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LIABILITY INSURANCE CONFLICTS AND PROFESSIONAL RESPONSIBILITY

INTRODUCTION

*Tom Baker**

Few institutions are more intimately bound up with law and lawyers than liability insurance. Indeed, liability insurance has become such a significant a feature on the legal landscape that it is the rare tort defense (or plaintiffs') lawyer whose income does not depend on payments from liability insurance companies. As a result, the working life of the defense lawyer involves a continuously changing cast of cases and defendants played out against a backdrop of a more stable set of relationships with the insurance companies that pay the bills. Because the defendants will not always have the same interests as the liability insurance companies, these relationships present the lawyer with potentially conflicting responsibilities.

These potential conflicts are of consequence to law and lawyers not only because they shape the working lives of a large segment of the American bar, but also because they shape the conduct of tort litigation by both plaintiffs and defendants. Thus, it is with good reason that they have long concerned members of the tort defense bar, as well as specialists in the fields of insurance and professional responsibility. What distinguishes the current effort to think through these conflicts is the simultaneous participation of lawyers from each of these three groups. This unusual development results from ongoing efforts to draft a Restatement Governing Lawyers, and, regardless of what one thinks about the utility of Restatements themselves, it demonstrates the utility of the Restatement *process* as a means for mobilizing intellectual resources to address important, real-world legal problems.

The articles in this issue of the Connecticut Insurance Law Journal represent the latest thinking about the liability insurance issues brought to the surface in the Restatement process. The papers grew out of a joint meeting of the Insurance and Professional Responsibility Sections of the American Association of Law Schools held in January 1997. Organized by Professor Charles Silver and Dean Kent Syverud, the meeting had several purposes, each

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of which is further served by the publication of this issue of the Connecticut Insurance Law Journal.

The first purpose was to bring to the attention of insurance specialists the Restatement-engendered debate: to alert us that important insurance things were happening out there in the professional responsibility world. Now was the time, Professor Silver and Dean Syverud told us, to pay particular and careful attention to the knotty lawyer conflict issues that we have dutifully covered in our insurance courses, but rarely fully engaged.

The second purpose was to bring to the attention of professional responsibility specialists the perspectives of people who think and write primarily about insurance and, at the same time, to bring to the attention of insurance specialists the perspectives of people who think and write primarily about professional responsibility. Professor Silver and Dean Syverud began that effort in their 1995 Duke Law Review article, *The Professional Responsibilities of Insurance Defense Lawyers*. The joint meeting was their opportunity to show insurance specialists just how little the liability insurance contract figures in the traditional professional responsibility analysis and to show professional responsibility specialists why at least some other academic lawyers think the liability insurance contract should have a larger role.

The final purpose was to use the intellectual energy generated by these different perspectives to say something new and important about the relationships between insurance defense lawyers, liability insurance companies and insured tort defendants. The American Law Institute votes in May 1998 on the adoption of the Restatement Governing Lawyers. Whether formally adopted or not, the Restatement will lead lawyers, courts and bar associations to reexamine longstanding liability insurance relationships. If legal scholars are to provide any guidance in that process, now is the time to do so.

Following the completion of the papers and comments presented at the joint AALS meeting, the Insurance Law Center reconvened the authors of the principal papers together with a new set of commentators for a seminar held at the University of Connecticut School of Law in October 1997. Edited transcripts of the comments, as well as an address by Judge Robert E. Keeton from the seminar, appear following the articles and written comments.

The articles and comments in this, the first symposium issue of the Connecticut Insurance Law Journal set a very high standard for the Journal to follow. Whether the authors have succeeded in meeting all the goals that Professor Silver and Dean Syverud set out for us will be for the reader to determine. We at the Insurance Law Center are very pleased to be able to invite you to make that judgment.

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WHAT INSURANCE SCHOLARS SHOULD KNOW ABOUT PROFESSIONAL RESPONSIBILITY

*Thomas D. Morgan**

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INTRODUCTION

My assignment in this symposium is to help establish the terms of the debate currently underway about the professional responsibilities of insurance defense lawyers. I have views about the merits of many of the issues and some of them may slip into my comments, but I understand that others are assigned to join that debate directly. While complete objectivity is probably impossible, my job is to help to set the scene impartially.[1]

Part I of this paper will describe the ABA Model Rules of Professional Conduct[2] which are most relevant to the analysis of an insurance defense lawyer's responsibilities. Part II will then take up the debate of whether defense counsel retained by an insurance company to represent an insured represents one client or two and examine what difference, if any, the answer makes. Part III will look at how the ALI Restatement of the Law Governing Lawyers[3] has

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1. I have not obeyed the instruction I was given to limit my discussion to matters insurance scholars "don't know." I have no idea how one would determine what issues were within or outside that category, nor how an article so based would be made coherent or readable.

2. The Model Rules have been adopted, as least in significant part, in about two-thirds of U.S. jurisdictions and are commonly understood to state the general rule on most issues of legal ethics in this country. Use of the ABA Model Code of Professional Responsibility or Codes or Rules of most states as the baseline for analysis would not have changed the conclusions expressed herein. Whenever the text uses term "Rule," the reference is to an ABA Model Rule unless the text says otherwise.

3. The reference is to the American Law Institute's RESTATEMENT OF THE LAW (THIRD): THE LAW GOVERNING LAWYERS. The Chief Reporter for the project is Professor Charles Wolfram. Professor John Leubsdorf and I are the Associate Reporters. The final version of that

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addressed these issues and comment on whether anyone should find its approach troubling. Finally, Part IV discusses a recent ABA Opinion on a lawyer's duties when an insured objects to a settlement proposed by the plaintiff that is within policy limits, and uses that Opinion to tie together the earlier observations.

I. THE ETHICAL FRAMEWORK WITHIN WHICH INSURANCE DEFENSE IS CONDUCTED

The two most basic obligations of any lawyer, whether or not engaged by an insurance company, are those of competence (Rule 1.1) and diligence (Rule 1.3). Rule 1.1 says the lawyer must perform competently[4] and Rule 1.3 says the lawyer must zealously pursue the client's interest.[5] Neither describes how one determines who the client is,[6] but taken together, the rules describe the lawyer's duty to serve each client's interest loyally and well. And, even though the Model Rules strictly eschew any relevance to issues of professional malpractice, violation of the substance of Rules 1.1 and 1.3 is what underlies most lawyer malpractice actions.

Restatement is a year or two away, but the most recent published version is Proposed Final Draft No. 1 (1996). All references to the RESTATEMENT in this paper are to that Proposed Final Draft unless the text states otherwise.

4. Model Rules of Professional Conduct Rule 1.1 states: "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation." MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.1 (1983) [hereinafter MODEL RULES].

5. The black letter of Model Rules of Professional Conduct Rule 1.3 provides: "A lawyer shall act with reasonable diligence and promptness in representing a client." The Comment to Rule 1.3 explains: "A lawyer should act with . . . zeal in advocacy upon the client's behalf." *Id.* Rule 1.3.

6. Probably the best guidance on analysis of that issue is that provided in § 26 of the RESTATEMENT:

> A relationship of lawyer and client arises when:
> (1) a person manifests to a lawyer the person's intent that the lawyer provide legal services for the person: and either
> (a) the lawyer manifests to the person consent to do so; or
> (b) the lawyer fails to manifest lack of consent to do so, and the lawyer knows or reasonably should know that the person reasonably relies on the lawyer to provide the services; or
> (2) a tribunal with power to do so appoints the lawyer to provide the services.

RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 26 (Tentative Draft No. 5, 1992) [hereinafter RESTATEMENT].

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Rule 1.2 describes two more key obligations of every lawyer. Rule 1.2(a) requires the lawyer to let the client make final decisions about certain key matters in the representation. For example, the lawyer may not settle a civil case; that decision is for the client alone.[7] Rule 1.2(c), in turn, allows a client to limit the objectives of a representation.[8] In the case of a defendant in a civil case, that might well include deciding how important it is to resist the plaintiff when the costs of resistance would exceed the judgment the plaintiff might recover. Rule 1.4 reinforces the above obligations. It requires the lawyer to communicate with his or her client.[9] The lawyer must keep the client reasonably informed of the status and progress of the matter and give the client enough information to make decisions, especially those reserved to the client under Rule 1.2(a).[10]

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7. The relevant language of Rule 1.2(a) is: "A lawyer shall abide by a client's decisions concerning the objectives of representation . . . and shall consult with the client as to the means by which they are to be pursued. A lawyer shall abide by a client's decision whether to accept an offer of settlement of a matter." MODEL RULES, *supra* note 4, Rule 1.2(a).

8. Rule 1.2(c) states: "A lawyer may limit the objectives of the representation if the client consents after consultation." *Id.* Rule 1.2(c). The Comment to Rule 1.2 makes clear:

> The objectives or scope of services provided by a lawyer may be limited by agreement with the client or by the terms under which the lawyer's services are made available to the client. For example, a retainer may be for a specifically defined purpose. . . . When a lawyer has been retained by an insurer to represent an insured, the representation may be limited to matters related to the insurance coverage. . . .
>
> An agreement concerning the scope of representation must accord with the Rules of Professional Conduct and other law. Thus, the client may not be asked to agree to representation so limited in scope as to violate Rule 1.1, . . . or the right to settle litigation that the lawyer might wish to continue.

Id. at 1.2(c) cmt.

9. The text of Rule 1.4 provides:

> (a) A lawyer shall keep a client reasonably informed about the status of a matter and promptly comply with reasonable requests for information.
>
> (b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.

Id. Rule 1.4.

10. Two tangentially related rules should be mentioned here. Rule 1.5(b) requires a lawyer to communicate with the client about "the basis or rate of the fee . . . , preferably in writing, before or within a reasonable time after commencing the representation." *Id.* Rule 1.5(b). Thus, knowing who the client is may affect who is required to get this communication.

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Of course, another central obligation of a lawyer is that imposed by Rule 1.6(a): "[a] lawyer shall not reveal information relating to representation of a client unless the client consents after consultation, except for disclosures impliedly authorized in order to carry out the representation . . . ."[11] The Comment to the Rule makes clear that a lawyer may not assist a client's crime or fraud by silence, but even in such cases, the obligation of confidentiality means that the lawyer must withdraw in the face of client fraud rather than reveal the fraud directly.[12]

The point of the above rules, then, is that lawyers owe significant duties to 'clients,' duties such as diligence, loyalty, confidentiality, and faithfulness to client objectives. Those duties, in turn, are what makes Rule 1.7—the prohibition against conflicts of interest—so significant. Rule 1.7(b) provides:

> A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:
>
> (1) the lawyer reasonably believes the representation will not be adversely affected; and
>
> (2) the client consents after consultation . . . .[13]

Similarly, Rule 2.1 states: "In representing a client, a lawyer shall exercise independent professional judgment and render candid advice." *Id.* Rule 2.1. Interestingly, the Rule does not expressly state the advice is to be rendered only to the client.

11. The exceptions in Rule 1.6(b) permitting disclosure to prevent "imminent death or substantial bodily harm" are not often relevant in insurance cases. On the other hand, insurance lawyers might sometimes invoke the exception in Rule 1.6(b)(2) permitting disclosure "to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, . . . or to respond to allegations in any proceeding concerning the lawyer's representation of the client." *Id.* Rule 1.6(b)(2).

12. The Comment to Rule 1.6 provides: "If the lawyer's services will be used by the client in materially furthering a course of criminal or fraudulent conduct, the lawyer must withdraw, as stated in Rule 1.16(a)(1)." *Id.* Rule 1.16(a)(1) cmt. The Comment to Rule 1.2 also expressly so provides. *See id.* Rule 1.2 cmt. On the duties to the former client after the lawyer withdraws, see Rule 1.9. *See also* RESTATEMENT *supra* note 6, § 117A (allowing direct revelation to prevent "substantial financial loss" to do a client fraud in which "the lawyer services were or are being [unwittingly] employed").

13. Rule 1.7(a), prohibiting representation that is "directly adverse" to a client is relevant to insurance defense lawyers if they sometimes take plaintiffs' cases and find themselves suing someone insured by the company that has retained them to represent its insured in another matter. *Cf.* Gray v. Commercial Union Ins. Co., 468 A.2d 721 (N.J. Super. Ct. App. Div. 1983) (lawyer may not sue insurance company directly on behalf of another client because it is a client in other matters). Because the Rule 1.7(a) issue has not seemed to be of major interest in the

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Clearly, Rule 1.7(b) applies whether or not the insurance company is said to be a co-client with its insured or a third party paying the lawyer's bill. If one adopts the insurer-as-third-party-payer view, however, Rule 1.8(f) applies as well:

> (f) A lawyer shall not accept compensation for representing a client from one other than the client unless:
>
> (1) the client consents after consultation;
>
> (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and
>
> (3) information relating to representation of a client is protected as required by rule 1.6.[14]

Finally, the practice of using lawyers employed on the staff of an insurance company to represent insureds implicates Rule 5.5(b).[15] While cases vary on the point, using staff lawyers instead of retaining lawyers on a case-by-case basis has sometimes been called a violation of the traditional prohibition against a corporation's practicing law.[16] If the insurance company were

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debate whether the insurance company is a "client" of the lawyers it retains to defend insureds, I will not mention it further.

14. The Comment to Rule 1.8 explains: "Rule 1.8(f) requires disclosure of the fact that the lawyer's services are being paid for by a third party. Such an arrangement must also conform to the requirements of Rule 1.6 concerning confidentiality and Rule 1.7 concerning conflict of interest." MODEL RULES, *supra* note 4, Rule 1.8 cmt. The Comment probably should also have cross-referenced Rule 5.4(c): "A lawyer shall not permit a person who . . . employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services." *Id.* Rule 5.4(c).

