

FEE AUDITS CUT MORE THAN FAT OUT OF BILLS, CUTTING HEART OF INSURANCE DEFENSE

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INTRODUCTION

Many liability insurance carriers, pursuant to insurance contracts with their insureds, have a duty to provide and pay for legal defense counsel for their insureds in the event of a lawsuit.¹ Insurance carriers, who are financially responsible for such defense costs, have historically reviewed and audited the defense counsel's legal bills in some manner.² Recently, though, audits have become more important as insurance carriers struggle to be competitive in a tight insurance market.³

An audit of an attorney's bill is a "careful examination of the legal bills and the underlying documents for the purpose of detecting billing errors, abuses and inefficiencies" according to one legal auditor.⁴ Audits serve as a tool to control litigation costs.⁵ Traditionally, the insurance carrier internally performed the audits; however, in the last decade, it has become increasingly popular to outsource this task to private firms.⁶ The practice of sending bills to outside auditors has sharply divided the defense bar and the insurance industry.⁷ The use of outside auditors raises a variety of ethical concerns. The practice is raising the eyebrows of many in the legal profession and has resulted in several state bar

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1. See Robert C. Heist, *The Tripartite Relationship and the Insured's Duty to Defend Contrasted with Its Desire to Manage and Control Litigation Through the Introduction of the Legal Audit*, 602 PRACTISING L. INST./LITIG. & ADMIN. PRAC. COURSE HANDBOOK SERIES 221, 223 (1999). Some states allow the insured to choose their own defense attorneys. See J. Stratton Shartel, *Tensions Between Insurers, Outside Counsel Remain Near the Boiling Point*, INSIDELITIG., Oct. 1993, at 1, 19. However, this Note deals only with outside defense counsel retained and chosen by the insurance company.

2. See Brian S. Martin, *Audits of Law Firm Bills: The Issues Inside and Out*, INS. LITIG. REP. 335, 335-56 (1999).

3. See *id.* at 355. At a recent roundtable meeting of outside defense counsel and insurance representatives, insurers expressed concern that insurance premium rates are highly regulated, yet the costs bore by insurance companies, including legal costs, are not regulated. See Shartel, *supra* note 1, at 19. Insurers claim that "[t]his, in combination with economic recession, . . . has made maintaining profitability difficult." *Id.*

4. Claire Hamner Maturro, *Auditing Attorneys' Bills: Legal and Ethical Pitfalls of a Growing Trend*, FLA B.J., May 1999, at 14, 16 (quoting 561 PRACTISING L. INST./LITIG. & ADMIN. PRAC. COURSE HANDBOOK SERIES 99, 157 (1997)).

5. See Martin, *supra* note 2, at 355.

6. See Lisa Brennan, *Driven to Defection: Fed Up with Insurers' Auditors, Defense Lawyers Go to Work for Plaintiffs*, NAT'L L.J., May 18, 1998, at A1.

7. See Lisa Brennan, *Outside Fee Audits Draw Bar Dissent: More State Bars Are Finding Ethical Problems in Audits*, NAT'L L.J., Aug. 3, 1998, at A6.

association ethical opinions on the issue.⁸

This Note addresses the problems created by the outside auditing of legal bills and offers suggestions on how the process can be improved. Part I of this Note will explore the process of legal auditing and the introduction of the auditing industry. It will also delve into the methods used by outside auditing firms and the outside auditor's self-interest in slashing bills. Part II will discuss the ethical rules for attorneys implicated by the use of outside audits. Part III will address the effect of outside audits on the relationships between insurance companies and their outside defense counsel. Finally, Part IV will evaluate the future of outside auditing and offer suggestions on how to improve the relationship between the insurance companies and their outside defense counsel.

I. THE AUDIT PROCESS

Most liability insurance policies contain "duty to defend" provisions that create an obligation for the insurance carrier to defend the insured in the event of a lawsuit resulting from a covered occurrence.⁹ The carrier is financially responsible for the attorney's defense cost and the bill is generally sent directly to the carrier. In an attempt to control litigation costs, insurance carriers historically assigned experienced claims professionals the responsibility of scrutinizing the fees charged by the defense attorney.¹⁰ The audit constituted an effort to determine not only the reasonableness of charges and expenses, but also compliance with the carrier's billing requirements.¹¹ Audits are a means by which insurance carriers can exercise their "rights to monitor the reasonableness of the fees charged and the propriety of the legal services performed."¹²

A. Types of Audits

"There is no single method or procedure by which legal bill audits are

8. See Michael Booth, *State Ethics Bans on Outside Fee Audits Mounting: Third-Party Access to Files Found to Violate Attorney-Client Confidentiality*, 154 N.J. L.J., Oct. 12, 1998, at 93.

9. See Heist, *supra* note 1, at 223. A typical duty to defend provision of an insurance contract might read: "The Company shall have the right and the duty to appoint counsel and to defend any suit against the Insured seeking damages which are payable under the terms of this Policy, even if any of the allegations of such suit are groundless, false or fraudulent." *Id.*

10. See Douglas R. Richmond, *Of Legal Audits and Legal Ethics*, 65 DEF. COUNS. J. 512, 512 (1998).

11. See *id.*

12. Kent D. Syverud, *The Ethics of Insurer Litigation Management Guidelines and Legal Audits*, 21 INS. LITIG. REP. 180, 189 (1999). The reasonableness of the attorney's fee goes to more than the carrier's subjective determination. Attorneys are ethically bound to charge only fees that are "reasonable." See MODEL RULES OF PROF'L CONDUCT R. 1.5 (1999). Reasonableness is determined by a number of factors including, but not limited to, "novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly, [nature and length of relationship, and] the fee customarily charged in the locality." *Id.*

conducted.”¹³ Legal fee audits take many forms; they range from “superficial” to “comprehensive.”¹⁴ The most comprehensive audit involves the application of a computerized program and a visit to the law firm.¹⁵ The visiting auditor interviews key law firm personnel and reviews “all fee and expense entries, law firm work product, expense documentation, pre-bills and time sheets.”¹⁶ Slightly less-comprehensive audits include an examination of all the same paper work, but no on-site visit or interviews are performed.¹⁷ Still less comprehensive audits include a review of all “the law firm’s fee and expense billing’ without reviewing ‘any expense documentation, work product, pre-bills or time sheets.’”¹⁸ The least comprehensive audits consist of a report that addresses specific concerns or issues identified from the attorney’s billing entries.¹⁹

The various types of audits exist because firms are audited for several different reasons.²⁰ Some audits may be ordered if the insurance company suspects that the law firm is issuing fraudulent bills.²¹ In this type of audit, the auditor would compare invoices, documents, and correspondence for which the firm billed, against the actual submitted bill.²² Another common reason for a legal fee audit is concern that the law firm is acting inefficiently, thus costing the insurance company more than warranted.²³ This type of audit would include reviewing bills for staffing inefficiencies that adversely affect the legal costs.²⁴

B. The Development of the Auditing Industry

Regardless of the type and purpose of the audits performed, insurance companies have begun to handle them all in a like manner—by outsourcing the work. By the early 1990s, insurance carriers began hiring outside firms to perform fee audits of their defense attorneys or firms.²⁵ At the same time, a few cases involving attorneys overbilling their insurance company clients were highly publicized.²⁶ In the mid-1990s, there was a rash of high-profile cases involving

13. Martin, *supra* note 2, at 359.

14. Matturro, *supra* note 4, at 16.

15. *See id.*

16. *Id.* (quoting James P. Schratz, *Cross-Examining a Legal Auditor*, 20 AM. J. TRIAL ADVOC. 91, 93 (1996)). Key law firm personnel often include bookkeepers, secretaries, and paralegals. *See id.*

17. *See id.*

18. *Id.* (quoting Schratz, *supra* note 16, at 93).

