern is whether compliance with [them] interferes with the independent professional judgment of insurance defense counsel and consequently with the quality of legal services provided."[117] Many states have prohibited defense lawyers from working under carrier-imposed guidelines after finding that interference is bound to

---

115. In California, many aspects of the relationship between defense counsel and a non-client carrier are governed by statute. *See* CAL. CIV. CODE § 2860 (West 2001). For a discussion, see Pryor & Silver, *Contested Coverage Cases, supra* note 18.

116. CAL CIV. CODE § 2860. California's statute recognizes the importance of various aspects of relationships between carriers and defense lawyers in third party payer situations. It requires the lawyer (and the policyholder) to give the carrier "all information concerning the action except privileged materials relevant to coverage disputes, and timely to inform and consult with the insurer on all matters relating to the action." *Id.* § 2860(d). It explains how claims of attorney-client privilege are to be handled. It requires independent counsel to cooperate with the carrier's own attorney and obligates the parties to allow both lawyers to participate in all aspects of the underlying litigation. These are practical matters that must be handled when, because of an ethical difficulty, a defense lawyer cannot represent a carrier and an insured jointly. *Id.* § 2860.

117. Ohio Bd. of Comm'rs on Grievances & Discipline, Advisory Op. 2000-3 (2000), *available at* 2000 WL 1005223. Even ABA Formal Opinion 01-421, which stated that "[i]n the vast majority of cases, litigation management guidelines do not raise ethical concerns," also observed that "[s]ome litigation management guidelines . . . give the insurance company the right to control the defense to the degree that the lawyer's professional judgment in rendering legal services may be materially impaired." ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 01-421 (2001).

occur.[118] According to these opinions, carriers interfere by micro-managing defense lawyers, for example, by refusing to pay for conversations between lawyers, by requiring that certain personnel perform certain tasks, or by paying for identified work at rates appropriate for associates even when partners are involved.[119] Advisory committees have been particularly put off by pre-approval requirements that obligate defense lawyers to request permission before conducting legal research, asserting claims on behalf of the insured, visiting accident scenes, scheduling depositions, hiring experts, scheduling medical examinations, or instituting surveillance. As the Ohio Advisory Committee wrote, "[t]o the extent that the insurer reserves unto itself the right to withhold approval for reasonable and necessary legal services to be provided to an insured, these provisions of the guidelines impermissibly interfere with the independent professional judgment of the inquiring attorney."[120] Several authorities have taken the further step of finding that because claims professionals are not lawyers, a defense lawyer who seeks a carrier's approval for a requested service thereby encourages the unauthorized practice of law.[121]

To my mind, the contention that litigation guidelines interfere with lawyers' judgment is a non-starter. As I explained in 1998:

> Budgetary restrictions and other ordinary payment terms do not and cannot interfere with a lawyer's independence of professional judgment ... because they do not limit the content or nature of the advice lawyers can render. Only restrictions that fetter lawyers' freedom to give clients the benefit of their judgment run afoul [of this requirement].[122]

The contrary position conflates "freedom of judgment" with "freedom of action." "Lawyers must always have the former, but they rarely, if ever, have the latter and no rule requires clients to give it to them."[123] To the contrary, when it comes to actions, the duty of obedience requires lawyers to respect clients' wishes:

> It is easy to forget, but essential to remember, that lawyers are first and foremost agents and advisors, not decision makers. Their job is to generate and recommend strategies for protecting clients' interests and, after doing so, to follow their client's lawful marching orders as given. Following orders may require a lawyer to employ a strategy a lawyer neither recommends nor endorses. This does not mean that a client violates a duty to the lawyer or that a client impairs a lawyer's independence of professional judgment. As a principal, a client can properly decline to follow a lawyer's suggestions, including suggestions that are simply too expensive.

---

118. Ohio Bd. of Comm'rs on Grievances & Discipline, Advisory Op. 2000-3 (2000), *available at* 2000 WL 1005223; Tex. Prof'l Ethics Comm., Op. 533 (2000), *available at* 2000 WL 987291.

119. Ohio Bd. of Comm'rs on Grievances & Discipline, Advisory Op. 2000-3 (2003) (citing Ind. State Bar Ass'n, Op. 3 (1998)), *available at* 2000 WL 1005223.

120. *Id.* (citing R.I. Ethics Advisory Panel, Op. 99-18 (1999)).

121. *Id.* (citing Cincinnati Bar Ass'n, Op. 98-99-02 (undated)).

122. Silver, *Flat Fees*, *supra* note 18, at 230.

123. *Id.* at 230–31.