15. Rule 5.5 provides: "A lawyer shall not . . . (b) assist a person who is not a member of the bar in the performance of activity that constitutes the unauthorized practice of law." *Id.* Rule 5.5. In addition, Rule 5.4(a) states that "A lawyer or law firm shall not share legal fees with a nonlawyer . . ." and Rule 5.4(d) provides: "A lawyer shall not practice in the form of a[n] . . . association authorized to practice law for a profit, if: (1) a nonlawyer owns any interest therein . . . ." *Id.* at 5.4(d).

16. *See, e.g.*, American Ins. Ass'n v. Kentucky Bar Ass'n, 917 S.W.2d 568 (Ky. 1996); Gardner v. North Carolina State Bar, 341 S.E.2d 517 (N.C. 1986) (prohibiting the use of staff attorneys). However, cases finding no impropriety include In re Petition of Youngblood, 895 S.W.2d 322 (Tenn. 1995), and In re Allstate Ins. Co., 722 S.W.2d 947 (Mo. 1987). ABA Code of Professional Responsibility DR 2-103(D) seemed to approve the practice, saying that a lawyer may be "recommended, employed or paid" by a profit-making entity to represent a client

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considered a co-client of the insured, the staff lawyers would be representing their own employer and arguably the objection would not be heard when the lawyers also represented insureds.

II. THE ONE-CLIENT, TWO-CLIENT ISSUE

Whether a lawyer retained to represent an insured has one client or two has been at least a theoretical dispute for many years.[17] Calling the relationship between insurer, insured and lawyer "triangular" has become a way to try to avoid an either-or choice.[18] Recently, however, the two-client view has been pressed in a series of increasingly shrill articles.[19] In this portion of the paper, we ask why anyone cares which characterization is applied.

Part I of this paper showed how important it is to be called a lawyer's "client." A client may complain about a lawyer's lack of competence and even sue the lawyer for malpractice. A client may define the objectives of a representation, decide when to settle a case, and is entitled to be kept informed by the lawyer. A client is entitled to have information kept confidential.

If the insured is considered to be the lawyer's client but the insurance company is said to be a non-client, the company may find itself frustrated. An insurance company paying a lawyer's bill will want to know how the defense is going. Further, companies typically have reserved the right under their policies to settle cases within policy limits; they would also like the freedom to decide how much spending on a defense is cost-effective. A non-client insurer is arguably little more than a stranger with no such rights at all. In addition, if a lawyer is careless or incompetent, the loss will fall on the

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if "such organization bears ultimate liability of its . . . beneficiary." MODEL CODE OF PROFESSIONAL RESPONSIBILITY D.R. 2-103(D) (1983).

17. *See, e.g.*, THOMAS D. MORGAN & RONALD D. ROTUNDA, PROBLEMS AND MATERIALS ON PROFESSIONAL RESPONSIBILITY, Problem 13 (6th ed. 1995). *See also,* Charles Silver & Kent Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 DUKE L.J. 255 (1995).

18. *See, e.g.*, Geoffrey C. Hazard, Jr., *Triangular Lawyer Relationships: An Exploratory Analysis*, 1 GEO. J. LEGAL ETHICS 15 (1987).

19. *See e.g.*, Charles Silver, *Does Insurance Defense Counsel Represent the Company or the Insured?*, 72 TEX. L. REV. 1583 (1994); Charles Silver & Michael Sean Quinn, *Wrong Turns on the Three Way Street: Dispelling Nonsense About Insurance Defense Lawyers*, 5 COVERAGE 1 (Nov./Dec. 1995); Charles Silver & Michael Sean Quinn, *Are Liability Carriers Second-Class Clients? No, But They May Be Soon—A Call to Arms Against the Restatement (Third) of the Law Governing Lawyers*, 6 COVERAGE 21 (Mar./Apr. 1996); Ronald E. Mallen, *Legal Experts' Proposal Threatens Insurance Defense Agreements*, 11 WASHINGTON LEGAL FOUND. LEGAL BACKGROUNDER, Apr. 26, 1996, at 1, 1. For a more mature, reflective account of these issues, see Thomas D. Morgan & Charles W. Wolfram, *Insurance Defense Lawyers and the Restatement: A Reply to Professors Silver and Quinn*, 6 COVERAGE 8 (Jan./Feb. 1996).

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insurance company and it would like the right to sue for malpractice. Finally, the cost and quality control possible in the use of employed staff lawyers to represent insureds is not something insurance companies are likely to forego willingly.

Even proponents of the one-client view have to concede that thinking of the insurance carrier as a second client of the lawyer might help solve some of these practical problems. An insurer clearly should have a right to know what is going on in the case, for example, as a client would. However, client status may not be required to accomplish this. Rule 1.6, quoted above, already authorizes "disclosures that are impliedly authorized in order to carry out the representation."[20] Disclosures to an insurance company about the status of a case seem to fit within that category, and a provision in the insurance policy itself granting the company a right to receive such reports—or a request for such authority in the lawyer's initial letter to the insured—could resolve any remaining doubt.

Similarly, insurance companies should have a right to sue for malpractice where they bear the loss from a lawyer's negligence. Client status would seem sufficient to give them that right but is not necessary to do so. Traditionally, only clients could sue for malpractice, but times are changing. Now, persons intended to be benefited by the lawyer's work can often sue the lawyer, for example.[21] Some courts have also been willing to use other theories such as "equitable subrogation" to allow a carrier to sue for malpractice in handling the insured's case.[22]

Likewise, my own view is that concerns about the "corporate practice of law" are the wrong way to approach the question whether an insurance company's staff lawyers should be permitted to defend policyholders. One might be concerned that staff lawyers would be insufficiently loyal to the interest of the insured, for example, but whether the company is denominated a co-client in the matter has little to do with how one would reasonably approach that question.

Indeed, calling the insurance carrier a second client would carry with it few of the benefits its proponents imagine and hope, and it would routinely create

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20. *See, e.g.,* Goldberg v. American Home Assurance Co., 439 N.Y.S.2d 2 (N.Y. App. Div. 1981) (upholding sending status reports). *But see,* American Mut. Liab. Ins. Co. v. Superior Court, 113 Cal. Rptr. 561 (Cal. Ct. App. 1974) (not all confidential information of insurer and insured can be shared with the other).

21. *See, e.g.,* Unigard Ins. Group v. O'Flaherty & Belgium, 45 Cal. Rptr. 2d 565 (Cal. Ct. App. 1995) (lawyer owes independent duty of care to the insurer). The Restatement will reach the same result in § 73 that is making its way through the approval process.

22. Atlanta Int'l Ins. Co. v. Bell, 475 N.W.2d 294 (Mich. 1991) (equitable subrogation theory).

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the potential for conflicts of interest. In easy cases settled quickly within policy limits, the conflicts would not be serious but adding a second client to a representation always at least increases potential problems.

Imagine a suit claiming $100,000 where policy limits are $25,000, for example. The case might settle within policy limits, but then again, it might not. In the meantime, the lawyer faces a conflict of interests. The insurance company paying for the defense would like to keep its costs down, for example, because its exposure is at most $25,000.[23] The insured, on the other hand, may have his or her entire net worth on the line and want the best defense possible, especially because the insurer is paying the bill.

Similar issues arise when the insurance company believes it may be able to assert a policy defense. If the evidence comes in one way, the jury will say the wrong was negligent and the insurer will have a duty to pay the claim. A little different light on the evidence, however, might result in a finding of an intentional wrong, indemnity for which might be excluded from the policy. The defense lawyer can often affect which result is reached, and calling the insurance company a co-client in such a case makes the problem no less complex, and probably more so.

Both kinds of potential conflicts render chimerical the perceived benefits of the two-client approach in permitting insurance carriers to control the defense and settlement of cases. If the insured is the only client and no actual conflicts are present, control of defense and settlement can be delegated by the insured to the insurance company exactly as the typical policy provides. If there is a conflict, calling the company a co-client does not change things for the better. One co-client cannot direct a lawyer to benefit itself over the other co-client.[24]

Similarly, one objective of the two-client approach seems to be to render the insured and insurer co-clients for purposes of the rule permitting sharing confidential information. However, the cases recognize that it isn't that easy. While a lawyer cannot stand by and watch an insured commit insurance fraud, the insured is entitled to have confidential information developed by the lawyer

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23. Actually, the exposure may be greater because of the law of bad faith refusal to settle. *See, e.g.,* Hecke v. Iowa Home Mut. Cas. Co., 97 N.W.2d 168 (Iowa 1959). *Cf.* Lysick v. Walcom, 65 Cal. Rptr. 406 (Cal. Ct. App. 1968) (lawyer assessed damages for refusal to settle). I assume that concept will be addressed in Professor Syverud's paper in this symposium, so I will say no more here. *See* Kent D. Syverud, *What Professional Responsibility Scholars Should Know About Insurance*, 4 CONN. INS. L.J. 27 (1997).

24. On the insurance company's obligation to see that the insured has independent counsel, *see, e.g.,* San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y, 208 Cal. Rptr. 494 (Cal. Ct. App. 1984). Again, I will leave discussion of that obligation to Professor Syverud's paper.

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during the course of representation kept confidential, even from—perhaps especially from—the insurance company.[25]

Further, the problems of getting the insured's consent both to have the lawyer represent the insured and to have the insurer pay the bill is not reduced by calling the insured a co-client. Whether a co-client or not, the insurance company is paying the insured's legal bill. Nothing in Rule 1.8(f) says that it does not apply when the insurer and insured are both the lawyer's clients.

Finally, if the insurer and insured are both clients and a conflict later does arise, Rule 1.9 would prohibit the lawyer from representing *either* the insurer or the insured when continuing to represent the insured would clearly be the most sensible course. The insurer could consent to the continued representation, of course, but consent can solve the problems whatever the underlying theory. In the battle between the one-client and two-client views, the requirements of Rule 1.9 clearly make one-client the preferable view.

I promised at the outset of this paper to try to be objective and some will say this section breaks that promise. I disagree. The point of this section is not that there is anything wrong with a retainer arrangement that makes the insurance company and insured co-clients of the lawyer. The point is simply that in most cases there will be no material difference in result depending on which characterization is chosen and that, more often than not, the one-client approach gives all parties better guidance on how to handle concrete issues as they arise in a case.

III. THE PROPOSED APPROACH IN *RESTATEMENT* § 215

I can say with authority that the drafters of Restatement § 215 did not see themselves doing something revolutionary when they put the Section forth. Rather, they saw themselves as dealing with a concrete set of practical problems and a need for a helpful framework within which to address them.

Section 215 in fact deals with more than the insurance situation. It deals with any situation in which one person proposed to pay another's legal bills and provides:

> (1) A lawyer may not represent a client under circumstances in which someone other than the client will wholly or partly compensate the lawyer for the representation, unless the client consents . . . with knowledge of the circumstances and conditions of the payment.

25. *See, e.g.*, Parsons v. Continental Nat'l Am. Group, 550 P.2d 94 (Ariz. 1976).

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> (2) A lawyer's professional conduct on behalf of a client may be directed by someone other than the client when:
>
> (a) the direction is reasonable in scope and character, such as by reflecting obligations borne by the person directing the lawyer; and
>
> (b) the client consents to the direction . . .[26]

Comment *f* applies these principles specifically to a lawyer paid by an insurance company to represent an insured and provides:

> A lawyer might be designated by an insurer to represent the insured under a liability insurance policy in which the insurer undertakes to indemnify the insured and to provide a defense. The lawyer represents the insured. The insurer is not, simply by the fact that it designates the lawyer, a client of the lawyer. Whether a client-lawyer relationship also exists between the lawyer and the insurer is determined under § 26. Whether or not such a relationship exists, communications between the lawyer and representatives of the insurer concerning such matters as progress reports, case evaluations, and settlement are communications with an agent of the client within the meaning of § 120. Similarly, because and to the extent that the insurer is directly concerned in the matter financially, the insurer has standing to assert a claim for appropriate relief from the lawyer for financial loss proximately caused by professional negligence or other wrongful act of the lawyer to the extent set forth in § [73][Chapter 4].
>
> The lawyer's acceptance of direction from the insurer is considered in Subsection (2) and Comment *d* hereto. The consent of the insured to direction of the lawyer by the insurer may be provided by a clause to that effect in the policy.

26. RESTATEMENT OF THE LAW GOVERNING LAWYERS, Council Draft No. 13, § 215 (1997).

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Illustration:

. . . . 4. Insurer, a liability insurance company, has issued a policy to Policyholder under which Insurer is to provide a defense and otherwise insure Policyholder against claims covered under the insurance policy. A suit filed against Policyholder alleges that Policyholder is liable for a covered act and for an amount within the policy's monetary limits. Pursuant to the policy's terms, Insurer designates Lawyer to defend Policyholder. Lawyer believes that doubling the number of depositions taken, at a cost of $5,000, would somewhat increase Policyholder's chances of prevailing and Lawyer so informs Insurer and Policyholder. If the insurance contract confers authority on Insurer to make such decisions about expense of defense, and Lawyer reasonably believes that the additional depositions can be forgone without violating the standard of care owed by Lawyer to Policyholder . . ., Lawyer may comply with Insurer's direction that taking [the additional] depositions would not be worth the cost.

Material divergence of interest might exist between a liability insurer and an insured, for example, when a claim in excess of policy limits is asserted against an insured with significantly exposed personal assets. If the lawyer knows or should be aware of such an excess claim, the lawyer may not prefer the interests of the insurer so as to put the insured at risk of excess liability. Similarly, when there is a question whether the claim against the insured is within the coverage of the policy, a lawyer designated to defend the insured may not reveal adverse confidential client information of the insured to the insurer concerning that question (see § 112) without explicit consent of the insured (see § 114). That follows whether or not the lawyer also represents the insurer as co-client and whether or not the insurer has asserted a "reservation of rights" with respect to its defense of the insured (compare § 112, Comment l (confidentiality in representation of co-clients in general)). . . .