19. *See id.*

20. *See id.*

21. *See id.*

22. *See id.*

23. *See id.*

24. *See id.*

25. *See* Debra Baker, *You Charged How Much? Insurers Hire Independent Auditors to Pick Apart Lawyers’ Bills*, A.B.A. J., Feb. 1999, at 20, 20; Brennan, *supra* note 6, at A1.

26. *See* Darlene Ricker, *Greed, Ignorance and Overbilling*, A.B.A. J., Aug. 1994, at 62, 65.

fraudulent billings by lawyers and law firms.²⁷ Amid this flood of cases, the practice of auditing bills became increasingly popular.²⁸ The heightened level of scrutiny applied to defense expenditures gave rise to the legal auditing industry. Since 1996, firms operating specifically as auditors of legal bills have sprung up around the country.²⁹ By early 1999, five nationwide legal auditing firms and many more regional firms existed.³⁰ These firms “promised insurance companies more efficient management of the bill review process.”³¹ They also promised to free insurance claim representatives from the tedious task of reviewing bills, allowing them to focus on the management of the case.³² The insurance industry took advantage of these services. The auditing industry allowed insurance carriers to free their employees from reviewing bills, and at the same time, allowed them “to review all attorneys’ bills, not just suspect or questionable ones.”³³

C. Method Employed by Outside Auditing Firms

The introduction of outside auditing firms allowed many insurance companies to pass off the task of auditing attorney bills. However, it did not make the audits more beneficial. An outside auditor’s job is to review bills, not to manage cases. Therefore, outside auditors’ only exposure to a case is the receipt of the bill. As a result, they often do not understand the context of the case.³⁴ Furthermore, they generally have little or “no direct litigation

In 1987, the Fireman’s Fund Insurance Company hired an outside firm to audit a number of suspicious legal bills received from several of their attorneys based in San Diego. The “audit uncovered the so-called ‘Alliance’ conspiracy, which resulted in [the convictions of about twenty attorneys for] racketeering and mail fraud.” *Id.* In 1991, an audit of a firm’s legal bills resulted in a voluntary write off of \$2.7 million in disputed fees. *See id.*

27. *See Brennan, supra* note 6, at A1. These high profile cases included the 1994 guilty plea of Webster Hubble, Associate Attorney General for the United States. *See Ronald L. Seigneur, How Cost Auditing Is Impacting Legal Services, ACCT. FOR L. FIRMS*, Nov. 1995, at 6, 6. Hubble pled guilty to two felony counts of mail fraud and tax evasion related to defrauding his prior law firm and its clients out of approximately \$394,000. *See id.*

28. *See Brennan, supra* note 6, at A1; Seigneur, *supra* note 27, at 7.

29. *See Wayne J. Baliga, Litigation Management’s Impact on the Insured, Insurer and Legal Counsel*, 602 PRACTISING L. INST./LITIG. & ADMIN. PRAC. COURSE HANDBOOK SERIES 187, 189 (1999) (stating that the mid-1990s saw an increase in third-party bill review firms); Martin, *supra* note 2, at 356.

30. *See Martin, supra* note 2, at 356.

31. Baliga, *supra* note 29, at 189.

32. *See id.*

33. Richmond, *supra* note 10, at 513.

34. *See Martin, supra* note 2, at 359; *see also* Baliga, *supra* note 29, at 193 (“The party reviewing the bill reviews [it] without reference to the case file and without reference to the outcome of the case.”).

experience."³⁵ Yet, even given the auditors' lack of knowledge and experience, they are hired for the purpose of scrutinizing attorneys' bills.

Auditors pay attention to the form of the bills, not the substance.³⁶ Because they are not familiar with the specific case being billed or the unique litigation needs of that case, the auditors must use a cookie-cutter approach. They use the same standard of review for each case regardless of its complexity.³⁷ Additionally, auditing firms use software to speed up the review process.³⁸ The very use of software demonstrates the mechanical, non-specific review outside auditors give to each bill.

Typically, when legal auditors receive bills to review, they first break down the time detail³⁹ to determine "the major activities performed, who performed them, and the time spent."⁴⁰ The auditor then looks at each entry and decides whether the case was properly staffed or had too many attorneys working on it, whether the work assignments were delegated to attorneys with the appropriate experience level, whether the tasks should have been performed by attorneys or paralegals, whether the work was duplicated, and whether the attorney performed an "informal cost/benefit analysis before starting research and other projects."⁴¹ The precise means by which the auditor determines each of these issues is unclear.⁴² However, because the auditor is only looking at the bill and not the context or outcome of the case, the means used must be a non-specific, standardized approach.

Using a non-specific, cookie-cutter approach is dangerous. "Review[ing] . . . bills without access to the work product underlying those bills can lead to arbitrary [reductions in fees]."⁴³ Different attorneys may use alternative approaches to handle the same case with no one approach being preferable to another.⁴⁴ For instance, some jurisdictions may be more inclined to grant summary judgment than others.⁴⁵ Therefore, based on the jurisdiction in which the case is being litigated, a motion for summary judgment may or may not be effective. Depending on the geographical location of the litigation, a motion for summary judgment may be an important litigation tactic or superfluous work. A

35. Martin, *supra* note 2, at 359.

36. See Brennan, *supra* note 6, at A1; Seigneur, *supra* note 27, at 7.

37. See Brennan, *supra* note 6, at A1.

38. See *id.*

39. "The time detail consists of a chronological list of entries indicating the date, the attorney who performed the work, the total number of hours spent that day, and a brief description of the work." Jed S. Ringel & Ellis R. Mirsky, *Legal Auditing: The Direct Approach to Controlling Outside Counsel Costs*, 496 PRACTISING L. INST./LITIG. & ADMIN. PRAC. COURSE HANDBOOK SERIES 631, 634 (1994).

40. *Id.*

41. *Id.* at 635.

42. See *id.*

43. Baliga, *supra* note 29, at 197.

44. See Martin, *supra* note 2, at 359.

45. See *id.*

cookie-cutter approach to auditing bills will not take this factor into account. As a result, a bill may be slashed and payment refused when the motion was appropriate because of the likelihood that it could end the litigation. Conversely, payment may be made even when the motion was inappropriate due to the slim chance that the court would grant it.

D. Outside Auditors' Self-interest

The cookie-cutter approach to legal-fee auditing is not the only downfall of the use of outside auditors. Outside auditors have a self-interest in cutting bills.⁴⁶ Insurance companies hire these firms for the purpose of scrutinizing their legal bills and cutting the costs. The auditors need to prove they are worth the carrier's money⁴⁷—the greater the reduction in the bill, the better the auditors look.⁴⁸ Auditors have “one thing in mind—cutting bills,” even if that means cutting legitimate bills.⁴⁹

Many auditors promise to slash bills by ten to twenty percent of the total amount billed by the outside counsel.⁵⁰ Additionally, for some auditors, payment is based on the savings they provide to the insurance company.⁵¹ The financial success and continued vitality of auditing firms is dependent on their ability to reduce the litigation costs for insurance carriers.⁵² This self-interest results in excessive and unnecessary reductions in legal bills.⁵³

II. ETHICAL CONCERNS

The interplay of several Model Rules of Professional Conduct raise legitimate concerns regarding the employment of outside auditing firms.⁵⁴

46. *See id.* at 358.

47. Insurance companies audit bills in an attempt to save money. Because the insurance companies must pay the outside auditors for this work, the bill cuts must be greater than the fees charged by the auditors. If the auditors' fees exceed the amount saved by the cuts, there would be no financial incentive to hire outside auditors. This reality pressures auditors to make more cuts in order to justify their employment.