> No rule requires a client to pay a lawyer for actions a lawyer wants to take. That clients frequently reject expensive suggestions and require lawyers to stick to budgets is a matter to which any experienced lawyer will attest.[124]

Anyone familiar with the *Restatement (Second) of Agency* or the *Restatement (Third) of the Law Governing Lawyers* should know better than to quarrel with this point. Both volumes recognize the duty of obedience to which all lawyers are subject.[125]

Neither advisory committee members nor judges have grappled with this analysis. They have ignored it, even when confronted with it directly. Not a single published opinion addresses the distinction between judgment and action or mentions the duty to obey instructions to which all lawyers are subject. The latter point is especially important for opinions that object to carriers' use of lay claims adjusters to supervise defense attorneys. Lawyers take orders from millions of nonlawyers, better known as clients, every day.

It is hard enough to forgive advisory committees that did their work before 1998 for missing the distinction between freedom of judgment and freedom of action. The duty of obedience has existed for centuries, and any dictionary will explain that the word "judgment" encompasses opinions, evaluations, and estimates, not actions taken pursuant to them.[126] The sentence, "In my judgment you ought to do X" makes a recommendation that one may or may not have the power to implement. A lawyer who can recommend any course of action he wishes has complete independence of professional judgment, even when a client refuses to go along.

That committees, courts, and commentators writing after 1998 condemned litigation guidelines without coming to grips with the distinction is inexcusable. The Insurance Practices Special Study Committee of the Florida Bar stated "that enforcement of [] guidelines as written may affect the independent professional judgment of lawyers representing insureds."[127] Its report says nothing about the duty of obedience or the difference between judgments and actions. Having personally brought these matters to the Committee's attention, I am

---

124. *Id.* at 231.

125. *See, e.g.*, RESTATEMENT (SECOND) OF AGENCY § 385(1) (1958) ("an agent is subject to a duty to obey all reasonable directions in regard to the manner of performing a service that he has contracted to perform"); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 16 cmt. c (2000) ("The lawyer ... must follow a client's instructions"); *id.* § 21(2) cmt. d ("a client may instruct a lawyer during the representation"); *id.* § 23 cmt. d ("a lawyer may not continue a representation while refusing to follow a client's continuing instruction"); *id.* § 23, cmt. c (2000) ("[A] lawyer has no right to remain in a representation and insist, contrary to a client's instruction, that the client comply with the lawyer's view of the client's intended and lawful course of action.").

126. *See* MERRIAM-WEBSTER COLLEGIATE DICTIONARY (10th ed. 1993) (listing definitions of "judgment" or "judgement"), http://www.m-w.com/cgi-bin/disctionary?va=judgment; *see also* AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE (4th ed. 2000) (defining "judgment" as "the formation of an opinion after consideration or deliberation").

127. FLA. INS. REP., *supra* note 25, at 15.

dismayed. The Montana Supreme Court concluded that "the requirement of prior approval fundamentally interferes with defense counsels' exercise of independent judgment."[128] As *amicus curiae*, I explained that lawyers are "agents and advisors, not decision makers," and that "clients who choose not to [follow lawyers' recommendations] do not thereby interfere with lawyers' freedom in any wrongful way [but] simply exercise their authority to make decisions."[129] I also quoted the portion of my 1998 article that distinguished freedom of judgment from freedom of action.[130] The court ignored these crucial points.

Our common law process relies greatly on persons in positions of authority to address arguments that oppose their philosophical, political, or personal leanings. The point of issuing a reasoned opinion is partly to show that a decision maker embraced this duty. Yet, when prohibiting lawyers from complying with litigation guidelines, advisory committees and judges ignored serious arguments that undercut their conclusions, even though these arguments were put to them directly. The only conclusion one can reach is that their commitment to reaching legally defensible conclusions is weak.

Insofar as I know, Professor Susan Randall is the only person to question my analysis of the duty to exercise independent professional judgment.[131] That Randall should be my critic is surprising. She accepts my view that a defending insurer is typically a defense lawyer's co-client, and she also believes that "[w]here the insurance company is a client . . . it makes sense to permit it to exercise a significant measure of control over the litigation."[132] Applying the latter point, she concludes that a defense lawyer may abide by co-client carrier's litigation guidelines without necessarily violating any rules.[133]

Yet, Randall rejects my argument that litigation guidelines and other budgetary constraints cannot cause lawyers to run afoul of Model Rule 1.8(f)(2) or 5.4(c), the rules applying the independence of judgment requirement to third party payer situations.[134] "Surely, this conclusion gets it backwards," she writes.