With respect to events or information that create a conflict of interest between insured and insurer, the lawyer

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> must proceed in the best interests of the insured, consistent with the lawyer's duty not to assist client fraud (see § [151] [Chapter 6A]) and, if applicable, consistent with the lawyer's duties to the insurer as co-client (see § 112, Comment *l*). The designated lawyer may be precluded by duties to the insurer from providing advice and other legal services to the insured concerning such matters as coverage under the policy, claims against other persons insured by the same insurer, and the advisability of asserting other claims against the insurer. In such instances, the lawyer must inform the insured of the limitation on the scope of the lawyer's services and the importance of obtaining assistance of other counsel with respect to such matters. Liability of the insurer with respect to such matters is regulated under statutory and common-law rules such as those governing bad-faith refusal to defend or settle. Those rules are beyond the scope of this Restatement.[27]

While others must make the ultimate judgment, I find it hard to find anything radical about the Restatement approach. First, it says that the lawyer represents at least the insured and may, by agreement, represent the insurer as well. Next, the lawyer may keep the insurance company informed under a theory that the company is an agent of the insured for the hiring and direction of counsel. Third, the insurer may bring suit against the lawyer for malpractice when it is the party injured by the malpractice.

The insurance company may direct the lawyer if the insurance contract so provides, unless and until there is a conflict of interest between insurer and insured. If such a conflict exists or arises, the lawyer may not prefer the insurance carrier's interest over that of the insured. Nor may the lawyer reveal confidential information of the insured to the insurance carrier in order to help it establish a policy defense. Other matters—for example, advice the lawyer may not provide to the insured about the insured's possible rights against the insurer—may require the lawyer to simply inform the insured that he or she needs other counsel.

I would have been willing to stand on the Section as written, but in response to the outcry from the insurance industry and its allies in the American Law Institute,[28] some of the changes proposed by the industry have been accepted by the Reporters.

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27. *Id.* § 215, cmt. f (1997).

28. *See, e.g.*, Jonathan Groner, *Insurance Lobby Aims at Normally Staid ALI*, XIX LEGAL TIMES OF WASHINGTON, June 10, 1996, at 1 ("[R]arely has this staid organization [the ALI] seen an orchestrated lobbying campaign like the one the insurance industry put on this year. . . . The

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First, the communications with the insurance company about the status of the case are said not to lose their character as privileged or work-product, a view consistent with the above-quoted treatment of the company as an agent of the insured. Second, the lawyer is said to owe a duty of care to the insurance company rather than it only being the case that an insurer has standing assert a malpractice claim. Third, in Illustration 4 quoted above, the lawyer would be said to be able to forego the depositions any time a judgment will not expose the insured to personal liability. Fourth, discussion of the right of the insured to get independent counsel if a coverage dispute arises is preserved but made shorter. Fifth, while the lawyer's obligation not to pass on confidential information of the insured relating to coverage to the insurance company is preserved, the question whether the usual rules relating to sharing information among co-clients are modified by principles of insurance law is expressly reserved. Finally, rights the insured might have against the insurer under insurance law, e.g., claims for bad faith refusal to settle, are said to be outside the scope of the Restatement.[29]

I believe I speak for all the Reporters in saying that even after all the hue and cry from the insurance industry, the proposed Section remains intact both in substance and spirit. We have welcomed constructive criticism and have responded to it, but at the end of the day, the proposal is legally sound and addresses the key issues. It should have been adopted in May, 1996, and it clearly should be adopted the next time it comes before the membership.[30]

IV. ABA FORMAL OPINION 96-403 (AUGUST 2, 1996)

The ABA Standing Committee on Ethics and Professional Responsibility recently addressed application of the Model Rules in its Formal Opinion 96-403: "Obligations of a Lawyer Representing an Insured Who Objects to a Proposed Settlement Within Policy Limits."[31] In doing so, it took a pragmatic approach much like that of the Restatement. The Opinion assumed that the insurance contract authorized the insurer to "control the defense and settlement

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insurers and their lawyers wrote position papers, identified their supporters in the grass roots, approached key decision makers through friends and colleagues, and even brought in a federal judge as an advocate to lend prestige and a sense of nonpartisanship to their efforts.").

29. Additional minor changes may also be proposed following circulation of the current proposals to a number of ALI members and other concerned persons and receipt of their comments.

30. It appears now that the ALI membership may not address the proposal until May 1998.

31. Citations in this paper will be to the pamphlet form of the opinion distributed by the ABA. The Opinion will be reprinted in the ABA/BNA LAWYERS' MANUAL OF PROFESSIONAL CONDUCT, § 1101:105, at 41.

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of the claim in its sole discretion without consultation with the insured,"[32] that such an offer was made and that the insurance company wanted to accept the offer.

The Opinion acknowledged that the Model Rules do not themselves describe how to determine the identity of the lawyer's client.[33] Recognizing without stating that the lawyer *must* represent *at least* the insured, the Opinion notes that courts have gone both ways on whether the lawyer represents *both* the insurer and insured and says that "nothing fundamental" turns on the characterization chosen.[34]

The Opinion notes that the Model Rules, not the insurance contract, "define the ethical responsibilities of the lawyer to his client."[35] At the outset of representation of the insured, pursuant to the requirements of Rule 1.2, "the lawyer must make appropriate disclosure sufficient to apprise the insured of the limited nature of his representation as well as the insurer's right to control the defense in accordance with the terms of the insurance contract."[36] The disclosure need not be elaborate. "A short letter clearly stating that the lawyer intends to proceed at the direction of the insurer in accordance with the terms of the insurance contract and what this means to the insured is sufficient to satisfy the requirements of Rule 1.2 in this context."[37] No oral communication, formal acceptance or written consent by the insured is required.[38]

When a settlement proposal within policy limits is received, the insurance company could presumably have a claims agent accept it without the insured or the lawyer's being involved at all.[39] However, if the insured does know of the proposed settlement and objects to it, "the insured retains the power to reject the defense offered by the insurer and to assume the risk and expense of his own defense."[40] Under Rule 1.9, the lawyer could not participate in settlement of the case on behalf of the insurer and over the objection of the

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32. *Id.*

33. "The Model Rules assume a client-lawyer relationship established in accordance with state law, and prescribe the ethical obligations of the lawyer that flow from that relationship." *Id.* at 42.

34. *See id.* Footnote 2 of the Opinion launches into an discussion of whether the insured might in some cases not be a client at all. The kindest thing to be said about the footnote is that it does not advance the analysis. Clearly, whoever is counsel of record in the case must represent the insured, whether or not he or she also represents the insurance company.

35. *Id.*

36. *Id.*

37. *Id.* at 43.

38. *See id.* Indeed, taking the opinion literally, it appears that there need not even be proof that the insured received the letter.

39. *See id.* at 44.

40. *Id.* (citing Model Rule 1.16).

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insured who is by then his former client.[41] Because the insured has this right to reject the settlement and assume the defense himself, the Opinion says, a lawyer who knows that the insured objects to the settlement must give the insured the opportunity to go his own way.[42]

My own view is that the principal significance of the ABA Opinion is how largely unremarkable it is. Prepared in the midst of the firestorm of criticism of the ALI proposal, one might have expected the ABA Committee to be under pressure to change the law. It did not do so.[43] While the expression of the governing principles has varied somewhat from case to case, the underlying principles have not changed. An insurance company has a legitimate interest in important aspects of cases involving its insureds that both the Restatement and the ABA Opinion acknowledge and respect. When thinking about the tripartite relationship between the insured, insurance company and lawyer, however, the lawyer who acts as if only the insured has the status of client will be least likely to go wrong.

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41. *See id.*

42. *See id.*

43. The hurry to get the Opinion out helps explain some of its less well thought out positions. The Opinion repeatedly speaks of a lawyer's representation of an insured as being "limited," without explaining exactly what those limitations are. Surely the ABA Committee is not suggesting there are limitations on the duty of loyalty or duty of zeal, for example.

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WHAT PROFESSIONAL RESPONSIBILITY SCHOLARS SHOULD KNOW ABOUT INSURANCE

*Kent D. Syverud**

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INTRODUCTION

A decade ago when I was in practice, my law firm represented Ted Bundy, a notorious mass murderer, in the habeas corpus proceedings challenging his convictions in state and federal court. It was a surreal experience for James E. Coleman, Jr., a partner at the firm, who is now on the Duke Law School faculty. He would constantly discover that normal rules of civil and appellate process were suspended because of the extreme

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horror of Ted Bundy's crimes. At one point, a federal judge denied a first petition based on evidentiary error in the trial court, even though the state court record had not yet been delivered. The implicit ruling seemed to be: "I don't need to look at any record, this is Ted Bundy." Lawyers at the firm started calling this the "Ted Bundy rule."[1] Our label meant that all rules of civil and appellate process could be warped or suspended if the client is vile enough, like Ted Bundy.

There have been times in the past two years, when, in discussion of proposed Section 215 of the Restatement of the Law Governing Lawyers[2] and professional responsibility law, it has felt a bit like the "Ted Bundy" rule again. Section 215 governs situations where a representation of a client by a lawyer is directed by someone other than the client; its applicability to liability insurance companies, who defend and settle most tort claims against defendants in the United States, is hotly contested.[3] The implicit rule at times seems to be that all rules of agency and professional responsibility will be warped or suspended because, after all, the complaining party is so vile. That party is, after all, an insurance company.

My concern over the Restatement of the Law Governing Lawyers, as it turns out, appears to have been exaggerated. Reason and process in the American Law Institute have prevailed despite a lot of heat and less light from the debate over Section 215, just as they ultimately did in Bundy's appeals. I support the current draft of the Restatement. Nevertheless, I have learned a lot about how many professional responsibility scholars look at insurance since 1995, when I last wrote on this subject.[4]

One thing I now understand is that for many professional responsibility scholars, insurance companies are the moral equivalent of Ted Bundy—knowingly ruining their insureds' lives, through conflicted counsel, at the very moment when insureds are most vulnerable because they have been sued. Professional responsibility scholars see insurance companies through the lens of classic professional responsibility cases involving insurers, and they are Bundy-like cases—cases where a liability insurance company cravenly puts its own interest in a trial above the insured's interest in a settlement, or where a company employed the lawyer

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1. *See* James E. Coleman, Jr., *Litigating at the Speed of Light: Postconviction Proceedings Under a Death Warrant*, 16 LITIG. 14 (Summer 1990).

2. *See* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 215 & cmt. c, d & f (Preliminary Draft No. 13, Aug. 11, 1997).

3. *See* Charles Silver & Kent Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 DUKE L.J. 255 (1995).

4. *See id.*

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defending a tort action to prepare a coverage defense against the insured.[5] And let's face it, there are companies among the 3500 American insurers whose behavior and reputation indeed sometimes resembles Bundy.

But just as I tremble for rules of civil and appellate process when they are designed on the assumption that all appellants are evil like Ted Bundy, I fear for professional responsibility rules designed on the assumption that all insurers are as evil as those in the extreme cases that feature in professional responsibility casebooks. The problem, I believe, arises from the two different world views of those who work in professional responsibility and those who work in insurance.

I. TWO WORLD VIEWS

In designing rules of professional responsibility and insurance law, it is vital that scholars understand the very different world views that each field tends to bring to bear on the relations between liability insurance companies, insured defendants, and defense counsel. Having now watched these two world views collide, I can vouch for four fundamental differences between them.

First, insurance looks at groups, at the socialization of risk through standard contracts sold to large numbers of similarly situated persons who face an uncertain risk. What is good for the group, as a whole, in face of uncertainty, may not be what is good for any individual when sued. Professional responsibility law looks at the individual insured, the client, and elevates (some would say enshrines) that client's goals as the uncompromisable absolute.

Second, insurance law focuses primarily on the bargain struck at the time a liability insurance policy is purchased—the deal agreed to by the insured before he or she knows whether the risk insured against will become the reality of a lawsuit. Professional responsibility law focuses on a different and later bargain—one struck when a suit is filed and the relationship between a particular lawyer and a particular client comes into existence. This difference in timing is everything, because an insured might want to strike very different bargains at those two different stages.

Third, insurance law has to take into account the economics of liability insurance—and in particular the effect of economics of liability insurance defense arrangements on (a) the cost and frequency of defending and indemnifying liability claims, which in turn affects (b) the cost and

5. *See, e.g.*, Crisci v. Security Ins. Co., 426 P.2d 173 (Cal. 1967); Parsons v. Continental Nat'l Am. Group, 550 P.2d 94 (Ariz. 1976).

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competitiveness of liability insurance against other competing ways to manage risk. Professional responsibility law is largely animated, as Professor Stephen Pepper argues, by a desire to protect clients from markets—to assure that insurance companies will provide insurers a lawyer and a type of defense that markets might otherwise not produce.[6]

Finally, much of professional responsibility law focuses on how to keep an agent's conduct "correct" in some sense—on how to make defense counsel behave appropriately in following the needs or desires of the insured. From an insurance law perspective, a "correctly behaving agent" who always defers to the wishes of the insured may well seriously undercut the focus of liability insurance—which is how to keep that product economically viable.

I doubt any scholar really has one extreme world view. In designing professional responsibility and insurance law rules, we must pay attention to both world views. The issue raised by the struggle over Section 215 is how to prevent one world view from mangling liability insurance (on the one hand) or the lawyer as a professional (on the other).

In this essay, I focus on the threat to liability insurance from the world view of the unadulterated professional responsibility scholar. In doing so, I don't mean to question for a moment that there is a threat to the role of a professional lawyer from the world view of insurance law. I trust my able co-contributors to this symposium, including most notably Professor Thomas Morgan, will demonstrate where insurance law must bend; I will focus on where professional responsibility law must acknowledge insurance realities.

II. WHAT PROFESSIONAL LIABILITY SCHOLARS SHOULD KNOW ABOUT LIABILITY INSURANCE.

There are six propositions about liability insurance that, I believe, are important and underappreciated by professional responsibility scholars.

A. Liability Insurance is not Inevitable.

By this I mean it is wrong to assume that, no matter how one defines the professional obligations of lawyers who handle claims against insureds, liability insurance will continue to exist, as currently structured, universally standing ready to fund litigation and provide and pay lawyers.