48. *See Booth, supra* note 8, at 93.

49. *Id.*

50. *See Hope Viner Samborn, No-Frills Approach Proving Costly*, A.B.A. J., Mar. 1998, at 30, 30-31; *see also Baliga, supra* note 29, at 196 (stating that auditing firms “routinely sell their product with the promise of [ten] to [fifteen] percent cost savings to their clients”).

51. *See Samborn, supra* note 50, at 31; *cf. Ricker, supra* note 26, at 65 (listing that most auditors charge a flat fee of \$10,000 to \$20,000 for a lengthy audit or an hourly rate of \$125).

52. *See Richmond, supra* note 10, at 513. “Even auditors who work for flat fees have a compelling interest in justifying their function and cost.” *Id.* The auditing industry thrives on the work of insurance companies. “About [seventy percent] of legal auditing firms' clients are insurance companies . . .” *Ricker, supra* note 26, at 65.

53. *See Martin, supra* note 2, at 358.

54. *See id.* at 357. The bar has been accused of “shroud[ing] the debate in ethical term.” *Baliga, supra* note 29, at 196. Carriers view the ethical arguments as disingenuous, noting that the

Ethical rules restrict the attorney's ability to disclose information relating to the representation of the client.⁵⁵ According to a 1997 decision by the First Circuit Court of Appeals, the disclosure of information released to an auditing firm may constitute a waiver of the attorney-client privilege defense.⁵⁶ Furthermore, an attorney is required to exercise independent professional judgment when rendering legal services⁵⁷ and may not allow the one who renders payment of the legal fees to direct or regulate that professional judgment.⁵⁸

These ethical rules restrict attorneys, and therefore, do not apply to auditors who are not members of the bar. When an attorney is required by contract to directly submit bills to an auditing firm or when the attorney is informed that the insurance carrier will subsequently submit bills to an auditing firm, many ethical dilemmas surface. Legal auditors claim that the "defense bar is using the ethics argument as a smoke-screen to hide its true motivation for trying to prevent reviews of bills: money."⁵⁹ Regardless of whether this issue is a smoke-screen, it is a real concern. The process of handing over bills to outside auditing firms interferes with the attorney's ethical obligations.

A. Confidentiality

An attorney is prohibited from revealing "information relating to [the] representation of a client unless the client consents after consultation, except for disclosures that are impliedly authorized in order to carry out the representation."⁶⁰ However, insurance companies require attorneys to submit extremely detailed bills.⁶¹ The details of such bills often contain "information about the nature of the legal services and specific legal research performed."⁶² This sensitive "information could disclose [the] counsel's mental impressions, strategic decisions and case theories."⁶³ Defense bills are, in essence, disclosures of specific information relating to the representation of the insured. When bills

tripartite relationship has functioned well for many years and the ethics of it were only raised when "bill review started to have a serious impact on the bottom line." *Id.*

55. See MODEL RULES OF PROF'L CONDUCT R. 1.6(a) (1999). "A lawyer shall not reveal information relating to representation of a client unless the client consents after consultation, except for disclosures that are impliedly authorized in order to carry out the representation . . ." *Id.*

56. See *United States v. Mass. Inst. of Tech.*, 129 F.3d 681, 686 (1st Cir. 1997).

57. See MODEL RULES OF PROF'L CONDUCT R. 1.8 (1999).

58. See MODEL RULES OF PROF'L CONDUCT R. 5.4 (1999).

59. *Baker*, *supra* note 25, at 20.

60. MODEL RULES OF PROF'L CONDUCT R. 1.6(a) (1999).

61. See *Richmond*, *supra* note 10, at 512.

62. *Id.*

63. *Id.* The bills could contain information regarding how many experts were interviewed. Aggressive plaintiffs' attorneys could easily deduce which of these experts were not chosen or refused to testify for the defense. See *Martin*, *supra* note 2, at 357. The plaintiffs' attorneys could then use this information to their advantage by potentially hiring the unused defense experts to testify for the plaintiffs. See *id.*

are sent to outside auditors, they are the equivalent of disclosures to third parties.

Outside audits improperly interfere with the confidential relationship between the attorney and the client.⁶⁴ Defense attorneys argue that giving bills to auditors breaches confidentiality, thus violating Model Rule 1.6(a), unless the consent of the client is obtained after consultation.⁶⁵ If an attorney, in accordance with the insurance contract, submits bills to an outside auditor without obtaining the client's permission, the attorney could face professional discipline for violating Model Rule 1.6(a). However, a question remains as to who the client is—the insurance company or the insured.

The insurance companies contend that sending bills to outside auditors is not a breach of confidentiality because the insurer, as well as the insured, are clients in the case.⁶⁶ Insurance carriers suggest that as co-clients they are and should be allowed to manage the legal fees they pay in accordance with the goals of the representation.⁶⁷

However, the co-client argument does not solve the confidentiality problem. If both the insurer and the insured are clients, the attorney must nevertheless obtain the permission of both the insurer *and* insured before revealing information relating to the representation of the clients.⁶⁸ If the insured refuses to grant permission to reveal information relating to his representation, the consent of the insurance company cannot override that decision. Since the information released would relate to the representation of the insured, the attorney may not ethically submit the bills to an outside auditor when the insured withholds consent.⁶⁹ This refusal to consent creates a conflict of interest for the attorney.⁷⁰ When such a conflict arises, it is important for the attorney to be aware of who is the primary client.⁷¹ Thus, the co-client argument defeats the

64. See Richmond, *supra* note 10, at 513.

65. See *id.* at 515. Some argue that the information submitted to the legal auditors is not confidential, thus there are no issues of confidentiality. See Baker, *supra* note 25, at 23. However, the Model Rules of Professional Conduct do not limit the attorney's duty of confidentiality to information protected by attorney-client privilege. See MODEL RULES OF PROF'L CONDUCT R. 1.6(a) (1999). The broad duty of confidentiality includes any information relating to the representation of the client. Under this broad definition, the information submitted to auditors is confidential. See John Freeman, *Ethics Watch*, S.C. LAW., Jan.-Feb. 1999, at 10, 10-11 (stating that "everything in a client's legal bill constitutes information 'relating' to the representation, and . . . is protected by Rule 1.6").

66. See Syverud, *supra* note 12, at 180.

67. See *id.*

68. See MODEL RULES OF PROF'L CONDUCT R. 1.6(a) (1999).

69. See J. Anthony McLain, *Third Party Auditing of Lawyer's Billings—Confidentiality Problems and Interference with Representation*, 60 ALA. LAW. 35, 37 (1999).

70. The attorney's representation of the insurance company, especially its desire to have bills audited, would be limited by the attorney's responsibility to the insured, the other client. Such a situation creates a conflict of interest. See MODEL RULES OF PROF'L CONDUCT R. 1.7(b) (1999).

71. The retainer agreement by which the defense counsel is employed to represent the insured regulates the attorney's rights and professional obligations. The retainer agreement should

confidentiality problem only if the insured consents to the disclosure.