> The goal of [Model Rules 1.8(f) and 5.4(c)] is to provide a client with competent, independent representation, free of nonclient, third party interference, and not to afford a lawyer and client the freedom to imagine but not to implement such a representation. Rule 5.4(c) in particular is directed at interferences with the lawyer's "professional judgment in rendering legal services." Legal services in some contexts may consist of advice, but an adequate representation in the context of litigation must also include the possibility of action based on advice.[135]

---

128. *In re* Rules of Prof'l Conduct and Insurer Imposed Billing Rules and Procedures, 2 P.3d 806, 815 (Mont. 2000).

129. Brief of Silver, *supra* note 28, at 15.

130. *Id.* at 16.

131. *See* Randall, *supra* note 112, at 23–24.

132. *Id.* at 51.

133. *Id.*

134. *Id.* at 23; MODEL RULES OF PROF'L CONDUCT R. 1.8(f)(2) & R. 5.4(c) (2002).

135. *Id.* at 23–24 (emphasis deleted).

There are many defects in this response. First, if Randall's construction of the independence of judgment rule is correct, her conclusion that carriers can use litigation management guidelines when they are co-clients must be wrong. The duty to exercise independent professional judgment applies equally to first party and third party payer situations.[136] Consequently, if professional judgment is wrongly constrained when a third party payer declines to pay for recommended legal services, a violation must also occur when a client refuses to pay.[137] It follows that if insurance carriers' litigation management guidelines cause lawyers to violate Rules 1.8(f) and 5.4(c), guidelines must also cause violations of Rule 2.1 when *clients* pay the bills.

This is a major difficulty. Many corporate clients use the same cost management techniques that insurance carriers apply.[138] They subject lawyers to guidelines requiring prior approval of legal services and expenses.[139] They maintain corporate counsel offices, some of which are enormous and handle large numbers of claims. They employ outside auditors for the purpose of assessing the reasonableness of lawyers' invoices. They use task-based billing arrangements that resemble flat fees. The ethical argument that prohibits insurers from using these techniques also prohibits corporate clients from using them. Now that this argument has the imprimatur of state supreme courts and state bar advisory committees, it is a question of politics, not of law, whether lawyers will target efforts to manage legal costs more generally.[140]

Randall ignores Model Rule 2.1, even though I explained its importance when discussing flat fees in 1998. The omission is fatal to her project, which attempts to force a distinction between first party payer and third party payer representations. Insofar as the requirement of independent professional judgment is concerned, no distinction exists. Litigation guidelines must therefore be permissible or impermissible in both contexts.

Second, Randall ignores the duty of obedience, another centerpiece of my analysis. This duty requires a lawyer to honor a client's lawful instructions, even when a client disagrees with a lawyer over the best course to pursue. Nor does Randall explain how, when a client rejects a lawyer's recommendation, a lawyer

---

136. *See* MODEL RULES OF PROF'L CONDUCT R. 2.1 (2001) ("In representing a client, a lawyer shall exercise independent professional judgment.").

137. Susan Randall misses this point. She believes that cost management techniques that violate Model Rule 1.8(f) (because they impair a defense lawyer's ability to exercise independent professional judgment) are permissible when a carrier is a co-client because they then are "consistent with the lawyer's professional obligations." Randall, *supra* note 112, at 3–4. Model Rule 2.1 eliminates this possibility by requiring lawyers to exercise independent professional judgment in first party payer situations. *See* MODEL RULES OF PROF'L CONDUCT R. 2.1 (2001).

138. *See* Brief of Am. Ins. Ass'n, *supra* note 30, at 12–13.

139. Examples of litigation guidelines used by clients can be found online. *See* THE DEVIL'S ADVOCATE, *at* http://www.devilsadvocate.com (last visited Oct. 30, 2002).

140. A survey conducted by National Economic Research Associates found that corporate spending on outside legal services is likely to decline in 2002, owing partly to "the adoption of cost-cutting plans that include routing more legal work to in-house lawyers." *U.S. Corporations Aim to Rein in Spending for Outside Lawyers*, *supra* note 54.

can satisfy this duty without violating Rule 2.1. In fact, the matter is simple. A lawyer never violates Rule 2.1 by respecting a client's decision to forego a recommended legal service because the rule requires only that the client receive the lawyer's independent recommendation. By rendering an honest and well considered opinion, a lawyer satisfies Rule 2.1 regardless of a client's reaction.

This account of the relationship between the duty of obedience and Rule 2.1 respects the plain language of the rule. As just explained, the rule talks of judgment, not of acting upon judgment. Given the importance of this language to Randall's project, it is curious that, when critiquing my position, she says nothing about the plain language of the rule.

Third, Randall errs by contending that the point of the independent judgment requirement is to ensure adequate representation. The standard of care serves this function by subjecting lawyers to liability for negligence. Yet, a lawyer never violates the standard of care by honoring a client's decision to omit a recommended service. As Comment h to Section 54 of the *Restatement (Third) of the Law Governing Lawyers* plainly states, "[a] client may not recover from a lawyer for any action *or inaction* that the client, after proper advice, instructed the lawyer to take."[141] The reference to "proper advice" supports my reading of the independent judgment requirement.