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6. *See* Stephen L. Pepper, *Applying the Fundamentals of Lawyers' Ethics to Insurance Defense Practice*, 4 CONN. INS. L.J. 27 (1997).

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Liability insurance is in reality a fragile product, a relatively new one[7] (not much older than the automobile), involving a very delicate merging of a duty to indemnify with a duty *and a right* to defend. Through professional responsibility law one can tinker with the design of that product, and to some degree one should. But one can also render it obsolete—and one can cause large portions of the market for traditional liability insurance to disappear in favor of no insurance, self-insurance, or other arrangements.

B. Tying a Duty to Indemnify to a Right to Control Defense is Not Economically Irrational.

There are good economic reasons for tying a *right* to control defense of a liability claim to a duty to indemnify that claim. Insurers who are obligated to pay a claim often have the strongest, and sometimes the only, economic interest in how that claim is defended. Unless they control that defense—which they are paying for—and control it in only the ways *clients* can control lawyers under professional responsibility law, that interest may not be adequately represented.

Tying a duty to indemnify to control over defense may minimize the cost of claims, and thereby the cost of liability insurance. Liability insurers have the experience to manage lawyers and the financial incentives to do so on behalf of all insureds in a way an individual insured, concerned only with one particular claim, may not.

Moreover, the individual insured who is actually sued may have interests at that stage that are positively inimical to both the goals of claims cost minimization and the interests of all insureds. The most prominent examples of this is intrafamilial tort claims of which *Montanez v. Irizarry-Rodriguez*, [8] is an excellent illustration. In *Montanez*, a wife sued her husband for negligence when she was injured in an automobile accident while he was driving. At the time of trial (as distinguished from the time he bought insurance) it was in the defendant's interest to lose as big a judgment as possible.

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7. The first sale of a policy of liability insurance in the United States occurred in 1886. *See* Mary C. McNeely, *The Geneology of Liability Insurance Law*, 7 U. PITT. L. REV. 169, 191 (1941).

8. 641 A.2d 1079 (N.J. Super. Ct. App. Div. 1994).

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C. It is Not Inevitable that Defense Lawyers Must Represent Insureds in Both Defense and Settlement of Claims.

The role currently employed by defense lawyers in handling liability claims is broader now than it has ever been. Professional responsibility rules could cause that role to be narrowed in the future.

It is a *recent* development, in the last three decades, to have defense counsel involved intimately in the investigation, negotiation, and settlement of most tort claims. It happened because of the access of injured victims to counsel, and a natural tendency of insurers to want a professional lawyer to handle all aspects of a claim when the claimant is represented by counsel.

But it doesn't have to be that way. For the first seventy years of American liability insurance, non-lawyer claims adjusters carried out virtually all the obligations of investigation negotiation and settlement that defense counsel now routinely perform.[9] Unless one is willing to assert that today it is malpractice (or bad faith) for a non-lawyer claims adjuster to handle a settlement of a tort claim against an insured, it remains feasible for liability insurance companies to take this responsibility away from defense counsel and thus away from the scope of regulation of professional responsibility rules.

There is thus a serious risk from putting obligations on defense counsel to favor the insured's interests over that of the insurance company. That risk is that lawyers just won't be used in the investigation, negotiation, or settlement of claims when there is a potential conflict of interest between the company and the insured.

D. Over the Past Decades, Standard Liability Insurance Arrangements Have Worked Well in the Vast Majority of Cases.

In most cases liability insurance has worked well for both the insured and the company. The policies have provided an ethical lawyer to defend the insured and have minimized claims costs. Intractable conflicts between insured and company have rarely developed, even though the insurance company largely calls the shots in the defense of claims. Thus, I believe that it is unusual for liability limits to be a serious concern in more than 5% of claims, and coverage disputes are the exception, not the rule, even

9. *See* LAURENCE ROSS, SETTLED OUT OF COURT 24 (1970).

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though they are the universe of practice for many insurance lawyers.[10] Moreover, and here I admittedly rely on my own perhaps biased experience, most counsel do not mindlessly pursue the company's interest with reckless disregard for the insured's concerns.

E. Where Conflicts Do Arise Between Insurance Company and Insured Over the Defense and Settlement of a Liability Claim, the Insured is Not Always in the Right, and the Company is not Always the One Taking Advantage.

This really is a situation where *both* parties have stakes in the outcome and either one can use unbridled control over the defense to abuse the other. And that abuse will occur both ways.

When an insured defendant and his or her insurance company disagree about how to handle the litigation surrounding a tort claim, it is tempting to lay the blame upon the insurance company. The insurance company has the power, the money, the knowledge of litigation, and the defense lawyer's respect or fear. The insured defendant is vulnerable, under stress of suit, and inexperienced at litigation. To many professional responsibility scholars, the situation cries out for a presumption—perhaps even an irrebutable one—that the insured defendant is the client whose preferences in the conduct of the litigation must always prevail over the insurance company. If insurance companies are the moral equivalent of Ted Bundy—and there are surely more than one or two bad faith cases where that moral equivalence is plausible to me—such a presumption, enshrined in the professional responsibility law, seems attractive.

The problem is that insurance companies have no monopoly on evil, and that malignant self-interest can be just as troubling when exercised by insureds. Both insurance companies and insureds have important and meaningful stakes in the outcome a lawsuit against the insureds, stakes that include not just the money that the insurance company must pay in defense and settlement, but also the uninsured liabilities of the insured, which include not just any judgment in excess of liability limits, but also the insured's reputation and other non-economic stakes.[11] The history of liability insurance suggests that unbridled control of the defense of litigation by either the insurance company or the insured creates incentives for the party exercising that control to take advantage of the other. Just as an insurance company may abuse control by coercing an insured to

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10. *See* Samuel Gross & Kent Syverud, *Don't Try: Civil Jury Verdicts in a System Geared to Settlement*, 44 UCLA L. REV. 1 (1996).

11. *See* Kent Syverud, *The Duty to Settle*, 76 VA. L. REV. 1113, 1126 (1990).

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contribute to a settlement within policy limits,[12] an insured may abuse control by conspiring to increase the judgment (and sharing the increase with the plaintiff).[13] Even if control is left just to the defense counsel (rather than to the insured or the insurer), that lawyer may abuse control by driving up defense costs.[14]

F. There are Hidden Costs to a Professional Responsibility Regime Designed on the Assumption that Insurance Companies are the Moral Equivalent of Ted Bundy.

Professional responsibility law could be designed to protect against the over-reaching insurance company. One way to do so would be to define the insurance company as a non-client in all liability insurance representations—to hold that the company's interests in the defense and settlement of a lawsuit are always to be subordinated to the insured defendant's interest when a dispute arises. Such a view, at its extreme, would suggest that the insurance company which tries to control the defense in litigation over the objections of the insured is acting in ways inimical to professional lawyering.

There are hidden costs to this view. They are serious. They include: causing conflicts between attorney and client that would not otherwise exist (for example, giving a plaintiff's lawyer an incentive to make settlement offers at policy limits, thereby "setting up" potential bad faith liability should a subsequent judgment exceed the limits);[15] creating incentives for insurance companies not to use lawyers in many aspects of the defense of liability claims; encouraging insurers to find ways to decouple the indemnity obligation from the defense obligation, as is increasingly done in policies with huge deductibles (deductibles which may be deeply regretted by insureds); and inspiring both insurance companies and insureds to manage liability risks through methods other than traditional liability insurance policies (such as self-insurance, risk retention pools, undercapitalized independent suppliers, etc.). These possibilities may increase the cost of liability insurance, reduce its availability, and increase the chance that defense lawyers will lose business and victims will go uncompensated.

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12. *See id.* at 1150.

13. *See Montanez*, 641 A.2d at 1079.

14. *See* Peter Carbonara, *Fleecing Insurance Companies, California-Style*, AM. LAW., Apr. 1990, at 52.

15. *See* Syverud, *supra* note 11, at 1169-70.

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CONCLUSION

In conclusion, I must again emphasize that this essay only addressed one half of a difficult conundrum. Just as professional responsibility law can warp insurance arrangements to the detriment of both insurance companies and insureds, insurance law can fail to take into account the important concerns of those who regulate the attorney-client relationship. I agree that insurance scholars must understand professional responsibility law better, just as professional responsibility scholars need to know more about insurance. Nevertheless, it remains that the most likely casualty of extreme reforms of professional liability law—and particularly extreme versions of Restatement Section 215—is the liability insurance contract as we know it, a contract that has served insureds well over many years and has made possible many of the underpinnings of our tort law regime. Just as I believe the way to address Ted Bundy's crimes is through the criminal law, not through creating special disabilities for him in the rules of appellate procedure, I believe the way to address a particular insurance company's abuse of an insured is through insurance law—and particularly through the law of bad faith—and not through disabling all insurance companies in their abilitiy to manage lawyers.

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APPLYING THE FUNDAMENTALS OF LAWYERS' ETHICS TO INSURANCE DEFENSE PRACTICE*

*Stephen L. Pepper***

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INTRODUCTION

They are old questions, but still difficult. When a lawyer is hired by an insurance company to represent an insured in a liability matter, who does the lawyer represent? The insured, the insurance company, or both? Does the lawyer have one client or two? These questions are really sub-issues of broader questions: How ought the lawyer in this situation behave? What

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** Professor, University of Denver College of Law; A.B. Stanford University, J.D. Yale Law School. Thanks to Charles Silver and Tom Baker for drawing me into this subject matter, to William Barker for his helpful and positive response to this article, and to the other participants at the Insurance Law Center symposium and the AALS joint section meeting for their helpful comments.

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are the lawyer's obligations to the insured and the insurer, and how do those obligations interact? In suggesting how we ought to begin framing answers to these questions, this article will elaborate two primary theses. (1) The one client model is ethically less problematic and more accurately models the underlying substance of the relationship among the three parties than does a two client model. (2) Although preferable, the one client model also involves genuine difficulties in aligning ethical obligation and underlying substance. This is the situation because the underlying insurance contract calls for a relationship alien to some fundamental principles of lawyers' ethics. Thus, neither the one client nor the two client model fits comfortably into our general understanding of lawyers' ethical obligations.

Part I of this article looks at the nature of the consent that the lawyer would have to obtain from the insured if there were in fact two clients, as argued by some, and as understood by many. Part II then turns to the underlying justification for professional ethics in general and considers what it suggests for insurance defense practice. Part III examines the basic substance of the transaction at issue and what it suggests for the ethics of the lawyer. Part IV turns to the limits of loyalty on the part of the lawyer and the difficulties involved in a "one client" understanding. Part V returns to the two client model to explore two rather different versions of that possibility. Throughout the background assumption is an unsophisticated insured, the ordinary owner of a non-business motor vehicle, for example, or the owner of a small business who rarely consults a lawyer. The insured is presumed to have little legal or business knowledge and relatively little, if any, interaction with lawyers or insurance companies.[1]

I. JOINT CLIENTS AND MODEL RULE 1.7(B)

Recently, able champions arguing for the two client view have come forward. From the point of view of one who teaches lawyers' ethics regularly, however, their position appears remarkably insensitive to underlying principles and basic rules of lawyers' professional ethics. Professors Silver and Syverud argue that what comes first is the agreement

1. There is obviously a spectrum, here, rather than a bright line. What I intend to rule out is a corporation large enough to have in house counsel, or to consult with a lawyer on a regular, frequent and comfortable basis. Thus a solo physician, or one affiliated with a small enough practice to have relatively infrequent contact with legal counsel, falls closer to the unsophisticated side of this spectrum. Those for whom consultation with a lawyer is not unusual, or for whom the costs of extended legal assistance are not particularly difficult to bear or unexpected, fall toward the other side of the spectrum.

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between the insurance company and the lawyer it selects to defend the insured.[2] If the company and the lawyer agree that the lawyer represents the insurance company, he or she does.[3] That is the given, the premise from which they begin. If the lawyer also represents the insured, or comes to do so thereafter, we necessarily have a situation of joint clients, governed by the ordinary rules of such relationships, including the ordinary fall back rule of no confidentiality as between joint clients.[4] For these commentators the joint client situation comes first, the ethical restraints second.

What is neglected when the issue is approached from this sequence is that the *creation* of a joint client relationship requires informed consent from both clients, and it is difficult—perhaps impossible—to get such consent from the ordinary, unsophisticated insured under the circumstances imagined by Professors Silver and Syverud. What they minimize or elide—and what requires informed consent from the insured at the outset—is the simple background fact that there are obvious *potential* conflicts of interests between the two clients at the inception of the relationship.

At the least, the lawyer is being hired to represent the insured in litigation. The insured either is or will be the defendant; the lawyer will enter an appearance on the insured's behalf and will represent the insured in pre-trial matters and at trial. That is the primary fact of the relationship and the place at which analysis ought to begin. The insurance company is not ordinarily a party to such litigation, and the lawyer need not formally represent the company. For any lawyer with any experience in the area, and for most law students who have taken a professional responsibility course, the situation at the very outset, before any particular facts are known, involves clear potential conflicts of interest between the insurance company which has contracted to provide a defense and pay damages up to the limits of liability and the insured, to whom those contractual obligations have been made. The point is made succinctly in the Keeton & Widiss text on insurance law:

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2. *See* Charles Silver & Kent Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 DUKE L.J. 255, 275 (1995).

3. *See id.*

4. It should be noted that what Professors Silver and Syverud mean by a joint client status is quite different from the usual understanding of joint client status among those defense practitioners who operate under the belief that the insured and the company are joint clients. This far larger group understands the insured to be the "primary" client, whose interests must be served if a conflict arises. These two quite different models are discussed in Part V, *infra*. *See, e.g., infra* notes 110-14 and accompanying text.