Several state bar associations have written ethical opinions on the issue of confidentiality as it relates to the submission of defense bills to outside auditors.⁷² Since 1997, sixteen state bar associations and the District of Columbia have issued opinions holding that submitting bills to outside auditors constitutes a breach of confidentiality.⁷³ Only Massachusetts and Nebraska have released opinions which seem to be, at least in part, inconsistent with the opinions of those sixteen states and the District of Columbia.⁷⁴

B. Attorney-Client Privilege

1. *United States v. Massachusetts Institute of Technology.*—In *United States v. Massachusetts Institute of Technology*⁷⁵ (MIT), MIT provided billing statements of law firms to an auditing agency for the Department of Defense in accordance with a contract between MIT and the Department of Defense.⁷⁶ The purpose of the audit was to ensure that the government was not being overcharged for services. The IRS requested the same billing statements to ensure that MIT qualified for tax exemption status. MIT submitted the statements to the IRS, but redacted information it claimed was covered by the attorney-client privilege. The IRS sought to obtain the same documents in unredacted form from the auditing agency used by the Department of Defense.⁷⁷

The First Circuit held that the IRS could obtain the unredacted documents because MIT had forfeited its attorney-client privilege when it disclosed the documents to the auditing agency.⁷⁸ The court stated that there exists “a small circle of ‘others’ with whom information may be shared without [waiving the

set forth who is the primary client: the insured or the insurance company. See Kent D. Syverud, *Special Project on Professional Responsibilities of Insurance Defense Lawyers*, 62 DEF. COUNS. J. 503, 503-04 (1995). Some believe that if the retainer agreement does not set forth who is the primary client, but states that both the insured and the insurance company are clients, then the attorney is not to favor either client and should withdraw from the case. See *id.* at 507; *cf.* McLain, *supra* note 69, at 36 (stating that “authorities conclusively establish the proposition that the insured is the attorney’s primary client and it is to the insured that the attorney owes his first duty of loyalty and confidentiality”); Maturro, *supra* note 4, at 18.

72. See McLain, *supra* note 69, at 38.

73. See Syverud, *supra* note 12, at 191 n.47 (listing Alabama, Alaska, Florida, Indiana, Kentucky, Louisiana, Maryland, Missouri, New York, North Carolina, Pennsylvania, South Carolina, Utah, Vermont, and Washington); see also McLain, *supra* note 69, at 38 (listing the Montana Bar Association also).

74. See McLain, *supra* note 69, at 38. These opinions appear to be unofficial or informal opinions. See *id.*

75. 129 F.3d 681 (1st Cir. 1997).

76. See *id.* at 683.

77. See *id.* at 682-83.

78. See *id.* at 687.

attorney-client] privilege.”⁷⁹ The auditing agency, however, was outside the circle, and when information is disclosed to a party outside the circle, the attorney-client privilege is waived.⁸⁰ The court noted that the potential for dispute and litigation existed as a result of the auditing agency’s review of the bills.⁸¹ Therefore, the auditing firm was a potential adversary.⁸²

2. *The Effects of United States v. MIT.*—The holding in *MIT* makes the disclosure of attorneys’ bills to an auditing agency a waiver of attorney-client privilege.⁸³ The facts in *MIT* are strikingly similar to those in which an attorney discloses billing statements to an auditing agency, at the request of the insurance carrier, for the purpose of ensuring to the insurance carrier that it is not being overcharged. If other courts adopt the reasoning of the First Circuit Court of Appeals, all bills given to auditing firms will lose attorney-client privilege protection.

At least one opponent has argued that the holding of *MIT* will not extend to disclosures made pursuant to insurance contracts since the “disclosure of billing information is necessary to facilitate the insured’s representation and because the insurer and insured have a common interest in efficient, cost-effective and appropriate representations.”⁸⁴ Assuming, *arguendo*, that the insured and insurer have a common interest in the efficient and cost-effective representation, this is the same interest that *MIT* and the Department of Defense had in *MIT*. Regardless of this interest, the court nevertheless found that the disclosure of the information to the auditing agency constituted a waiver of the attorney-client privilege.⁸⁵

The auditors in insurance contracts are in the same adversarial position as auditors in the *MIT* case. Both auditors review bills for potential billing disputes. Moreover, the possibility of a resulting dispute is even greater in the insurance defense case because many auditing firms promise to slash bills by ten to twenty percent.⁸⁶ Therefore, the holding in *MIT* would apply to insurance defense

79. *Id.* at 684.

80. *See id.* at 686.

81. *See id.* at 687.

82. *See id.*

83. *See id.*

84. Syverud, *supra* note 12, at 192. The argument can be made that the employment of an outside auditing firm does not necessarily facilitate the insured’s representation, and thus, may not be in the best interest of the insured. Auditing firms can often hamper the representation of the insured by slashing bills and disallowing payment for necessary and appropriate litigation tactics. Refusal to pre-approve or make payment for necessary and appropriate litigation tactics could harm the insured’s case and possibly cause the insured to face personal liability. If the lawsuit involves a claim that is in excess of the insurance coverage limits, and the insurance company, acting through the outside auditor, refuses to pre-approve or make payment for necessary tactics, the insured could lose the lawsuit and be held personally liable for the amount of the judgment in excess of the insurance coverage. Such a result would not facilitate the insured’s representation.

85. *See MIT*, 129 F.3d at 687.

86. *See Samborn, supra* note 50, at 30-31. In 1998, scrutiny by Law Audit Services, a

contracts, and the disclosure to the auditing agency would waive the attorney-client privilege.⁸⁷

The holding in *MIT* has not yet been adopted by other jurisdictions. However, the potential for a waiver of the attorney-client privilege exists in all jurisdictions. Where the possibility exists that disclosure will result in a waiver of the attorney-client privilege, the “[a]ttorney[] . . . should err on the side of non-disclosure.”⁸⁸

C. Independent Professional Judgment

1. *The Applicable Model Rules.*—The release of case information to the outside auditing firm waives the attorney-client privilege. When the outside auditing firm reviews the information and attempts to control the management of the case by disapproving payment for necessary services, the auditor infringes upon the attorney’s independent professional judgment, in violation of the Model Rules of Professional Conduct. The Rules permit a lawyer to accept compensation from someone other than the client, for his representation of a client, only if “(1) the client consents after consultation; (2) there is no interference with the lawyer’s independence of professional judgement or with the client-lawyer relationship; and (3) information relating to representation of a client is protected as required by Rule 1.6.”⁸⁹ Additionally, a lawyer cannot allow a person who pays the lawyer for legal services rendered for another to “direct or regulate the lawyer’s professional judgement in rendering such legal services.”⁹⁰

2. *The Implication of the Model Rules.*—The use of outside auditors infringes on the lawyer’s ability to exercise his independent professional judgment and represent the client to the “fullest extent possible.”⁹¹ To a certain degree, insurance carriers try to delegate to outside auditors the power to dictate how a case should be litigated. The founder of one auditing firm admits that auditors tell lawyers “how to practice law.”⁹² “Unlicensed outsiders, untrained in the law and not subject to [the] Supreme Court’s disciplinary oversight, have

national auditing firm, resulted in cuts of approximately ten percent of the bills’ dollar value. See Milo Geyelin, *Crossing the Bar: If You Think Insurers Are Tight, Try Being One of Their Lawyers*, WALL ST. J., Feb. 9, 1999, at A1.

87. Some argue that because an agency relationship exists between the insurance company and the auditors, the disclosure would not constitute a waiver of attorney-client privilege. See Baker, *supra* note 25, at 23. However, the same agency relationship was present in *MIT*; nonetheless, the court found a waiver of the attorney-client privilege.