Neither agency law nor the law governing lawyers establishes a free-floating requirement of adequate representation. Under both bodies of law, the sufficiency of a lawyer's conduct depends on what a client wants and is willing to pay for. If a client is unwilling to purchase a service, a lawyer may properly omit it. Even the duty of competence leaves a lawyer free to omit recommended services at a client's request, as I have argued elsewhere at length.[142]

In sum, the point of the various rules that require lawyers to exercise independent professional judgment is to ensure that a client receives "straightforward advice expressing the lawyer's honest assessment."[143] Professional independence is the focus of these rules, not service levels. Lawyers must be candid with clients, even when clients, third party payers, or persons referring clients want lawyers to be patsies.

Even if I were wrong about all this, it would still be appropriate to ask whether litigation management guidelines harm policyholders. Do they cause defense lawyers to represent policyholders inadequately? No judge, advisory committee, or scholar has made a serious effort to answer this crucial empirical question. All assume that the goodness or badness of litigation guidelines turns solely on whether state bar rules allow lawyers to work under them. This is shallow thinking. State bar rules are fallible guides. A policy analysis might show that litigation guidelines have desirable consequences, leading one to conclude that rules restricting their use should be revised or more narrowly construed.

---

141. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 54 cmt. h (2000) (emphasis added).

142. *See* Pryor & Silver, Excess Exposure Cases, *supra* note 18, at 639–644.

143. MODEL RULES OF PROF'L CONDUCT R. 2.1 cmt. 1 (2001).

It was especially wrong of the Insurance Practices Special Study Committee to obsess on rules. Its mission statement required it to determine whether "the business practices of certain insurance companies . . . compromise the quality of the defense provided to Florida insureds."[144] This is a question of fact, not of law. One cannot answer it by citing rules. Yet, the Committee relied on rules to the exclusion of facts when discussing guidelines and other cost containment techniques. After emphasizing their dangers, the Committee wrote:

> [F]or the most part, insureds have no idea that any of this is occurring. [M]ost insureds do not appreciate the potential harm. Insureds typically want the claim resolved within policy limits and they want to be involved in the process as little as possible. The Bar, however, has important interests that must be protected in all of this. Our Rules of Professional Conduct must be enforced and the Bar must be ever vigilant in enforcing our UPL rules. This is our solemn obligation.[145]

A person interested in facts would want to know why, if the dangers are as formidable as the Committee contends, policyholders are unconcerned. Such a person also would want to know whether litigation guidelines have caused the frequency or severity of excess judgments or settlements to rise. After all, the Committee's contention is that "[i]nsureds typically want the claim resolved within policy limits."[146] The Committee's Mission Statement required it to address factual questions like these. Instead of doing so, the Committee justified its efforts to regulate insurers by citing its "solemn obligation" to enforce the rules.

Rule-bound policymaking would be less bothersome if courts, advisory opinions, and commentators routinely got the law right. Unfortunately, when the subject is legal ethics, they err with great frequency. One must therefore urge authorities to honor the maxim "first do no harm." Because harm is a matter fact, however, adherence to the maxim requires looking beyond rules. The "solemn obligation" to enforce rules impedes this. We thus have a dismal situation in which bad policies based on bad law are impervious to factual assault.

Discussions of fee audits confirm this impression. Although insurers have been auditing defense lawyers' bills for decades, the campaign against audits makes no use of facts. It rests wholly on strained readings of the law. This time, the law at issue is the duty of confidentiality that defense lawyers owe insureds. The endlessly repeated allegation is that "disclosure by defense counsel of detailed descriptions of professional services to third party auditors without first obtaining the contemporaneous fully informed consent of insureds violates client confidentiality under the Rules of Professional Conduct."[147] This was, in fact, the holding of the Montana Supreme Court.

When evaluating this position, it seems fitting to begin by noting that no court presiding over a dispute between a policyholder and a defense lawyer or an

---

144. FLA. INS. REP., *supra* note 25, at 3.

145. *Id.* at 15–16.