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> There is a very substantial prospect that actual or potentially conflicting interests between an insurer and an insured will exist in regard to almost any tort claim that may be covered by liability insurance.[5]

They follow this statement with a list of fifteen specific areas where such conflict may arise.[6]

The situation is analogous to a lawyer putting together a corporation or partnership for several types of investors: the entrepreneur (the person with the idea), the passive investor, and the active manager of the venture. Although all have a common interest in the success of the venture, each has potential conflicting interests with the others in regard to structuring the business.[7] For example, the passive investor and the active manager may have quite different interests in regard to paying money out as salary, as dividends, or withholding it for business growth or risk. Similarly, if the business turns out not to be successful, or only modestly successful, each of the three may have quite different preferences in regard to initial decisions concerning business structure, articles of incorporation, and bylaws. Another surprisingly analogous potential conflict situation is that of the married couple who have worked out an agreement and seek an amicable divorce facilitated by one lawyer. If everything proceeds as contemplated, there may well be no conflict of interest requiring two lawyers. As with the business venture, however, there may be legal and factual issues the couple have not foreseen and do not yet understand which will create conflicts, or the mere process of the divorce may create them. (Many believe that in the divorce situation conflict is so likely that joint representation ought to be prohibited.)[8]

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5. ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW 809 (student ed. 1988). Professors Silver and Syverud do not disagree. They state early in their article: "Problems arise when the threat of an unknown future claim ripens into a specific lawsuit . . . . Disagreements may arise for at least four reasons." Silver & Syverud, *supra* note 2, at 266. These four general reasons are set out *infra* note 23.

6. KEETON & WIDISS, *supra* note 5, at 809-10.

7. For an overview of potential conflicts in corporation formation, see Note, *Simultaneous Representation: Transaction Resolution in the Adversary System*, 28 CASE W. RES. L. REV. 86, 94-116 (1977).

8. It is interesting that lawyers as a whole tend to take such a hard line on joint representation in the divorce context (requiring two lawyers and two fees and perhaps greater fees due to the increased adversity two lawyers make more likely), a situation where we have non-institutional, non-repeat player clients with relatively low resources. In the insurance defense situation, however, with a repeat player, institutional client paying the fees, a joint client, single lawyer, single fee status is considered acceptable and perhaps the norm. One

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Similarly, the lawyer for the insured does not yet know whether a conflict with the insurance company is likely to ensue, or is just a possibility, but she is aware that the two have quite different general interests in the matter.[9] The client may at a later date reveal to the lawyer that someone else—not the insured—was actually driving the car; or that the insured's conduct was intentional rather than negligent. (In the analogous divorce situation, one of the spouses may reveal hidden assets, or a secret intention to move far away with the children.) An offer of settlement may come which the insurer believes is too high, but the insured may have a strong preference for avoiding the time, irritations, and anxieties of trial and preparation. Or, as the case proceeds it may become apparent that there is exposure for punitive damages, or damages beyond the limits of the liability, thus creating a conflict situation if an offer to settle within the policy limits is made. Or the insured may have a simple and understandable humane preference that the plaintiff he has injured be paid compensation by the insurer, whether or not plaintiff and insured are related family members, friends, or strangers. (It is possible the insured believes she was too intoxicated to be driving, but the plaintiff will have a difficult time proving it, or proving other negligence. Perhaps the insured feels he ought to volunteer the facts suggesting he was negligent, but a reasonable reading of the relevant discovery requests does not request those facts.) At the least the insured is likely ignorant of her obligations under the insurance policy. Education about those obligations, how they might or might not be enforced, and the limits on the obligations of the insurance company may change how the insured sees and understands the situation, and consequently how she communicates with "her" lawyer and with the insurance company.[10]

A. What the Model Rules Require

It thus should be obvious to any lawyer familiar with insurance defense practice that there is a potential conflict of interest in any liability insurance defense. A clear rule of ethics covers such situations. Model Rule 1.7(b) states:

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might wonder whether the difference is due to the sophistication and bulk purchasing power of the insurance companies, rather than to any drastic difference in likelihood of potential conflicts ripening into actual conflicts. For an exploration of the issue in the divorce situation, see Nancy J. Moore, *Conflicts of Interest in the Simultaneous Representation of Multiple Clients: A Proposed Solution to the Current Confusion and Controversy*, 61 TEX. L. REV. 211, 245-58 (1982).

9. *See* Silver & Syverud, *supra* note 2, at 266-68, 358-59.

10. *See* discussion *infra* Part IV.A.

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> A lawyer shall not represent a client if the representation of that client *may be materially limited by the lawyer's responsibilities to another client* or to a third person, or by the lawyer's own interests, unless
>
> (1) the lawyer reasonably believes the representation will not be adversely affected; and
>
> (2) *the client consents after consultation.* When representation of multiple clients in a single matter is undertaken, *the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.*[11]

No *current* conflict is required. No *current* material limitation on the lawyer's behavior is required.

What is required is that there "may be" such a limitation, and in insurance defense, as developed above, it is a given that there is a clearly a foreseeable risk of such limitation.[12] On behalf of the insured an independent lawyer might argue to the insurance company that a settlement offer should be accepted; evaluation of that same settlement offer on behalf of the insurance company may well elicit an opinion that the offer is too high, and the better risk for the company is going to trial—clearly a material difference. Or, a particular fact revealed by the insured might raise an argument for the insurance company of no coverage. If the lawyer represents the insured only, no communication of the damaging fact to the insurer will need to occur, and the obligations of confidentiality will frequently prevent it from occurring. Under joint representation where proper warnings and waivers have occurred, the lawyer probably must reveal the fact to the company. Or, depending upon what warnings and waivers have or have not been given, in that situation the lawyer may have to withdraw, implicitly informing the company of a conflict, and providing it with the incentive to explore the facts to find out what the conflict is. Such situations clearly involve a material change from what an

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11. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7(b) (1983) (emphasis added) [hereinafter MODEL RULES].

12. Professors Silver and Syverud ignore Rule 1.7(b) until a conflict is imminent. *See* Silver & Syverud, *supra* note 2, at 326-331. This does not seem consonant with the "may be" language of the rule, or with the general practice in regard to joint representation in analogous situations such as divorce or the forming of a business partnership or corporation.

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independent lawyer representing only the insured would do. By the very nature of liability insurance defense, the lawyer's representation may in the future be materially limited if she represents both the insured and the insurance company.[13]

Professors Syverud and Silver may be correct that the insurance company can retain the lawyer to represent both the company and the insured. They are quite incorrect, however, in believing that absent some specific indication of a particular conflict, Rule 1.7(b) is not triggered.[14] The lawyer who has been retained by a company to represent both it and the insured will be in violation of the requirements of 1.7(b) if she proceeds without having the client "consent after consultation." "'Consultation' denotes communication of information reasonably sufficient to permit the client to appreciate the significance of the matter in question."[15] Pursuant to Rule 1.7(b)(2), part of that consultation must include "an explanation of the implications of the common representation and the advantages and risks involved."[16] And even if 1.7(b) were not triggered, Model Rule 1.4(b), the general rule on communication with the client, would require essentially the same conversation with the insured:

> A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.[17]

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13. *See* KEETON & WIDISS, *supra* note 5, at 812-19 (detailing possible conflicts in the insurance defense context). Keeton and Widiss, under a heading referring to "The Pervasiveness of Conflicting Interests," state:

> It is rather unlikely that all of the problem areas that may produce conflicting interests can be avoided when a substantial tort claim asserted against an insured does not yield to settlement and therefore proceeds to adjudication.

Id. at 821.

14. In a conversation on Lexis Counsel Connect pursuant to the Hofstra Legal Ethics Symposium seminar, Professor Silver opined that "the consent needed to establish a joint client representation and to provide for its terms differs from the consent needed to waive a conflict. The former need not be 'fully informed'; the latter must be." Counsel Connect Interchange (copy on file with the author) [hereinafter Counsel Connect Interchange]. Under circumstances of clearly foreseeable potential conflicts this is incorrect. *See also* MODEL RULES, *supra* note 11, Rule 1.4(b) (quoted *infra* text accompanying note 16).

15. MODEL RULES, *supra* note 11, at 9 (Terminology Section).

16. *Id.* Rule 1.7(b)(2).

17. *Id.* Rule 1.4(b).

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Whether to accept joint representation with the insurance company is clearly a significant decision "regarding the representation," and the lawyer will have to "explain" the risks of potential conflict in some detail before the client's decision will be "informed."

Once the client is educated by the lawyer pursuant to these requirements it is difficult to see what advantages there are for the insured in joint representation. To the contrary the advantages of joint representation accrue to the insurance company, not the insured. The insurance company's primary gain is the economic efficiency of a single lawyer learning about the case for purposes of both representing the insured at a possible trial and informing the company in regard to settlement negotiations and offers. The insurance company also has more direct influence over the litigation and its expenses and more direct access to information about the matter. If a direct conflict arises concerning the possibility of lack of coverage or other issues, the company will be alerted to it either by the explicit or implicit communication of the lawyer, or by the withdrawal by the joint lawyer. With sole representation the insured gets a lawyer who will communicate with the company when and to the extent it is in the client's benefit, and will advise the insured regarding potential conflicts from the perspective of the insured. (Of course the insured does have the contractual obligation to cooperate with the company, and the lawyer will advise the insured in regard to this obligation as well.)[18] The insured gains nothing directly from joint representation, and loses access to a lawyer serving only her interests and advising solely from her perspective. Imagine yourself in the insured's situation and it should not be too difficult to understand which option you would most likely choose.[19] If given candid advice by the lawyer, the insured simply has no reason to accept joint representation with the company other than the altruistic one of saving insureds as a group money on their premiums.

That fact highlights the personal conflict of interest which would be faced by the lawyer hired and paid by the insurance company, usually on a repeat basis, when she approached the initial consultation required by Rules 1.7 and 1.4, knowing that the insurance company preferred that the insured accept joint representation. It is not beyond the imaginable for the

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18. *See* discussion *infra* Part I.B.

19. It is thus no coincidence that legal malpractice defense lawyers generally reject the notion of "joint representation" of the insured lawyer and the insurance company. And it is surely no accident that most legal malpractice policies allow the insured to select the lawyer. Ponder for a moment what that implies in relation to the advice a competent lawyer should give an insured in relation to the decision Rule 1.7 gives her in regard to accepting or rejecting joint representation.

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lawyer to guess that the company might choose a different lawyer in the future if too many insureds refuse to consent to a joint representation with the insurance company.[20] How likely is it that the lawyer's interest would skew the advice given concerning the "advantages and risks" of joint representation?

Only if the insurance company was to waive all policy defenses in advance (without knowledge of what it might be waiving), and also commit to cover all losses, judgments and settlements, even when over policy limits, would there be a strong reason for the insured to choose joint representation. *The fact that the insurance company is highly unlikely to agree to such a waiver brightly highlights the potential conflicts which trigger the conversation and informed consent requirements of Rules 1.7(b) and 1.4.* If there were no such potential conflicts, why would the insurance company be unwilling to grant such waivers in return for the insured's agreement to joint representation?[21] Thus, even if the insurance company and the lawyer enter into a retainer agreement making the company a client of the lawyer,[22] the insured would have to consent to joint representation after consultation pursuant to Rules 1.7(b) and 1.4(b) for the lawyer to avoid a violation of the rules, and the insured is highly unlikely to do so if that consultation is competently performed.

Professors Syverud and Silver are quite aware of the pervasive potential for conflicts, but prefer to put the lawyer in the ethical hot seat of a conflict between joint clients in the absence of informed consent by one of them and in the absence of any advance agreement as to how the lawyer is to proceed in the event of conflict.[23] They prefer this for a simple policy reason:

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20. *See generally*, 3 RONALD E. MALLEN & JEFFREY M. SMITH, LEGAL MALPRACTICE § 28.3, at 488 (4th ed. 1995).

21. The possibility of such waiver is discussed in the concluding paragraph of Part V.A, *infra*.

22. Professors Silver and Syverud frequently refer to this "retainer agreement" as the basis for both joint representation and various obligations to the company adverse to the insured, although admitting that such agreements rarely exist in writing and rarely have any specific content. *See* Silver & Syverud, *supra* note 2, at 269-70.

23. Professors Silver and Syverud describe "at least four reasons" such conflicts may arise:

> First, . . . the insured no longer bears a risk of paying a judgment or settlement. . ., but does bear other risks related to the lawsuit. These risks include all the manifold side effects of civil litigation. . . .
>
> Second, the company and the insured may disagree about the defense of the lawsuit because the company will bear the costs of the defense and

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economic efficiency in regard to legal expenses for the liability insurance industry.[24] This is surely an important aspect of the issue, but hardly one which trumps a lawyer's basic ethical obligations to unsophisticated insureds. The route Professors Silver and Syverud take to reach the goal often finesses fundamental ethical problems. Ignoring Rule 1.7(b) until it is too late is one example. A second is that they claim to examine only the situation in which "the existence of insurance coverage is clear and the amount of coverage is clearly sufficient to cover the insured's exposure to liability."[25] But this caveat elides a large part of the fundamental problem: the lawyer doesn't know whether or not this is the situation at the critical time at which they claim the joint representation is created. If it were known to be the situation, then the insurance company waivers mentioned in the previous paragraph ought to be forthcoming, and with such waivers in place there would indeed be much less problem with obtaining informed consent to joint representation by the insured. That such waivers are not forthcoming demonstrates the unreality of this very substantial caveat Professors Silver and Syverud place at the base of their analysis. For a lawyer to act as if it were the situation, when the insurance company is unwilling to so act, would be wrongful in relation to the insured whom the lawyer has been hired to represent in the matter.[26]

B. The Insurance Contract

The insurance contract between the insured and the company neither alters nor eliminates the requirements of Rule 1.7(b). The company is

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> insured will not. Most often, this fundamental difference will mean that the insured will prefer a more expensive defense effort, . . .
>
> Third, the company and the insured may disagree about the defense of the lawsuit because the company has an additional stake in the outcome beyond the amount paid to defend or settle it. . . . [*E.g.* establish a particular precedent, defeat a particular defense lawyer.]
>
> Finally, the company and the insured may disagree simply because each can take strategic advantage of the additional stake in the lawsuit possessed by the other. . . .
>
> *Unfortunately, it is defense counsel who often must sort out these disagreements between the company and the insured in particular lawsuits.*

Silver & Syverud, *supra* note 2, at 266-67 (emphasis added).