88. McLain, *supra* note 69, at 38.

89. MODEL RULES OF PROF’L CONDUCT R. 1.8(f) (1999).

90. MODEL RULES OF PROF’L CONDUCT R. 5.4(c) (1999).

91. Baker, *supra* note 25, at 20.

92. *Id.* at 23 (quoting Richard Robbins, Founder of the Manhattan-based auditing firm, Law Cost Management). Robbins explained that auditors dictate what the attorney should do “in terms of what everyone else is doing.” *Id.*

no business trying to regulate how lawyers exercise their independent professional judgment on behalf of client-insureds."⁹³

Without necessarily having knowledge of the case, auditors make value judgments about the time required to perform certain tasks and whether the task should be performed at all.⁹⁴ Auditors determine, based on the description of the task contained in the bill, whether a paralegal or secretary, as opposed to an attorney, should perform the task.⁹⁵ These arbitrary judgments concerning services rendered impede the lawyer's independent professional judgment.⁹⁶ In one instance, an attorney drafted a twenty-page coverage opinion.⁹⁷ The auditor of the bill refused payment for the work because he thought the attorney should have billed for less than one hour for the services rendered.⁹⁸ The auditor either failed to recognize (1) that this particular opinion was so extensive (twenty pages) that it would require more than the usual allotted time for drafting of opinions or, (2) that the complexity of the case required such a detailed opinion.⁹⁹ These arbitrary judgments made by auditors threaten a lawyer's ability to fully and completely represent clients.¹⁰⁰ Attorneys can either perform the work they believe is necessary to the representation and risk refusal of payment or refrain from rendering a particular service and breach the ethical obligation to zealously represent the client.¹⁰¹ Recognizing the changing circumstances in insurance defense, Justice Gonzales, in his concurrence and dissent in *State Farm Mutual Automobile Insurance Co. v. Traver*,¹⁰² expressed concern "that defense lawyers may be reluctant to resist cost-cutting measures" established in billing restrictions and audits.¹⁰³ This reluctance raises the risk of compromising the attorney's "autonomy and independent judgment on the best means of defending an insured."¹⁰⁴

Attorneys should resist following any tactics or strategies recommended by the auditor that would dictate how the case should be handled. Decisions of how

93. Freeman, *supra* note 65, at 11; see also Booth, *supra* note 8, at 93. Only a small percentage of auditors are also attorneys. See Brennan, *supra* note 6, at A1. *But cf.* Ricker, *supra* note 26, at 65 (stating that most auditors are attorneys with accounting backgrounds).

94. See Booth *supra* note 8, at 93.

95. See Brennan, *supra* note 6, at A1.

96. See Baker, *supra* note 25, at 20.

97. See *id.*

98. See *id.*

99. Neither of these points would be recognized by computer software used by some auditing firms as discussed *supra* Part I.C. This example demonstrates how a cookie-cutter approach to reviewing bills is inadequate.

100. See Baker, *supra* note 25, at 20.

101. See MODEL RULES OF PROF'L CONDUCT R. 1.3 cmt. 1 (1999). A lawyer should advocate zealously on his client's behalf. See *id.* A lawyer should use "professional discretion in determining the means by which a matter should be pursued." *Id.*

102. 980 S.W.2d 625 (Tex. 1998).

103. *Id.* at 634 (Gonzalez, J., concurring and dissenting).

104. *Id.*

a case should be handled are to be made by attorneys and clients, not those hired to slash bills.¹⁰⁵ Attorneys must use their independent professional judgment, examine the idiosyncrasies of each case and determine what actions are appropriate. Outside auditors lack expertise¹⁰⁶ and flexibility, and as a result, often fail to consider the complexities of each case.¹⁰⁷

D. Unauthorized Practice of Law

The Model Rules prohibit a lawyer from “assist[ing] a person who is not a member of the bar in the performance of any activity that constitutes the unauthorized practice of law.”¹⁰⁸ There is no one definition of the “practice of law”; instead it varies with the laws of each jurisdiction.¹⁰⁹

In *In re Youngblood*,¹¹⁰ the Tennessee Supreme Court ruled on the extent of control an insurance company may exercise over a defense attorney it hires for its insured. In *Youngblood*, the court held, notwithstanding the existence of the employer-employee relationship, the insurance company could not “control the details of the attorney’s performance, dictate the strategy or tactics employed, or limit the attorney’s professional discretion with regard to the representation.”¹¹¹ To avoid aiding in the unauthorized practice of law, insurance defense attorneys “must ensure that the insurance company does not control or interfere with the exercise of [their] professional judgment in representing insureds.”¹¹²

Attempting to dictate the strategies and tactics of the case can amount to the unauthorized practice of law, whether it is done by the insurance company or an

105. See Freeman, *supra* note 65, at 11.

106. See *supra* Part I.C.

107. See Brennan, *supra* note 7, at A6.

108. MODEL RULES OF PROF’L CONDUCT R. 5.5 (1999).

109. See MODEL RULES OF PROF’L CONDUCT R. 5.5 cmt. 1 (1999) (indicating that many jurisdictions do not have a specific statute defining the practice of law, but allow the courts to determine on a case-by-case basis whether an activity constitutes the unauthorized practice of law); see also *State v. Martinez*, 996 P.2d 371, 374-75 (Kan. Ct. App. 2000) (“[w]hat constitutes the unauthorized practice of law must be determined on a case-by-case basis”) (internal citation omitted); *Rahbaran v. Rahbaran*, 494 S.E.2d 135, 139 (Va. Ct. App. 1997) (“Court[s] ha[ve] the inherent power . . . to inquire into the conduct of any person to determine whether that individual” is engaging in the unauthorized practice of law); *In re Opinion No. 24 of Committee on Unauthorized Practice of Law*, 607 A.2d 962, 966 (N.J. 1992) (quoting *In re Application of the New Jersey Soc’y of Certified Pub. Accountants*, 507 A.2d 711, 714 (N.J. 1986)) (“The practice of law is not subject to precise definition. It is not confined to litigation . . .”). Accordingly, the actions of the outside auditor, if reviewed, could be found to be the unauthorized practice of law.

110. 895 S.W.2d 322 (Tenn. 1995). This case dealt with an attorney who was a salaried employee of the hiring insurance company. However, regardless of whether the insurance company hires an in-house attorney or outside counsel, the employer-employee relationship is the same.

111. *Id.* at 328.

112. *Id.* at 331 (internal citations omitted).

outside auditor.¹¹³ Essentially, when an outside auditor reviews bills and refuses to approve payment for specific actions, the auditor is dictating how the case should be litigated. In doing so, the outside auditor infringes on an attorney's exercise of independent professional judgment and makes decisions that must be made by an attorney. According to the law of some jurisdictions, this simple act might be the unauthorized practice of law. Therefore, an attorney who allows strategies or tactics to be regulated by outside auditors risks being the subject of disciplinary action for assisting in the unauthorized practice of law by the auditor.¹¹⁴

III. EFFECT OF OUTSIDE AUDITS ON ATTORNEY-INSURER RELATIONSHIP

A. Animosity

The use of outside auditors has not only affected defense attorneys' legal ethics, but it has also created animosity between defense attorneys and insurance companies. The increased use of outside auditors is fraying ties between defense attorneys and insurers.¹¹⁵ Insurance companies insist on conducting audits based on their perception that lawyers are overcharging for their services.¹¹⁶ However, lawyers perceive audits to be arbitrary.¹¹⁷ At least one defense attorney believes that no other single issue "has more sharply divided the defense bar and the insurance industry."¹¹⁸ Audits are causing such a great chasm because many lawyers feel that when their bills are continuously reviewed, their integrity is being questioned.¹¹⁹ One such defense attorney believes the underlying assumption with audits is that lawyers cannot be trusted—"all lawyers cheat."¹²⁰ Other defense attorneys see outside fee audits as personal attacks and liken them to the managed care systems that subject doctors to review committees that second guess the types of procedures doctors deem necessary for their patients.¹²¹

Insurance companies deny that questioning bills is a personal attack on the

113. An insurance company would have more leeway in attempting to control the strategy and tactics of the case if it is considered a co-client. However, the auditing firm is not a co-client and would have less leeway in attempting to dictate strategy and tactics.