146. *Id.*

147. *In re* Rules of Prof'l Conduct and Insurer Imposed Billing Rules and Procedures, 2 P.3d 806, 822 (Mont. 2000).

insurer has ever held that a defense lawyer violated the duty of confidentiality by submitting bills to a third party auditor for review. Nor has any court presiding over a discovery dispute held that the attorney/client privilege was waived because an external auditor reviewed a defense lawyer's bills. On the latter point, even the Montana Supreme Court equivocated. After finding that auditors fall outside the "magic circle" of persons to whom the privilege extends, the court immediately added, "however, we do not hold that the disclosure of detailed descriptions of professional services to a third party auditor necessarily violates any privilege that may attach to them. Resolution of that issue would clearly entail findings of fact that we have not made."[148]

Given the dearth of cases, the legal basis for a rule barring defense lawyers from sending bills to auditors must be slim. And so it is. The claim that the attorney/client privilege is endangered rests on a strained reading of *United States v. Massachusetts Institute of Technology*,[149] a case in which the party asserting the privilege had previously turned over its records to an auditor associated with its adversary, the Department of Defense. When hired by insurers, external fee auditors are agents, not enemies. It is therefore quite a reach to apply the *MIT* case to insurers.

The argument that the duty of confidentiality prohibits defense lawyers from sending bills to third party auditors without policyholders' consent is no stronger. Defense lawyers have been submitting detailed invoices to insurers for decades. No one denies that this is proper.[150] Only distribution to third parties is contested. Insurers are therefore free to audit bills internally, something they have also done for years. Plainly, the distinction between internal audits and external audits elevates form over substance. A carrier that is willing to acquire an auditing firm can scrutinize defense lawyers' bills as intensively as it wants.

Still, those who endorse the distinction have forged ahead. They contend that revelation to third party auditors violates confidentiality because it is neither expressly nor impliedly authorized by insureds. Express consent is lacking because carriers do not ask policyholders to give it. Implied consent is absent because, unlike secretaries and paralegals, auditors do not help lawyers represent insureds. Their only function is to reduce defense lawyers' bills.

This argument too is a stretch. Insurance companies and other purchasers of legal services derive many benefits from audits. One is protection against over-billing. Another is information about a lawyer's honesty, obedience, organization, and performance. Clearly, this information helps insurance companies provide for the legal representation of insureds. It may influence a carrier's decision to hire a particular lawyer, to assign the lawyer responsibilities, to have a claims manager monitor a lawyer with unusual care, or to obtain a second opinion when a lawyer submits a case evaluation or recommends a strategy for defending a case. Diverse

148. *Id.* at 821.

149. 129 F.3d 681 (1st Cir. 1997).

150. *See, e.g.*, *In re* Rules of Prof'l Conduct and Insurer Imposed Billing Rules and Procedures, 2 P.3d at 821 (stating "[p]etitioners do not dispute that disclosures of billing information to *insurers* are impliedly authorized to carry out representation") (emphasis in original).

businesses use audits to ensure compliance with guidelines and operating procedures.[151] They do so because compliance generates the consistent performance that is needed to assure the delivery of high quality goods and services. The Total Quality Management movement relies heavily on compliance with procedures to minimize the frequency of mistakes.[152]

Those who reject this argument have a difficult burden to bear.[153] Internal fee audits and external audits serve the same functions. Consequently, if external audits contribute nothing to the representation of insureds, internal audits must suffer the same defect. It must therefore follow that the duty of confidentiality prohibits defense lawyers from allowing carriers to audit legal bills internally. Policyholders' implied consent allows defense lawyers to reveal information only as needed to carry out representations.[154] A defense lawyer may not reveal confidences to a law firm's janitor. Unless an internal audit helps a representation progress in an appropriate way, a lawyer may not share confidences with an internal auditor either.

In view of this, one must proceed in one of two directions. Either one must require that policyholders expressly consent to in-house audits, or one must rethink the belief that audits are not reasonably related to the legal defense of insureds. I see no need for the former approach. Insurance companies have been reviewing lawyers' statements internally since the first carrier paid the first defense bill. In all this time, no one has suggested that internal audits are improper or that defense lawyers violate the duty of confidentiality to insureds by participating in them. Given the tradition that has been established and the lack of demonstrable harm to policyholders, there is no reason to change. Second, audits are reasonably related to the delivery of legal services to insureds, for the reasons just stated. They help carriers gauge and control the quality of service that defense lawyers provide when pursuing the jointly held goal of loss minimization. Because insurers rely heavily on defense lawyers' recommendations when litigating and

---

151. *See, e.g.*, PRAXIOM RESEARCH GROUP LTD., ISO 9001 2000 INTERNAL AUDIT PROGRAM (explaining that a "Procedures Audit evaluates how effective your quality procedures, policies, plans, and instructions are"), *at* http://praxiom.com/iso-audit.htm (last modified June 7, 2002); STANFORD LINEAR ACCELERATOR CENTER, QUALITY ASSURANCE AND COMPLIANCE DEPARTMENT: OVERSIGHT PROCEDURE (1992) (describing in detail auditing procedure for ensuring that all "activities are conducted in a safe and sound manner, in compliance with . . . laws and regulations as well as [Stanford Linear Accelerator] policies and procedures, and in a fashion consistent with the Quality Assurance Program"), *at* http://www.slac.stanford.edu/esh/manuals/9203QACD.pdf; NATURAL NUTRITIONAL FOODS ASS'N, GOOD MANUFACTURING PRACTICES CERTIFICATION PROGRAM (explaining use of third party inspections and comprehensive audits "to verify compliance of member suppliers of dietary supplements with a standardized set of good manufacturing practices"), *at* http://www.natrol.com/gmp.html.