24. *See* Silver & Syverud, *supra* note 2, at 268, 362-63.

25. *Id.* at 263.

26. Joint client status in return for the company assuming any liability above policy limits and waiving any policy defenses—considered as a legitimate possible compromise solution—is discussed briefly in the concluding paragraph of Part V.A, *infra*.

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obligated to provide a defense, but there is nothing in the contract stating or implying that the defense must be provided by a lawyer who has the company as a client as well. Provision of a defense suggests an uncompromised one, not one subject to the problematic potential conflicts involved in joint representation of insured and insurer.[27] The contract obligates the insured to cooperate in that defense, but cooperation does not entail an obligation to consent to joint representation in the face of clear potential conflict of interest. In addition to the duty to provide a defense, the insurance company has the right to do so, and this implies that it has some authority to control the litigation. A contractual right as against the insured to control the litigation, however, does not equate with the lawyer's obligation to follow the directions of the company if they conflict with that of the insured. Such a right also does not make the company a client of the lawyer retained to represent the insured, nor would it seem to obligate the insured to agree to joint representation. The contractual obligation of the insured is not self-executing.[28] If the right were self-executing and binding upon the lawyer, then it would seem that an insurance company could direct that the lawyer cross examine and impeach the insured—her client—if it were in the company's interest for that to occur. As one might guess, a lawyer is not permitted to act in such a way.[29]

It should also be noted that even if the insurance contract did contain a promise by the insured to accept joint legal representation with the insurance company in the event of a lawsuit, this would not relieve *the lawyer* of her Rule 1.7(b) obligations. That rule puts independent obligations upon the lawyer to protect the client by requiring informed consent to joint representation with foreseeable conflicts. The contract, on the other hand, is between the company and the insured. Such a contractual provision would not communicate the information necessary for informed consent (and therefore would not function as a substitute for the substance of the rule). Also, it is highly unlikely the insured would be educated as to

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27. *See* John K. Morris, *Conflicts of Interest in Defending Under Liability Insurance Policies: A Proposed Solution*, 1981 UTAH L. REV. 457, 464.

28. The cases appear to hold that the lawyer is obligated to follow the instructions of the insured if they conflict with that of the insurance company. *See* 3 MALLEN & SMITH, *supra* note 20, § 28.3, at 491. The company's remedy is for breach of contract, perhaps as a defense to its obligation to pay an ensuing judgment. Specific performance allowing the company directly to control the litigation despite the objection of the insured party defendant ordinarily is not granted.

29. For a recent case disallowing such conduct see Montanez v. Irizarry-Rodriguez, 641 A.2d 1079 (N.J. Super. Ct. App. Div. 1994). Other cases and authorities are cited in Silver & Syverud, *supra* note 2, at 316-26.

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the meaning or implication of such a provision in the contract by the selling agent. And most important, the contract is simply not binding upon the lawyer, a non-party.[30] What does bind upon the lawyer are the rules of ethics. Insured and insurance company agreement cannot change the public policy embodied in and enforced by the Model Rules of Professional Conduct.[31]

Professors Syverud and Silver acknowledge that the lawyer is not a *party* to the contract. They then argue that the lawyer is nonetheless *controlled* by the contract. To get to this destination they emphasize that "the retainer agreement [between the insurance company and lawyer for the insured] is of overwhelming importance," having, however, earlier observed that such agreements usually are not in writing, and in fact usually have little or no content. As a matter of fact, usually it is clear that the lawyer is being hired for the insured, but a lawyer-client relationship with the company is not made explicit at all. Professors Silver and Syverud then assert that

> it is reasonable and natural that the content of the latter [insurance contract] should inform the content of the former [retainer agreement]. In other words, the liability contract should "bleed" into the retainer agreement.
>
> . . . For example, the company will use the retainer agreement to confer upon itself exclusive authority to instruct counsel on the defense of the suit and the

30. *See* 3 MALLEN & SMITH, *supra* note 20, § 28.3, at 491-92.

31. The public policy underlying Rule 1.7(b) brings up another interesting issue if we hypothesize a promise in the contract by the insured to accept joint representation. Assuming the lawyer were to attempt to follow the rule, would "consent" under threat of losing the benefits of the policy if one were to refuse be held to constitute binding, genuine consent on the part of the insured. Or would Rule 1.7(b) not have been met due to the coercive circumstances? (Note that the critical promise regarding legal representation would have been made in the insurance contract, without meaningful education or warning as to its meaning and risks.) If the requirements of the rule were not met, the lawyer would face discipline is she proceeded as if binding consent had been given.

As a matter of contract interpretation and enforcement, as opposed to lawyer discipline under Rule 1.7(b), perhaps the promise of the insured would be held to be severable: if the insured refused to accept joint representation the insurance company would remain bound to all its obligations under the contract, and might later sue for damages caused by the insured's breach of that specific provision. But what damages could the insurance company prove? And would the amount be worth a lawsuit?

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> settlement of the claim, to reserve the right to dismiss counsel, and to approve expenses and fees.[32]

This seems odd: the lawyer is not obligated by the insurance contract, but he is obligated by the (generally unwritten and unarticulated) retainer agreement, *which is with the insurance company only*, and which has had a transfusion of content from the insurance contract. Note the convenient elision or evasion: *the lawyer never agrees with the insured—his client—that any of this is to occur*; he never even has to inform his client unless the inconvenience of a conflict arises, at which point it is too late for the insured. The "bleeding" and the retainer agreement (which the insured has not seen, is not a party to, and has not been informed about) are supposed to take care of the small problem of client consent.

Before moving on, one of the implications of the fact that the insured's obligations under the contract are not self-effectuating should be observed. The law and economics approach to the law of contracts has emphasized that the contract imposes an obligation only to comply with the promise or pay damages. Efficient breach theorists argue strongly that breach is a perfectly viable, morally acceptable, and sometimes economically efficient option.[33] That is why, they argue, it is enforced by compensatory damages only, not by punishment, and only rarely by specific performance. According to this view of contract, breach should be regarded as simply one option available to the insured, not as something that must be prevented by a self-executing specific performance obligation binding upon a non-party to the agreement: the lawyer hired to defend the insured. Professors Silver and Syverud's "bleeding" theory of contract interpretation and enforcement is a form of specific enforcement. For that reason alone it should be regarded with skepticism.

Finally, can the Rule 1.7(b) obligations be avoided by concluding that the lawyer is hired only to defend the insured in litigation filed by a plaintiff? Because that litigation does not directly involve the insurance company or the insurance contract, can it be argued that limiting the scope of representation narrowly to only the litigation removes the foreseeable conflicts between insured and insurance company which trigger 1.7(b)?[34]

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32. Silver & Syverud, *supra* note 2, at 271.

33. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 4.9, at 89-90 (2d ed. 1977). *See generally* Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 630 (1988).

34. Professors Silver and Syverud emphasize this "scope of representation" issue, and at times seem to imply a position close to it. Such a position on scope of representation, wide for

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The answer is that if this position is taken by a lawyer, essentially the same conversation, warnings, and informed consent will be required under Rule 1.2(c). The lawyer is being paid by a client (assuming for the moment that the insurance company is a client) whose interests are different than the insured's and potentially conflicting. The two clients are parties to a pre-existing contract which directly connects to the litigation, which has caused the hiring of the lawyer, and which has provisions limiting the insured's and (arguably) the lawyer's conduct of the litigation. For example, it provides the insurance company with authority to settle. Normally the obvious close connection between such a contract and the litigation would lead a competent lawyer to assume that relevant advice about the contract was part and parcel of the overall representation in the litigation.[35]

In other words, the two are so obviously connected that most competent lawyers would consider both to be part of the job; and if they did not they would be careful to explain that to the client. For the lawyer to delimit the scope of representation more narrowly therefore requires informed consent of the client pursuant to Rule 1.2(c): "A lawyer may limit the objectives of representation if the client consents after consultation."[36] And, as noted above, consultation "denotes communication of information reasonably sufficient to permit the client to appreciate the significance of the matter in question."[37] To appreciate the significance of a representation which does not include advice about the obligations of the insurance contract and the relevance of such matters as insurance company control over the conduct of the litigation and settlement, the client will have to be informed concerning the same potential conflicts, and the risks and benefits of joint representation, as would be required under Rule 1.7(b).

Moreover, lawyers are usually advised to take care to inform a client concerning matters which the client may not have thought of and may not have consulted the lawyer in regard to, but which the lawyer believes may be important to the client, whether or not directly related to the matter for

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the company, narrow for the insured, is quite revealing. *See infra* notes 102 & 103 and accompanying text.

35. *See* Tank v. State Farm Fire & Cas. Co., 715 P.2d 1133, 1137-38 (1986) (should a coverage issue arise, attorney owes insured duty to provide full advice concerning potential conflict and its ramifications).

36. MODEL RULES, *supra* note 11, Rule 1.2(c). Rule 1.2(a) states that a "lawyer shall abide by a client's decisions concerning the objectives of representation, . . . and shall consult with the client as to the means by which they are to be pursued." *Id.* Rule 1.2(a).

37. MODEL RULES, *supra* note 11, Terminology Section, ¶ 2.

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which assistance has been sought.[38] This is particularly the case with a client who is unsophisticated in legal matters, and hence unlikely to take care in regard to, or have the knowledge necessary to understand, the appropriate scope for the representation.[39]

II. THE PURPOSE OF PROFESSIONAL ETHICS

The traditionally understood function of professional ethics is to protect the relatively powerless and ignorant client or patient from the relatively powerful and knowledgeable professional. The client or patient has a strong need for something the professional controls access to: medical care or legal assistance, for example. What defines something as a "profession," in distinction from other, more ordinary, service providing "trades," is that the needed assistance entails a great deal more specialized information, training and experience to be competently performed. With what we think of as the "learned professions" this usually requires years of

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38. Assume, for example, a lawyer is hired to pursue a workers' compensation claim, and the facts of the matter might support a tort claim against a third party. If the lawyer pursues only the workers' compensation claim without informing the client of the possible tort claim, she may well be liable for malpractice.

39. Note Justice Powell's remarks concerning what an unsophisticated consumer might expect in responding to an advertisement for an "uncontested divorce" and what the competent lawyer ought to provide:

> The processing of court papers—apparently the only service appellants provide for $100—is usually the most straightforward and least demanding aspect of the lawyer's responsibility in a divorce case. *More important from the viewpoint of the client is the diagnostic and advisory function: the pursuit of relevant inquiries of which the client would otherwise be unaware, and advice with respect to alternative arrangements.*

Bates v. Ariz., 433 U.S. 350, 393 (1977) (emphasis added).

> The average lay person simply has no feeling for which services are included in the packaged divorce, and thus no capacity to judge the nature of the advertised product.

Id. at 394. Similarly, such an unsophisticated client ordinarily would have no feel for the appropriate scope of advice relating to a litigated insurance defense matter or the underlying insurance contract. Thus, Rules 1.2(c) and 1.4 would require explanation and informed consent. (These rules would also be implicated because advice concerning contractual obligations directly connected to the litigation normally would be considered part of the lawyer's function).

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higher education and more years of on the job training. For this reason, so the traditional understanding runs, the market can't work; the buyer (patient, client, student) is not in a position to evaluate or understand the service she needs.

If you have a bad ache in the abdomen, do you need to worry about an ulcer; a heart attack; or is it just indigestion? If you want to direct what will happen to your property upon death, is it adequate to just jot a note down and leave it in your safe deposit box at the bank; or is something more elaborate required? Caveat emptor is thought to be fundamentally unfair in regard to such services because the non-professional simply does not have the knowledge requisite to judge the quality of service he will receive. The professional is making a living from the need of patients and clients and from the fact that the professional's specialized knowledge, training and experience puts her in the position to meet that need.

Thus (1) the client or patient is unusually vulnerable (she has a strong need for something she cannot understand or evaluate); (2) the professional is making a living from that need and vulnerability; and (3) the professional is in a position to exploit the vulnerability of the client or patient for profit. With this situation, it is thought that profit maximization will lead to bad results too often; the invisible hand of the market won't work because of insufficient knowledge on the part of the buyers of the service. Something is needed in addition to ordinary market constraints.

The remedy is the notion of professional obligation: society decides that those who provide services in these situations must be "professionals," and to be a professional means that one has special obligations and status beyond and above that of the market.[40] Although the professional is

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40. For a recent reaffirmation of this view, see Justice O'Connor's dissent in Shapero v. Kentucky Bar Ass'n, 486 U.S. 466, 488-91 (1988):

> Precisely because lawyers must be provided with expertise that is both esoteric and extremely powerful, it would be unrealistic to demand that clients bargain for their services in the same arms-length manner that may be appropriate when buying an automobile or choosing a dry cleaner. Like physicians, lawyers are subjected to heightened ethical demands on their conduct towards those they serve. These demands are needed because market forces, and the ordinary legal prohibitions against force and fraud, are simply insufficient to protect the consumers of their necessary services from the peculiar power of the specialized knowledge that these professionals possess.

Id. at 489-90.

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making a living from the need of the client or patient, she must put the interests of the client or patient above her own.[41] Even if the physician makes money from surgery, surgery ought not be recommended if it is not the best treatment. Even if settling the law suit would mean a quick, easy contingent fee, the plaintiff's lawyer may not recommend it if the client is likely to come out substantially better by the long, hard efforts of the lawyer's work in discovery and trial preparation. (Or, conversely, if the litigator is working on an hourly fee basis she ought not discourage an early, reasonable settlement because she prefers the larger fees to be earned through extensive discovery and trial preparation.) Thus an important part of professional regulation is a set of ethical prescriptions (sometimes codified in rules) which are intended to prevent professionals from exploiting the vulnerabilities of their customers. Put more simply, limits are placed on the ways professionals are allowed to maximize profit.[42]

> This view of the legal profession need not be rooted in romanticism or self-serving sanctimony, though of course it can be. Rather, special ethical standards for lawyers are properly understood as an appropriate means of restraining lawyers in the exercise of the unique power that they inevitably wield in a political system like ours.