114. See Freeman, *supra* note 65, at 11.

115. See Geyelin, *supra* note 86, at A1; see also Baker, *supra* note 25, at 20 (stating that audits are "effectively destroying the relationship between insurance firms and the legal profession") (internal citations omitted).

116. See Baker, *supra* note 25, at 23.

117. See *id.*

118. Brennan, *supra* note 7, at A6 (quoting Robert E. Scott Jr., a partner in the Baltimore firm, Semmes, Bowen & Semmes, and president of the Defense Research Institute, an organization of 21,000 insurance defense attorneys based in Chicago); see also Brennan, *supra* note 6, at A1.

119. See Brennan, *supra* note 6, at A1.

120. Geyelin, *supra* note 86, at A1 (quoting Terrance C. Sullivan, who worked as an insurance defense attorney for fourteen years in Atlanta, Georgia).

121. See Brennan, *supra* note 6, at A1.

honesty of the lawyers.¹²² Insurers are responsible for paying the reasonable costs and expenses of defending claims.¹²³ They insist that audits are a means of determining which costs are reasonable.¹²⁴ Insurance companies claim the real reason for auditing is financial—controlling litigation costs.¹²⁵ Insurers are aware of recent studies that show that litigation costs have risen to between thirty percent and fifty percent of every dollar paid out on claims.¹²⁶ Insurers, armed with these results and confronted with the rash of headlines concerning billing abuses by law firms, have employed audits to scrutinize attorneys' bills.

Insurance companies point to high-profile cases of billing abuses in an attempt to justify their use of audits.¹²⁷ For instance, in 1996, a Florida attorney hired by Lloyd's of London Insurance Company was convicted of fraudulently billing the company \$5 million.¹²⁸ Other egregious billing abuses reported include lawyers overbilling insurance companies for four and one half hours to look up an address in a library,¹²⁹ for billing a total of thirty-eight hours in one day,¹³⁰ and for billing a non-refundable airline ticket and a tuxedo rental when an attorney missed an out-of-town wedding due to a trial continuance.¹³¹ Instances such as these and many others¹³² seem to provide sufficient justification for insurance companies to audit attorneys' bills.

Insurance companies have compiled numerous examples of how some attorneys abuse the ability to bill insurance company clients freely and unchecked. Thus, insurance companies face a dilemma—risk paying fraudulent bills by accepting attorney bills without question or straining the relationship

122. See Shartel, *supra* note 1, at 20. Insurance companies make the claim that they are not questioning the honesty of lawyers, but nonetheless, they employ auditing firms that promise to reduce bills by a predetermined percent. Promised bill cuts "presume[] that all firms run their practice in an inefficient manner[,] and presume that some firms operate dishonestly. Baliga, *supra* note 29, at 197.

123. See Howard M. Tollin & Tammy Feman, *Litigation Management: What Legal Defense Costs are Reasonable and Necessary?*, 63 DEF. COUNS. J. 529, 529 (1996).

124. See *id.* at 530.

125. See Shartel, *supra* note 1, at 20.

126. See Martin, *supra* note 2, at 355. Regardless of the exact amount, "it [is] clear that legal fees [are] growing while premium and investment dollars to pay those fees [are] decreasing." Baliga, *supra* note 29, at 190. "Litigation costs nationwide had jumped to 34.8% of total losses paid out in 1994, from 29.5% in 1988." Geyelin, *supra* note 86, at A1. Insurers suspect that a large part of that increase is due to excessive billing by lawyers. See *id.*

127. See Martin, *supra* note 2, at 361.

128. See Geyelin, *supra* note 86, at A1; Martin, *supra* note 2, at 361.

129. See Geyelin, *supra* note 86, at A1.

130. See *id.*

131. See Martin, *supra* note 2, at 361.

132. See Seigneur, *supra* note 27, at 6-7. Other examples of outrageous overbilling include charging clients for lost money when an employee's purse was stolen during an out-of-town deposition and weekend late-night limousine service, including a gratuity, an additional tip, and a "special order" for an attorney. *Id.*

with their defense attorneys by auditing the legal bills, causing attorneys to feel mistrusted. Although obvious problems exist, the increased use of outside auditors is not the solution. Audits have caused a dramatic decline in constructive discussions between insurance companies and defense attorneys.¹³³ Carriers' aggressive attempts to eliminate fraudulent billings have resulted in the existence of unhealthy tensions between insurance carriers and their outside defense counsel.¹³⁴

B. Audits Create Burden for Insurance Defense Attorneys

Attorneys' discontent with fee audits goes beyond their sense that the audits are a personal attack on their integrity and honesty. Audits hit lawyers where they are most vulnerable—their time.¹³⁵ Bill cuts have forced attorneys to spend more time trying to get paid than actually working on files.¹³⁶ Some attorneys have complained about spending as much as one-third of the workday trying to get paid by insurance companies for work performed.¹³⁷ One firm even assigned an associate “to do nothing but deal with ‘silly billing questions’ from insurers.”¹³⁸ If attorneys wish to receive payment for services provided but subsequently cut, they must spend otherwise billable hours pouring over bill cuts and challenging them.¹³⁹

The increased use of bill auditing has created a tremendous administrative burden on attorneys.¹⁴⁰ The loss of otherwise billable time has made insurance defense an unprofitable area of law.¹⁴¹ Insurance defense traditionally was “among the thinnest profit margins in the legal business,” and the increased use of fee audits has made it even more so.¹⁴² Insurance defense attorneys had already given insurance companies a sweetheart deal; they agreed to charge

133. See Brennan, *supra* note 6, at A1. This decline is contrary to the claimed purpose of audits. Carriers claim the purpose of bill review “is to create a dialogue with counsel concerning the handling of cases.” Shartel, *supra* note 1, at 20.

134. See Baliga, *supra* note 29, at 189 (stating that outside audits create tensions between the insurance company, the auditing firm, and the defense attorneys); Shartel, *supra* note 1, at 20.

135. See Geyelin, *supra* note 86, at A1.

136. See Brennan, *supra* note 6, at A1.

137. See Geyelin, *supra* note 86, at A1. Attorneys are forced to spend time getting prior authorization from the insurance company to perform simple tasks, such as research requiring more than two hours. See *id.* Additional time is spent reviewing cuts made by the auditors and responding in an attempt to receive payment. See *id.*

138. Shartel, *supra* note 1, at 19.

139. See Geyelin, *supra* note 86, at A1. If the attorney wishes to challenge the cuts, he often must appeal to the auditing firm first. If payment is again denied, he can then appeal to the insurance company directly. See *id.*

140. See Samborn, *supra* note 50, at 31. Attorneys must spend time writing detailed bills and disputing bill cuts. See *id.*

141. See Brennan, *supra* note 6, at A1.

142. Geyelin, *supra* note 86, at A1.

carriers a lower hourly fee in exchange for a high-volume of caseloads and predictability of payment.¹⁴³ The use of fee audits is eroding this arrangement by making payments time consuming and less than predictable.¹⁴⁴ The costs of fighting bill cuts often outweigh the benefits gained by the cuts themselves.¹⁴⁵

C. Diminished Quality of Representation for Insurance Defense

The increased burden audits have placed on insurance defense attorneys has caused many insurance defense attorneys to leave the practice. Many defense firms and individual attorneys are switching sides of the bar or expanding their practices to include more lucrative practice areas.¹⁴⁶ Many attorneys remaining in the area of insurance defense are facing or staving off bankruptcy.¹⁴⁷

Faced with a narrowing profit margin, Lewis & Gellen, a Chicago medical malpractice defense firm, recently expanded its practice to include other types of litigation.¹⁴⁸ Similarly, Kincaid, Gianuzio, Caudle & Hubert, an insurance defense firm in Oakland, California, closed its doors in 1996.¹⁴⁹ LaBrum & Doak, a Philadelphia insurance defense firm, closed its doors in 1998 after ninety-two years of practice.¹⁵⁰