152. *See, e.g.*, Mark R. Chassin, *Is Health Care Ready for Six Sigma Quality?*, 76 Milbank Q. 565, 566 (1998) (discussing use of procedures to minimize error rates in health care).

153. *See, e.g.*, Douglas A. Richmond, *Of Legal Audits and Legal Ethics*, 65 DEF. COUNS. J. 512, 522 (1998) (contending that "[a]uditors cannot improve the quality of defense lawyers' work").

154. *See* MODEL RULES OF PROF'L CONDUCT R. 1.6 cmt. 7 (1999).

settling claims, information about lawyers' honesty, reliability, and efficiency is of great importance to them and their insureds.

VI. CONCLUSION

The quality of the debate over defense lawyers' professional responsibilities is depressing. Despite the enormity of the stakes, regulators have made little effort to study or think about the consequences of modern litigation cost management techniques in a serious way. Instead of examining the history of carrier control of defensive representations, advisory committees, judges, and commentators have ignored the facts and even shown disdain for them. Many also have done an exceedingly poor a job of reading and applying the law. In 1998, I wrote that the law governing insurance defense lawyers was basically sound but needed some "weeding and pruning."[155] Now, the weeds have taken over the garden. The doctrinal foundation of the practice of insurance defense is endangered as never before.

All this happened because liability insurers sought to manage litigation costs. In other words, it happened because they tried to do their job. Policyholders contract with insurance companies so that insurers will handle litigation management for them. Part of managing lawsuits is managing costs. Policyholders would manage costs themselves if they were bearing expenses. Insurers must manage costs when they are in charge. The problem that rankles defense lawyers is that insurers do the job too well. They place significant pressure on defense lawyers to become more efficient. This is purely a matter of economics; it raises no problems of ethics.

Nor does carriers' success in moderating defense costs provide a basis for regulation. In a liberal society, the primary justification for regulation is to prevent people from harming others without their consent. Tripartite relationships are contractual. Insurance contracts govern relationships between carriers and policyholders, and retainer agreements govern the principals' relationships with defense lawyers. These agreements attenuate the need for governmental intervention by providing a consensual foundation for the manner of allocating benefits and costs within tripartite relationships. Moreover, if the point of regulation is to prevent harm, proof of harm in the absence of regulation is indispensable. Because participants in the campaign to empower defense lawyers offered no evidence of harm to policyholders, regulators should have declined to come to their aid.

155. Silver, *Lost World*, *supra* note 18, at 785.

Appendix 1: Recent Opinions Concerning the Tripartite Relationship

Third Party Audits			
	State	**Date**	**Citation**
1.	Alabama	November 9, 1998	Ala. OGC Formal Op. 98-02, http://www.alabar.org/page.cfm?page=im_include/im_fopDisplay.cfm&oneId=2
2.	Alaska	January 7, 1999	Alaska Ethics Op. 99-1, 1999 WL 271925
3.	Arizona	September 21, 1999	Ariz. Jud. Advisory Op. 99-08, 1999 WL 1004269
4.	Colorado	September 17, 1999	Colo. Bar Ass'n Ethics Comm. Formal Op. 107, http://www.cobra.org/Static/comms/ethics/fo/fo_107.htm
5.	Connecticut	September 25, 2000	Conn. Ethics Op. 00-20, 2000 WL 33170661
6.	District of Columbia	April 20, 1999	D.C. Ethics Op. No. 290, http://www.dcbar.org/attorney_resources/opinions/Opin290.pdf
7.	Florida	December 31, 1997	Staff Op. 20591
8.	Florida	March 9, 1998	Staff Op. 20762
9.	Florida	June 2, 2000	Fla. Ethics Op. 99-1, 2000 WL 863109
10.	Georgia	April 2000	Formal Advisory Op. 99-R2, 5 Ga. B. J. 5:62
11.	Hawaii	March 25, 1999	Formal Op. 36, http://hsba.hostme.com/Disc/36.htm
12.	Idaho	January 2000	Idaho Ethics Op. 136, http://www.2.state.id.us./isb/_ethicsdisc/00000005.htm
13.	Indiana	July 1998	Ind. State Bar Op. 4 (1998), http://www.dri.org/dri/about/3of1998hidden.cfm
14.	Iowa	September 8, 1999	Iowa Ethics Op. 99-01, http://www.iowabar.org/ethics.nsf/e61beed77a215f668625649700 4ce492/b662fde548eef686862567e80053fa52!OpenDocument
15.	Kentucky	June 1998	Ky. Bar Ass'n Ethics Op. 404
16.	Louisiana	April 1998	La. State Bar Ass'n, Ethics Advisory Service Comm. (unnumbered), http://www.dri.org/dri/about/stateguidetoethicsopinionshidden.cfm
17.	Maine	December 2, 1998	State Bar Op. 164
18.	Maryland	January 1999	Ethics Docket 99-7
19.	Massachusetts	November 20, 1997	Mass. Op. No. 97-2, http:www.Massbarorg/phpslash/public_Html/article.php3?sid=20000 525071401
20.	Massachusetts	September 2000	Mass. Op. No. 00-4, http://www.Massbar.org/phpslash/public_Html/article.php3?sid=20 000929085733
21.	Mississippi	April 8, 1999	Op. 246, http:www.msbar.org/opinions/ 246.html
22.	Missouri	September 9, 1998	Informal Advisory Op. 980188, http://www.mobar.org