Id. at 489.

41. *See, e.g.*, JOHN KULTGEN, ETHICS AND PROFESSIONALISM 73-76, 81-83 (1988).

42. Some years ago I summarized this traditional understanding of the notion of a "profession" in seven definitional characteristics:

> 1. A profession is a means of making a living.
>
> 2. A profession is based on specialized knowledge, training, and ability, often requiring intellectual labor and many years of higher education.
>
> 3. The services rendered by the professional, based upon this foundation of knowledge and ability, are necessary to individuals at various points in their lives and are frequently of the utmost personal concern (for example, services relating to physical health, liberty, religious salvation, or psychological well-being).
>
> 4. Because of the specialized knowledge involved, the quality of the services rendered by the professional is untestable from the perspective of the layman. The individual *needs* the service but is unable to evaluate it, and therefore the individual is *vulnerable* in relation to the professional.
>
> 5. The profession holds a monopoly on a service frequently needed by individuals, and as a result wields significant economic power.
>
> 6. The profession is largely self-regulated in determining and administering the qualifications for membership and in policing professional activities.

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There are parts of this conception of professional obligation which may seem foolish or anachronistic. Nonetheless, it remains the way we structure our professions; it is still reflective of the internal ideologies and education of the professions, and of how we regulate and license them. It reflects the law and form of our professions, even if it only partly reflects the reality. And most of us tend to prefer it that way; we rely to a significant extent, for example, on the fact that the physicians we see are licensed professionals.[43]

With regard to lawyers' ethics there is a significant counter-vision that has been influential for some time. Some empirical work on lawyers and their clients suggests that the model drawn from the nature of the professional relationship sketched above is in error, and the more usual situation is a relatively weak and economically dependent lawyer serving a

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7. Part of the self-regulation usually includes ethical prescriptions that articulate a service orientation. . . .

> The seven characteristics add up to an inherent advantage for the professional over those in need of his services and to a pervasive economic conflict of interest between the professional and those who need (and pay for) his services. As a remedy for this unbalanced conflict, there is a primary underlying professional obligation: When the client's interest and the professional's interest conflict, the professional is to forgo his interest in favor of the client's.

Stephen L. Pepper, *The Lawyer's Amoral Ethical Role: A Defense, A Problem, and Some Possibilities*, 1986 AM. B. FOUND. RES. J. 613, 615-16 (1986). For further elaboration of this basic understanding of professionalism, see ELIOT FREIDSON, PROFESSIONALISM REBORN: THEORY PROPHECY AND POLICY (1994); BURTON BLEDSTEIN, THE CULTURE OF PROFESSIONALISM 87 (1976); WILBERT MOORE, THE PROFESSIONS: ROLES AND RULES 4-22 (1970).

43. We may feel perfectly competent to make a choice between butter and margarine without government assistance. In the absence of government licensing, however, would we feel equally competent to choose who would be a trustworthy and able surgeon or dermatologist? Should Professor Hyman's butter/margarine example lead us to deregulate and deprofessionalize legal and medical services, leaving it solely to the market to determine who is and who is not a competent surgeon or litigator? David A. Hyman, *Professional Responsibility, Legal Malpractice, and the Eternal Triangle: Will Lawyers or Insurers Call the Shots?*, 4 CONN. INS. L.J. 353, 395 (1997). Or should the example caution us toward skepticism concerning whether professional rules and traditions are in fact protecting the consumer or the professional? That professional regulation has often functioned as guild protectionism, *see infra* note 48, does not necessarily mean that there is no need for professional regulation or that professionalism does not often function as intended to protect the vulnerable patient or client.

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stronger, dominating client.[44] The image called up under this vision is that of the client as a large corporation with a lot of legal business, sophisticated and demanding management, and a corporate profit ethic instead of a humane conscience; juxtaposed against a lawyer in a much smaller economic unit (albeit, perhaps, a large, profitable law firm), dependent upon that client for a substantial chunk of his or her livelihood in a market for legal services growing more and more competitive. Recently, the common example posited has been the lawyers and law firms who serviced the savings and loan institutions which violated legal regulations and became insolvent, victimizing investors and the taxpaying public. An earlier common example was the client who wished to export to Africa or Latin America a drug found harmful or unsafe by the FDA and banned in the United States but lawful in the less developed world.

The counter-vision leads to an ethic more concerned about client wrongdoing and lawyer complicity than with the lawyer's exploitation of a vulnerable client. From this view one is more likely to construct an ethic concerned with protecting a lawyer vulnerable to economic pressure from a client guided only by profits, or to protect society from the powerful lawyer-client combine. This view is less concerned with vulnerable clients whose needs may be exploited than with powerful clients who may exploit the economic weakness of lawyers.

One might argue that these two visions suggest the need for two different sets of lawyer ethics, one for each of the two basic "hemispheres" of lawyer practice observed and described by Heinz and Laumann.[45] The larger firm, more elite lawyers might require ethical rules which protect them from incentives and pressure to assist the wrongdoing of some of their large powerful clients. The less elite lawyers, ironically, might need a set of rules which prevent them from exploiting the need and vulnerability of their less powerful clients.[46]

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44. *See* JEROME E. CARLIN, LAWYERS' ETHICS: A SURVEY OF THE NEW YORK CITY BAR 58 (1966) (examining the relationship between ethics, types of client base, and types of lawyer partnerships); Murray L. Schwartz, *The Reorganization of the Legal Profession*, 58 TEX. L. REV. 1269, 1284-86 (1980) (noting that large firms face strong pressure from clients); MARC GALANTER & THOMAS PALEY, TOURNAMENT OF LAWYERS, THE TRANSFORMATION OF THE BIG LAW FIRM (1991); ROBERT L. NELSON, PARTNERS WITH POWER, SOCIAL TRANSFORMATION OF THE LARGE LAW FIRM (1988).

45. *See* JOHN P. HEINZ & EDWARD O. LAUMANN, CHICAGO LAWYERS: THE SOCIAL STRUCTURE OF THE BAR 319-79 (1982).

46. For a description of how elite and non-elite lawyers might have different interests in regard to rules of ethics, see Philip Shuchman, *Ethics and Legal Ethics: The Propriety of the Canons as a Group Moral Code*, 37 GEO. WASH. L. REV. 244 (1968); *see generally* JEROLD S.

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Interestingly, both visions contain important insights relating to the issues of insurance defense ethics. First, the traditional model reflects the actuality in the situation of the ordinary, unsophisticated purchaser of insurance: the client/insured is relatively ignorant in relation to law, litigation, insurance, contracts, settlements, and the behavior and interests of lawyers and insurance companies. This client *is* vulnerable in relation to the lawyer.[47] Rules which require genuine informed consent, such as Rules 1.7 and 1.2(c), clearly serve an important function to ameliorate the relative ignorance and vulnerability of the client, and to remind the lawyer of her basic obligations and allegiance.

Second, the temptation of the lawyer to exploit the vulnerable insured derives partly from the countervision: insurance defense lawyers are in turn vulnerable in relation to insurance companies. The companies control the livelihood of the lawyer; if they decide to stop purchasing a particular lawyer's or firm's services it may well mean economic disaster. (The lawyer will have to retool in mid-career; essentially learn a new kind of lawyering and compete for an economically viable position within the profession.) The lawyers are thus small economic fish dependent upon the much larger insurance companies. If the companies prefer that the interests of a few insureds be risked or sacrificed here and there in favor of the larger interests of all insureds (that is, the well being—profit—of the insurance company), then what's a well-meaning lawyer to do?[48]

The awkwardness of such a "divided loyalty" situation for the lawyer, and the vulnerability of the unsophisticated insured, exemplify the utility of special professional obligations. In the situation of insurance defense both the traditional understanding of client vulnerability and the countervision of lawyer vulnerability demonstrate how rules such as 1.7(b) and 1.4(b) can function to protect the client and guide the lawyer.

AUERBACH, UNEQUAL JUSTICE (1976). My own view is that two separate sets of rules is not the right solution. *See* Stephen L. Pepper, Lawyers' Ethics: Who Needs Protection From Whom, in Association of American Law Schools Workshop on Professional Responsibility 21 (1993), (on file with the author).

47. Cases like Parsons v. Continental Nat'l Am. Group, 550 P.2d 94 (Ariz. 1976) and Employers Cas. Co. v. Tilley, 496 S.W.2d 552 (Tex. 1973), make it perfectly clear that victimization occurs. How frequently, we do not know.

48. There is, of course, a third, more critical and external view of professionalism, which perceives it as an effort by particular well positioned groups of workers to increase their power, independence, and status; with the more traditional rhetoric of professionalism as window dressing for efforts at organized economic exploitation. *See* Hyman, *supra* note 43, at Part III. This appears to be the view of Professors Silver and Syverud, who perceive defense lawyers as attempting to use ethics rules to force insurance companies to pay more for legal services than is economically justifiable. *See* Silver & Syverud, *supra* note 2, at 362.

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Moreover, the perspective from both the vision and the countervision highlight the danger involved in joint representation of the insurance company and the insured.

III. THE SUBSTANCE OF THE TRIPARTITE RELATIONSHIP

Part I suggests that Rules 1.7(b) and 1.4(b) require substantial "informed consent" by the insured before a joint client status would be ethically acceptable. It further suggests that ordinarily it would not be to the benefit of the insured to accept such status as opposed to an ordinary single client relationship without the problem of divided loyalties. Part II elaborates the general ethical theory which underlies the rules as drafted, and also demonstrates that the underlying reasons for the rules are fully applicable to the insurance defense situation. With Part III we turn to rules which apply more specifically to insurance defense, rules regarding third party payment of legal fees.

As noted above, the irreducible core of the insurance defense situation is that the lawyer has been hired to represent the insured as defendant in a lawsuit. That much is simple and unproblematic. The difficulty arises from the additional fact that the lawyer who is clearly representing the insured is selected and paid by someone other than the insured, and from the fact that the payor has interests and goals distinct from those of the insured. As the last paragraphs of the prior section show, this suggests that an unsophisticated insured is vulnerable in relation to the lawyer, and the lawyer is in a position to be tempted to subordinate the well-being of the client/insured to that of the payor should their interests in fact diverge.[49] The substance of such a relationship involves risks so clear that lawyers' ethics has long provided specific rules to cover the situation in addition to the more general "informed consent" provisions of Rules 1.7(b) and 1.4(b). These more specific provisions are currently embodied in Rules 1.8(f) and 5.4(c):

> 1.8 (f) A lawyer shall not accept compensation for representing a client from one other than the client unless:
>
> (1) the client consents after consultation;
>
> (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and

49. *See supra* text accompanying notes 46-48.

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> (3) information relating to the representation of the a client is protected as required by rule 1.6.[50]

> 5.4 (c) A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services.[51]

One might say that these rules are simply a special application of that part of Rule 1.7(b) which refers to the possibility of a conflict with "the lawyer's own interests."[52] Here the conflict is so obvious and so likely, however, that in addition to the requirement of informed consent, a specific requirement of independence from the payor is imposed, and the lawyer is reminded that the obligations of confidentiality limit what the lawyer may communicate to the payor concerning the representation.[53]

The substance of the situation is clear; as is the consequent need for ethical restraint and protection. The applicability of the rules to the situation also seems quite clear, as do the lawyer's consequent obligations. The difficulty lies in the contract between the insured and the insurer. That contract ordinarily provides that the insurance company has the "right to defend" the insured, generally interpreted to mean that the company has the right to control the litigation.[54] That obligation on the part of the insured—to cede control of the litigation to the insurance company—was not obtained pursuant to the informed consent ("consultation") required by the rules of lawyers' ethics.[55] Moreover, it does not directly bind the lawyer because she was not a party to the contract.[56] Arguably, therefore, by complying with the insured's contractual obligation, the lawyer will be violating the rules of ethics which govern her conduct.

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50. MODEL RULES, *supra* note 11, Rule 1.8(f).

51. MODEL RULES, *supra* note 11, Rule 5.4(c). The predecessor rules to 1.8(f) and 5.4(c) were from the 1969 MODEL CODE OF PROFESSIONAL RESPONSIBILITY, DR 5-107(A), (B) (1969). The rule derives from the 1908 CANONS OF PROFESSIONAL ETHICS, Canon 38.

52. MODEL RULES, *supra* note 11, Rule 1.7 (b).

53. *See id.*, Rule 1.8, cmt.4.

54. *See* MALLEN & SMITH, *supra* note 20, § 28.3 at 488 & n.5.

55. We have now seen three applicable rules also containing this same requirement: MODEL RULES, *supra* note 11, 1.7(b), 1.4(b), and now 1.8(f)(1).

56. *See, e.g.*, MALLEN & SMITH, *supra* note 20, § 28.6 at 517 (". . . although a breach of the insurance contract provisions may justify a denial of coverage by the insurer, it does not warrant the withdrawal by the defense counsel without consent by the insured or a court.")

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The solution here does not appear too difficult. The lawyer ought to obtain informed consent from the client/insured pursuant to Rule 1.8(f)(1) to follow direction from the insurance company. Required disclosures would include who selected and will pay the lawyer; the potential conflicts between the insured and the company; the basic obligations on the part of the lawyer to the client/insured [including at least Rules 1.6 and 5.4(c)]; the primary and relevant contractual obligations on the insured and the company under the contract; and possibly the consequences to the insured if one or more of those obligations were to be breached by the insured and discovered by the company.[57] Because the company would not be a joint client [and Rules 1.6 (confidentiality) and 5.4(c) (independent judgment) would still apply], the necessary disclosures and advice would probably be less elaborate than those contemplated under the discussion in Part I above concerning Rule 1.7(b). For the same reasons the decision of a rational, well-informed client would likely be different; to accept the insurance company role in directing the defense (as opposed to accepting the company as a joint client, which entails quite different risks).