Audits have also caused many attorneys to switch sides of the bar.¹⁵¹ Flocks of formerly dedicated insurance defense attorneys are leaving the practice.¹⁵² Terrance C. Sullivan, an attorney who successfully defended an insurance company in a \$1.3 million medical malpractice case, left his practice to join one of Georgia's top plaintiffs' firms.¹⁵³ Another attorney, James M. Ianiri, "[f]ed up with documenting his work just to pass audits," left his position as a senior associate at the prestigious Boston firm of Morrison, Mahoney & Miller to form his own plaintiffs' firm.¹⁵⁴

The heightened use of fee audits has caused many experienced lawyers to leave the insurance defense practice area, diminishing the quality of representation available for insurance defense.¹⁵⁵ When experienced lawyers

143. *See id.*

144. *See id.*

145. *See Samborn, supra note 50, at 31.*

146. *See id. at 30.*

147. *See Brennan, supra note 6, at A1.*

148. *See Samborn, supra note 50, at 30.*

149. *See id.*

150. *See id.*

151. *See Brennan, supra note 6, at A1.*

152. *See id.; see also Brennan, supra note 7, at A6.*

153. *See Geyelin, supra note 86, at A1.* Attorney Terrance C. Sullivan founded Sullivan, Hall, Booth & Smith, a firm specializing in insurance defense. Sullivan left his firm in 1998 after becoming frustrated with arbitrary bill cuts by outside auditors and the time consuming process required to get insurance companies to pay. *See id.*

154. *Brennan, supra note 6, at A1.*

155. *See Richmond, supra note 10, at 520.*

leave the practice, insurance companies must hire less experienced counsel to represent their insureds. Less experienced counsel may charge the company lower rates to handle cases, but may be less able to protect the insurance company's interests. Thus, the costs saved on the lower legal fees must be balanced with the costs of losing more cases.

IV. FUTURE OF FEE AUDITS AND PROPOSED SOLUTIONS

The disruption in the insurance defense industry caused by the increased use of fee audits does not necessarily mean that the practice of fee audits must be completely abandoned. The insurance defense industry can survive even with the continued use of fee audits.¹⁵⁶ However, to avoid irreparably damaging insurance defense, the insurance companies should alter their approach to legal fee audits.

A. Insurance Companies Have Gone Too Far

Legal fee audits are not entirely evil innovations. Attorneys are ethically bound to charge clients only reasonable fees.¹⁵⁷ Auditing legal bills is a "reasonable and appropriate means by which insurers exercise their rights to monitor the reasonableness of the fees charged."¹⁵⁸ Fee audits also serve as an opportunity for law firms to "improve their processes and efficiencies."¹⁵⁹

Although fee audits can be beneficial, the employment of outside auditors to review every legal bill from every defense attorney is extreme, and the secondary effects reduce the benefits. A national practice of scrutinizing every attorney's bill, even those who have not previously engaged in abuses and are not suspected of current abuse, is too extreme.¹⁶⁰ Insurance companies have taken their fight against overbilling too far.¹⁶¹ Although the extensive employment of audits has helped insurance companies discover billing abuses,¹⁶² they have also damaged the relationship between insurance companies and defense counsel.

B. Revitalizing the Relationship

1. *Return to In-House Auditors.*—Insurance companies will most likely continue to audit the bills of their defense attorneys in an attempt to control litigation expense. However, the carriers would benefit in a return to the

156. Although their use was not as prevalent, many insurance companies performed legal fee audits for many years, and the industry has survived.

157. See MODEL RULES OF PROF'L CONDUCT R. 1.5(a) (1999). "A lawyer's fee shall be reasonable." *Id.*

158. Syverud, *supra* note 12, at 189; see also Shartel, *supra* note 1, at 21.

159. Shartel, *supra* note 1, at 21.

160. See *id.* at 20.

161. See *id.* at 21.

162. See *id.* at 20. Audits have identified extensive research on marginal issues, multiple charges for file review unconnected to any objective, and other unnecessary or fraudulent charges. See *id.*

traditional practice of using in-house auditors.¹⁶³ This shift would allow the insurance companies to use audits to control legal costs and relieve the tension between attorneys and insurance companies resulting from the employment of outside auditors. This in turn would allow attorneys to feel less threatened¹⁶⁴ because the in-house auditors are not motivated by self-interest in making unreasonable cuts to the legal bills.

In addition to removing self-interest motivation, in-house audits will also benefit the attorney-carrier relationship because the audits can be particularized for each case. Many attorneys complain that outside auditors use a cookie-cutter approach to determine which actions are necessary and which are superfluous and accordingly make cuts to the bills.¹⁶⁵ The very definition of in-house auditors implies that the auditors have regular access to in-house counsel and the insurance claims representatives handling each case. The auditors can consult with these insurance company employees who are familiar with the case to determine whether questionable billing entries are proper actions in the context of each particular case. Audits will be more case-specific and will not result in fee cuts for actions that do not fit the cookie-cutter model of litigation.

Most importantly, the return to in-house auditors will also help solve attorney-client confidentiality problems created by the employment of outside auditors.¹⁶⁶ In-house auditors are the carrier's employees;¹⁶⁷ as employees, the auditors will share the carrier's attorney-client privilege with defense counsel.¹⁶⁸ Information will not be sent to an auditor who is outside the "small circle of 'others' with whom information may be shared."¹⁶⁹ Therefore, the threat of breaching the attorney-client privilege will not exist as it does with the use of outside auditors.¹⁷⁰

Insurance companies do not deny the benefits of in-house audits. Nevertheless, they complain that in-house auditors increase their costs.¹⁷¹ The

163. See Brennan, *supra* note 6, at A1.

164. See Martin, *supra* note 2, at 358; Larry Smith, *A Profession in Transition: Auditors Expand Practice Amid Growing Criticism*, OF COUNS., Oct. 4, 1993, at 5-6; see also Richmond, *supra* note 10, at 522. In-house auditors are employees of the insurance company and, therefore, will be paid regardless of the amount of cuts they make. This is contrary to outside auditors who are often paid according to the dollar amount of cuts they make. See Samborn, *supra* note 50, at 31.

165. See Brennan, *supra* note 6, at A1.

166. See Martin, *supra* note 2, at 358.

167. See *id.*

168. See *id.*

169. *United States v. Mass. Inst. of Tech.*, 129 F.3d 681, 684 (1st Cir. 1997).

170. See Martin, *supra* note 2, at 358.

171. See *id.* Insurance companies must pay for the audits whether they are preformed in-house or by an outside firm. Thus, auditing itself, rather than the use of in-house auditors, increases insurance companies' cost. The cost difference is in the total amount of bill cuts made by the auditors. Outside auditors only appear to cost less because they routinely make more bill cuts than in-house auditors. This is not necessarily saving the insurance company money. See *supra* Part

companies fail to recognize that “[t]he decision whether to use in-house staff or an outside auditing firm is not as simple as deciding which is more cost effective.”¹⁷² Outside audits create a potential for confidentiality problems and strain the relationship between the insurance company and the defense attorney. These factors need to be considered in conjunction with the financial costs when companies are determining whether to employ in-house or outside auditors.