23.	Nebraska	January 8, 1998	Letter to John C. Brownrigg, http://www.dri.Org/dri/about/responseoct2297hidden.cfm
24.	Nebraska	November 2000	Advisory Op. 00-1, http://www.nebar.com/legalresources/opinions/00-1.htm
25.	New Hampshire	November 16, 2000	Advisory Op. 2000-01/05, http://www.nhbar.org/pdfs/AO00-01-5.pdf
26.	New York	March 3, 1999	N.Y. Ethics Op. 716, 1999 WL 221884
27.	North Carolina	July 16, 1998	98 Formal Ethics Op. 10, http://www.ncbar.com/eth_op/ethics_sel.asp?ID=271
28.	Ohio	June 1, 2000	Ohio Advisory Op. 2000-2, 2000 WL 1005220; Ohio Advisory Op. 200-3, 2000 WL 1005223
29.	Ohio-Cincinnati	February 5, 1999	Ohio Advisory Op. 99-1, 1999 WL 72203
30.	Oklahoma	June 10, 2000	Op. 1998-04
31.	Oregon	June 1999	Or. Ethics Op. 1999-157, 1999 WL 521543
32.	Pennsylvania	June 1998	Philadelphia Ethics Op. 98-9, 1998 WL 309870
33.	Rhode Island	October 27, 1999	Op. 99-17
34.	South Carolina	November 4, 1997	Ethics Advisory Op. 97-22
35.	South Dakota	April 16, 1999	Ethics Op. 99-2, http://www.sdbar.org/members/ethics/1999/eo99-02.htm
36.	Tennessee	June 14, 1999	Tenn. Ethics Op. 99-F-143, 1999 WL 406886
37.	Texas	July 2000	Tex. Ethics Op. 532, 2000 WL 987293
38.	Utah	April 17, 1998	Utah Ethics Op. 98-03, 1998 WL 199533
39.	Vermont	October 1998	Vt. Bar Ass'n Advisory Ethics Op. 1998-07, http:www.vtbar.org/AdvisoryEthics Opinions/1998/98-07.pdf
40.	Virginia	November 23, 1998	Legal Ethics Op. 1723, http://www.vacle.org/opinions/1723.TXT
41.	Washington	January 1999	Formal Op. 195
42.	West Virginia	April 30, 1999	Legal Ethics Inquiry 99-02, http:// www.wvbar.org/barinfor/wvlegalresearch/ethics/le99/00-02htm
43.	Wisconsin	September 15, 1999	Prof'l Ethics Op. E-99-1, http://www.wisbar.org/ethop/formal/ethics99-1.html
44.	American Bar Association	February 16, 2001	Formal Op. 01-421

Litigation Management Guidelines			
	State	**Date**	**Citation**
1.	Alabama	November 9, 1998	Ala. OGC Formal Op. 98-02, http://www.alabar.org/page.cfm?page=im_include/im_fopDisplay.cfm&oneId=2
2.	Arizona	September 21, 1999	Ariz. Jud. Advisory Op. 99-08, 1999 WL 1004269

3.	Colorado	September 17, 1999	Colo. Bar Association Ethics Comm., Formal Op. 107, http://www.cobar.org/static/comms/ethics/fo/fo_107.htm
4.	Florida	March 31, 2000	Fla. Bar Ass'n Ethics Comm. Op. 99-3, http://www.dri.org/dri/about/993synopsishidden.cfm
5.	Georgia	April 2000	Formal Advisory Op. 99-R2, 5 Ga. B. J. 5:62
6.	Hawaii	March 27, 1999	Formal Op. 37, http://hsba.hostme.com/Disc/37.htm
7.	Indiana	July 1998	Ind. Ethics Op. 98-4, http://www.inbar.org/content/legalethics/legalethics2.asp
8.	Iowa	September 8, 1999	Iowa Eth. Op. 99-01, http://www.iowabar.org/ethics.nsf/e61beed77a215f6686256497004ce492/b662fde548eef686862567e80053fa52!OpenDocument
9.	Massachusetts	September 2000	Mass. Op. No. 00-4, http://www.massbar.org/phpslash/public_html/article.php3?sid=20000929085733
10.	Mississippi	April 8, 1999	Op. 246, http://www.msbar.org/opinions/246.html
11.	Missouri	September 9, 1998	Informal Advisory Op. 980188, http://www.mobar.org/
12.	Missouri		Informal Advisory Op. 980124, http://www.mobar.org/opinions/opinion_query.cgi
13.	Montana	April 28, 2000	299 Mont. 321, 2 P.3d 806, No. 98-612
14.	Nebraska	November 2000	Advisory Op. 00-1, http://www.nebar.com/legalresources/opinions/00-1.htm
15.	New York	September 27, 1999	N.Y. Ethics Op. 721, 1999 WL 1756189
16.	Ohio	June 1, 2000	Ohio Advisory Op. 2000-3, 2000 WL 1005223
17.	Rhode Island	October 27, 1999	Op. 99-18, http:www.dri.org/dri/about/Stateguidetoehticsopinionshidden.cfm
18.	Tennessee	June 14,1999	Tenn. Ethics Op. 99-F-143, 1999 WL 406886
19.	Tennessee	September 8, 2000	Tenn. Ethics Op. 00-F-145, 2000 WL 1687507
20.	Texas	July 2000	Tex. Ethics Op. 533, 2000 WL 987921
21.	Utah	February 27, 2002	Utah Ethics Op. 02-03, 2002 WL 340262
22.	Vermont	October 1998	Vt. Bar Ass'n Advisory Ethics Op. 1998-07, http://www.vtbar.org/Advisory EthicsOpinions/1998/98-07.pdf
23.	Virginia	November 23, 1998	Legal Ethics Op. 1723, http://www.vacle.org/opinions/1723.TXT
24.	Wisconsin	October 1999	Prof'l Ethics Op. E-99-1, http://www.wisbar.org/ethop/formal/ethics99-1.html
25.	American Bar Association	February 16, 2001	Formal Op. 01-421

Flat Fees			
	State	**Date**	**Citation**
1.	Connecticut	September 24,1997	Informal Op. 97-20, Conn. Ethics Op. 97-20, 1997 WL 700692
2.	Florida	June 18, 1998	Fla. Eth. Op. 98-2, 1998 WL 796691
3.	Kentucky	1996	Am. Ins. Asson'n v. Kentucky Bar Ass'n, 917 S.W.2d 586 (Ky. 1996)
4.	Missouri	September 9, 1998	Mo. Informal Advisory Op. 980188, http://www.mobar.org/
5.	Ohio	December 5, 1997	Ohio Adv. Op. 97-7, 1997 WL 782951
6.	Utah	February 27, 2002	Utah Eth. Op. 02-03, 2002 WL 340262
7.	West Virginia	February 19, 1999	Amended Legal Ethics Inquiry 98-01, http://www.wvbar.org/barinfo/wvlegalresearch/ethics/le98/98-01.htm

Staff Counsel			
	State	**Date**	**Citation**
1.	Alaska	October 22, 1999	Ala. Ethics Op. 99-3, 1999 WL 1494993
2.	Kentucky	1996	Am. Ins. Ass'n v. Kentucky Bar Ass'n, 917 S.W.2d 586 (Ky. 1996)
3.	New Jersey	August 26, 1996	N.J. Unauthorized Practice Op. 23, 1996 WL 520891
4.	New York	February 2, 2000	N.Y. Ethics Op. 726, 2000 WL 567960
5.	Oklahoma	March 27, 1998	Legal Ethics Advisory Opinion No. 309, 1998 WL 384612
6.	Oregon	September 1998	Or. Ethics Op. 1998-153, 1998 WL 717727
7.	Texas	November 1999	Tex. Ethics Op. 531, 1999 WL 1007267
8.	West Virginia	July 9, 1999	W. Va. Op. 99-01, http://www.wvbar.org/barinfo/wvlegalresearch/ethics/le99/99-01.htm

* * *