2. *Increase Communication.*—Even if insurance carriers choose not to return to using in-house auditors, the insurance carriers should keep their lines of communication open with their defense attorneys in any attempt to control litigation costs. “[D]etailed and candid communication can lessen the tensions” created by audits.¹⁷³ Attorneys most commonly suggest increased communication as a means to improve the relationship between insurance companies and defense counsel.¹⁷⁴ When an insurance company consciously increases communication with its defense attorneys, after having alienated them for years as a result of the auditing process, the company’s defense attorneys will express that the quality of the relationship has improved, even if only slightly.¹⁷⁵

3. *Involve the Defense Counsel in the Process.*—Increasing communication will allow the outside counsel to feel as though they are involved in the auditing process. To further improve the relationship, companies should take steps beyond simply increasing communication; they should actually involve their defense counsel in the auditing process from the outset.¹⁷⁶ Companies should advise their outside counsel that their bills will be audited.¹⁷⁷ The attorneys should be advised of the techniques used by the auditors and the goals of the audits.¹⁷⁸ This sharing of information would present auditing as a “joint effort to achieve quality legal representation at [a] reasonable cost.”¹⁷⁹ The tone used by the carrier to communicate with its defense attorney will control how smoothly the audit will go.¹⁸⁰ If the insurer communicates to the attorney that the audits are not a personal attack and are intended to help litigate the case in the most efficient manner, the process will appear less threatening to the outside counsel. Furthermore, carriers should adopt the philosophy, and communicate it to their attorneys, that the insurance company assumes that the attorney is acting in good faith until proven otherwise.¹⁸¹ Such actions will reduce the attorneys’ impressions that the auditor is hired to criticize their work and

III.C.

172. Martin, *supra* note 2, at 356.

173. *Id.* at 363.

174. See Shartel, *supra* note 1, at 23.

175. See *id.*

176. See Ringel & Mirsky, *supra* note 39, at 641.

177. See *id.*

178. See *id.*

179. *Id.*

180. See Shartel, *supra* note 1, at 21.

181. See *id.*

professionally ambush them.¹⁸²

4. *Develop Legislation.*—Legislation would also be helpful in removing sources of tension between carriers and their outside counsel.¹⁸³ Fifteen years ago, a California court¹⁸⁴ held that insureds could select their own defense counsel.¹⁸⁵ In the aftermath of this decision, insurance companies complained that independent attorneys chosen by the insured and not under contract with insurance companies were charging rates in excess of the prevailing rates.¹⁸⁶ As a result, the California legislature enacted a statute to control the fees for which insurance companies are responsible when their insureds obtain independent counsel.¹⁸⁷ The statute provides that “[t]he insurer’s obligation to pay fees to the independent counsel . . . is limited to the rates which are actually paid . . . in the defense of similar actions in the community where the claim arose or is being defended.”¹⁸⁸

This same concept can be applied to situations in which the carrier selects and retains the defense counsel. States should enact legislation that sets a standard against which carriers can compare the fees their defense counsel has charged them. This would set a universal standard to which attorneys could consult to ensure their fees are within a reasonable amount. Attorneys would know in advance what fee they could bill for work performed for the insurance carrier. This would eliminate the need for arbitrary judgments in auditing regarding whether the fee charged for an activity was reasonable.¹⁸⁹

Although such statutes would help establish general fee guidelines attorneys and insurers could consult, it would not eliminate all disputes created by fee audits. Audits evaluate whether certain performed legal services were necessary or unnecessary. The suggested legislation could not control these disputes. Therefore, legislation controlling charges for defense activities is only a partial solution and would need to be combined with other reforms¹⁹⁰ in order to improve the strained relationship between many insurance companies and their outside counsel.

182. See Ringel & Mirsky, *supra* note 39, at 641.

183. See Shartel, *supra* note 1, at 22.

184. See *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc’y, Inc.*, 162 Cal. App. 3d 358 (1984).

185. See Paul M. Vance & Cindy T. Matherne, *Legal Ethics—Defense Counsel’s Responsibilities to Insured and Insurer*, 6 U.S.F. MAR. L.J. 157, 162 (1993).

186. See *id.*

187. See *id.* at 164-65.

188. CAL. CIV. CODE § 2860(c) (West 1999).

189. Measures would need to be taken to ensure that this standard would allow for some flexibility and would not be a statutory enactment of the cookie-cutter approach currently used by outside auditing firms. Standards would need to be developed that differentiate between cases based on complexity or that can be rebutted by showing that a particular charge was reasonable because of the complexity of the issue or task, even if it is higher than the universal standard.

190. See discussion *supra* Part IV.B.1-2.

CONCLUSION

Insurance companies, faced with regulated premium rates and increasing legal costs, view legal fee audits as a means to control litigation costs.¹⁹¹ Carriers, fearing that defense attorneys fraudulently bill, implemented a system of reviewing all attorney bills.¹⁹² This led to the development of an auditing industry, which has enabled insurance companies to outsource the audits instead of performing traditional in-house audits.¹⁹³

The insurance industry's employment of outside auditing firms has been successful in some aspects. It has led to the identification of some frequent and obvious billing abuses by outside counsel.¹⁹⁴ However, this practice has also raised ethical concerns for attorneys and has given rise to great animosity and tension between the insurance companies and their outside defense counsel.

The insurance industry must recognize the ethical issues raised by outsourcing fee audits. Sending legal bills to outside auditors may breach the attorney's duty of confidentiality. More importantly, the information released to the outside auditor may lose the protection of the attorney-client privilege.¹⁹⁵ As a result, plaintiffs' attorneys would be able to obtain the information contained in the legal bills through the discovery process, and it could be used to the detriment of the insured and the insurer at trial.¹⁹⁶ Additionally, to the extent that fee audits are an attempt to tell attorneys how to practice law, they interfere with attorneys' abilities to exercise independent professional judgment. Finally, an auditor who attempts to dictate how a case should be litigated and who makes decisions that should be controlled by an attorney may be engaging in the unauthorized practice of law.

The ethical issues are not the only concerns of which insurers need to be aware before they choose to employ outside auditing firms. Outside audits have created an adversarial relationship between the insurance companies and their outside defense counsel. As a result, many experienced attorneys have left the insurance defense industry.¹⁹⁷ The departure of experienced defense counsel has diminished the quality of representation available to insureds. Insurance companies are forced to replace these experienced attorneys with less experienced attorneys who may not be able to protect insurance companies' interests. The total financial and social costs of employing outside auditors far outweigh any minor financial benefit insurance companies may receive from their use.

It is not only possible, but also predictable, that some amount of overbilling

191. See Martin, *supra* note 2, at 355.

192. See Shartel, *supra* note 1, at 1.

193. See Brennan, *supra* note 6, at A1.

194. See Shartel, *supra* note 1, at 20.

195. See generally *United States v. Mass. Inst. of Tech.*, 129 F.3d 681 (1st Cir. 1997).

196. See *id.*

197. See generally Samborn, *supra* note 50.

will occur.¹⁹⁸ Faced with this truth, insurance companies need to take precautions to ensure that they only pay reasonable defense expenses. However, in their effort to do so, insurance companies need to take into account attorneys' perceptions of the process. Insurance carriers need to remember that strong relationships with talented and committed defense lawyers are a good long-term investment.¹⁹⁹

Legal fee auditing serves a desirable function in insurance defense. It can monitor and control legal costs by ensuring work is done efficiently and alert carriers to possible fraudulent billing. However, insurance carriers need to ensure that the process of auditing serves these important goals without damaging the attorney-carrier relationship. Audits need to be performed in a manner that allows outside counsel to benefit, without feeling their work is being attacked on a personal level. Changes need to be made to the auditing process before irreparable damage is done. Outside auditing firms that promise to cut the fat out of attorneys' bills instead chop into the very heart of the insurance defense bar, which has left insureds in a critical condition.

198. See Ricker, *supra* note 26, at 65.

199. See Martin, *supra* note 2, at 355.