In regard to insurance company control of the day to day aspects of the litigation, given (1) the client's lack of expertise and understanding concerning litigation and settlement; (2) the insurance company's expertise in these two areas; (3) the client/insured's probable lack of time and interest to learn; (4) the absence of an actual, present conflict of interest (as opposed to the underlying potential conflicts discussed in Part I above); and (5) the insurance company's contractual right to control the litigation, there would seem to be good reason for the insured to consent.[58] The insurance contract as supplemented by the subsequent informed consent would essentially make the insurance company the agent of the insured for the limited purpose of controlling the litigation.[59] The informed consent

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57. Such advice could be complicated by the fact that the company might well have little remedy for a breach by the insured of the obligation to cede control of the litigation without proof of prejudice. *See* KEETON & WIDISS, *supra* note 5, § 7.3(b); *see supra* note 54. In the absence of any present (as opposed to potential) reason for the insured to refuse to cede control to the company, it is not clear that the lawyer would need to go into such subtlety regarding the contract and its enforcement.

58. Unfortunately there is a sixth, more awkward, reason: because the lawyer has an interest in repeat business from the insurance company, she is unlikely to steer the insured toward a decision to refuse to allow the company to control the defense.

59. Professors Morgan and Wolfram believe the issue can be elided by finding "implied consent" to control in the policy, in the absence of disclosure and consultation, and this is reflected in the proposed Restatement of the Law Governing Lawyers. *See* Thomas D. Morgan & Charles Wolfram, *Lawyers Retained by Liability Carriers to Represent Insureds in the Restatement of the Law Governing Lawyers*, 6 COVERAGE 44 (Mar./Apr. 1996). If the lawyer's

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resulting from the conversation would allow the lawyer to follow the directions of the insurance company and still be in compliance with Rules 1.8(f), 5.4(c) and the underlying ethical obligations they embody.

The wisdom of such consent would be clearer, and the lawyer's advice to consent more soundly based, if the lawyer placed a limit upon its execution. To protect the client and fully comply with Rule 5.4(c), the lawyer ought to inform the insured that if a situation were to arise in which the lawyer had doubts as to whether the company's instructions were in the best interests of the insured, the lawyer would no longer feel bound by the client's direction to follow the instructions of the company. The lawyer instead would return for further discussion with the client to determine if he still wished the insurance company to control the litigation. The contours of such a discussion might well be complicated given that the contractual obligation of the insured to cede control to the company, on one hand, and courts' reluctance to allow lawyers to behave in ways overtly adverse to their clients (the insureds),[60] on the other hand, might well point in different directions.

Professor Silver appears to believe that the difficulty posed by Rules 1.8(h) and 5.4(c) is avoided if the insurance company is a client in addition to the insured. Nothing in the two rules, however, or in the policy underlying them, suggests that they do not apply if the person paying the fees for a client is also a client of the lawyer.[61] One might as well say that the obligation of Rule 1.4 to keep the client informed, or those of Rule 1.2(a) concerning client control over decisions, do not apply to one joint client if they are met as to another joint client. This would only be true, however, if a prior explicit agreement made client "a" the agent of client "b" for the purpose of the particular rule or rules, and if in addition such agreement was reached in compliance with the informed consent

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understanding was clearly consonant with the suggestion in the following paragraph in the text, this constructive consent approach might be acceptable.

The proposed Restatement accepts implied consent only in vary narrow circumstances:

> [W]hen a claim against a client-insured will be fully covered by an insurance policy pursuant to which the lawyer is appointed and is to be paid, consent other than that implicit in the action of the insured in forwarding the claim to the insurer is not required.

RESTATEMENT OF THE LAW GOVERNING LAWYERS, Council Draft No. 13, § 215, cmt. b (1997).

60. *See, e.g., infra* note 29 and accompanying text.

61. Thomas D. Morgan, *Whose Lawyer Are You Anyway*, 23 WM. MIT. L. REV. (forthcoming 1998).

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requirement of Rule 1.2(c). As discussed above, such an agency can be created without the agent being a joint client. More significantly, a limited purpose agency allowing the lawyer to accept direction from the insurance company pursuant to the insurance contract, particularly if limited as suggested in the previous paragraph, subjects both lawyer and insured to far less risk than does a joint client status.

IV. THE SINGLE CLIENT MODEL AND THE PROBLEM OF PARTISAN ADVOCACY

The single client model more accurately reflects both the underlying substance of the relationship—the insurer is providing a lawyer for the insured in a lawsuit in which the insured is the defendant—and the ethical reality of a clear potential conflict of interest. But, given the usual substantial alignment of insured and company interests in the underlying litigation, does the single client model create a situation in which the lawyer will be too partisan in favor of the insured? Will there be a tendency for the insured's lawyer to transform potential conflict into actual conflict given the traditional one-sided understanding of a lawyer's allegiance? Will there be a tendency, as a result of that transformation, for the insured's lawyer to deceive and possibly prejudice the company which must rely on that lawyer's cooperation? This may be the anxiety underlying the pressure for "joint representation:" the fear that not only will the lawyer consider herself an advocate for the insured/defendant against the plaintiff, but against the insurance company as well.

Several factors, most of which we have looked at above, structure this concern:

> 1) Because of client vulnerability, the lawyer must be a zealous client advocate, and must subsume her own interests to those of the client. This includes the lawyer's interest in continued employment by the insurance company.
>
> 2) There are always potential conflicts of interest between the company and the insured.
>
> 3) The contract between the company and the insured requires the insured to cooperate and gives the insurance company control of the litigation (and hence, arguably, of the lawyer.)
>
> 4) The lawyer is not a party to that contract, however, and the lawyer's ethical obligations require that she serve the client's best interests. Those best interests may be served

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by less than complete cooperation should one of the many potential conflicts arguably come into play.

5) The legal sanctions for breach of the cooperation clause are relatively weak.[62] Balancing the gains from limited cooperation against the risks of the sanctions may indicate that the former is the better course for the client, and hence his lawyer.

A. Evaluation of the Case and Settlement

One situation where this problem arises is settlement. For the insurance company to reach an economically efficient choice regarding settlement it needs objective advice combining trained legal understanding with knowledge of the facts underlying the litigation. Ordinarily this combination of legal sophistication and knowledge of the facts resides with the lawyers representing plaintiff and defendant. Often, however, providing objective assessment of the matter will not be in the client/insured's best interest as he understands them, thus placing the lawyer paid and selected by the insurance company in an awkward position.

If there is a significant possibility of a judgment in excess of policy limits, then the insured's lawyer obviously must recommend settlement regardless of her assessment of the merits and likely outcome at trial.[63] (And if this quite clear conflict becomes the situation, very few argue that the two client model remains viable.) Even if judgment in excess of the policy limits is extremely unlikely and an objective assessment suggests any liability is unlikely, an informed client quite rationally might prefer settlement to the very small risk of excess judgment. Or a busy or conflict

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62. In most jurisdictions the insurance company must prove prejudice in addition to breach. *See* KEETON & WIDISS, *supra* note 5, § 7.3(b). Moreover, the insurance company ordinarily has to pursue its remedy after the defense of the insured has been completed in the underlying lawsuit; that is after the decisions have been made, the risks chosen, and the insurance defense costs expended. Courts also show a distinct concern with the welfare of the injured plaintiff, who has not breached a contract or behaved wrongly in relation to the insurance company, yet will be the primary loser if the insurance company is released from its obligation to pay a judgment on behalf of the insured. *See, e.g.*, Morrison v. Lewis, 221 N.E.2d 401 (Mass. 1966) (determining that insured's incorrect answer to whether anyone had been drinking was not prejudicial). One lawyer prominent in the Denver insurance defense bar went so far as to suggest to me that the co-operation clause is so rarely enforced that it has become a joke among insurance defense lawyers.

63. For a compilation of cases finding conflict in this situation, see KEETON & WIDISS, *supra* note 5, § 7.6(a)(2)(v) & n.27.

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averse client may simply prefer to avoid the time loss and stress of a trial. Or the client/insured may prefer that the plaintiff (his customer or friend or child) receive a significant settlement regardless of an objective assessment of the legal merits. Or a trial may bring out in public an embarrassing fact the insured prefers not become generally known.

All of this suggests that a lawyer who perceives the insured as the sole client (and consequently the insured's interests as those she is to serve) may well provide the insurance company with an assessment of the case skewed more toward settlement than would result from a fully objective evaluation. This, in turn, suggests that to the extent insurance companies rely on such assessments, settlements may be higher than they "ought" to be—thus moving liability insurance premiums to a level higher than they ought to be.

Slanted evaluations thus appear to be a substantial and legitimate concern in regard to a single client model. Joint client status would be a clearly inappropriate remedy, however, unless we intend to ignore and subvert our usual rules and understandings concerning conflict of interest and lawyer loyalty. If an "objective" evaluation serves the company's interest and a "skewed" one serves the insured's, then we clearly have the kind of conflict that renders joint representation difficult, if not impossible. We have the representation of one client "materially limited" by that of another, triggering Rule 1.7(b).[64]

The client/insured's obligations under the insurance contract also do not provide a clear remedy to the situation because they are (1) not self-executing and (2) not binding upon the lawyer, who is a non-party to the agreement. Cooperation by the insured and control by the company could each be interpreted to require that the insured's lawyer provide an objective assessment of the case to the company. A client educated by the lawyer concerning (1) the risks and benefits of such an assessment, and (2) the risks and benefits of breaching (or "fudging") those particular obligations of the contract, may well prefer that the lawyer skew the assessment; advocate for the insured rather than objectively assess for the insurance company.

There is a strong argument that the client/insured ought to have the benefit of just such sophisticated legal advice. A lawyer is required to "explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."[65] Also, a lawyer

64. Further exploration of the joint client understanding leads either back to the discussion in Part I *supra*, or to the brief discussion in Part V.A, *infra*.

65. MODEL RULES, *supra* note 11, Rule 1.4(b).

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must "abide by a client's decisions concerning the objectives of representation . . . [and must] consult with the client as to the means by which they are to be pursued."[66] The fact that advice educating the client about the law and how it impacts on his circumstances may lead to a breach of contract does not mean that the lawyer is prohibited from providing the advice. Rule 1.2(d) is quite limited and explicit in this regard:

> A lawyer shall not counsel a client to engage, or assist a client in conduct that the lawyer knows is *criminal or fraudulent*, but a lawyer *may discuss the legal consequences of any proposed course of conduct* with a client . . .[67]

The Holmesian "bad man" view on contractual obligation (and the law and economics view) is that the client always has a choice; perform or breach and pay damages if the other party succeeds in a lawsuit. It is not criminal to breach a contract; normally it is not tortious. Thus, providing the insured/client with the same sophisticated understanding of the law which the insurance company has, and which lawyers have, is arguably required by the rules of ethics—even if it may lead to a breach of the insured's obligations to cooperate or to allow the insurance company to control the litigation.[68]

Do we have a slippery slope here, leading to an adversary relationship (either covert or overt) between insured and insurance company? I would suggest several stopping spots on that slope. First is the distinction between the common understanding of an opinion letter (an expression of the lawyer's educated legal judgment from an objective perspective) and the common understanding of a brief (legal argument toward a particular end favored by a particular party). If the lawyer purports to be providing the company with an objective assessment of the case (an opinion letter) but is in fact arguing for a view which favors the insured (a brief), then the lawyer is engaged in misrepresentation to the company.[69] Second, the

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66. MODEL RULES, *supra* note 11, Rule 1.2(a).

67. MODEL RULES, *supra* note 11, Rule 1.2(d) (emphasis added).

68. This is a difficult and awkward part of lawyers' ethics which I have explored at some length previously. *See* Stephen L. Pepper, *Counseling at the Limits of the Law: An Exercise in the Jurisprudence and Ethics of Lawyering*, 104 YALE L. J. 1545 (1995).

69. MODEL RULES, *supra* note 11, Rule 8.4 prohibits a lawyer from engaging "in conduct involving dishonesty . . . or misrepresentation." MODEL RULES, *supra* note 11, Rule 4.1 states that a lawyer "shall not knowingly: (a) make a false statement of material fact or law to a third

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Model Rules clearly contemplate that a lawyer may provide an objective assessment concerning a client's situation to a third party, providing as usual that informed consent is obtained from the client.[70] Third, there is little reason to believe that most insureds would be particularly eager to move to or initiate an adversary relationship with the company, or eager to breach their obligations under the contract, even when given candid advice by the lawyer.[71] Sometimes the type of facts hypothesized in the second

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person." A lawyer masquerading an argumentative position as an objective assessment would, I believe, clearly be violating the former, and arguably the latter as well.

70. *See* MODEL RULES, *supra* note 11. Rule 2.3 provides:

> (a) A lawyer may undertake an evaluation of a matter affecting a client for the use of someone other than the client if:
>
> (1) the lawyer reasonably believes that making the evaluation is compatible with other aspects of the lawyer's relationship with the client; and
>
> (2) the client consents after consultation.
>
> (b) Except as disclosure is required in connection with a report of an evaluation, information relating to the evaluation is otherwise protected by rule 1.6 [confidentiality].

Id. at Rule 2.3.

It would seem that the tripartite relationship between insured, company, and lawyer—along with the insurance contract—would make this an appropriate situation for effectuating this rule and meeting the requirement of sub-section (a)(1). The comments show that the drafters were leery, however, of the joint role of litigation advocate and neutral evaluator:

> For example, if the lawyer is acting as advocate in defending the client against charges of fraud, it would normally be incompatible with that responsibility for the lawyer to perform an evaluation for others concerning the same or a related transaction.

Id. at Rule 2.3 cmt. 4.

71. Unsophisticated lay persons tend to perceive the law more normatively than do lawyers and academics. They are likely to feel bound by a valid contract whose benefits they are relying upon.

> The key implication of the Chicago study is that normative issues matter. People obey the law because they believe that it is proper to do so. . . The image of the person resulting from these findings is one of a person whose attitudes and behavior are influenced to an important degree by social values about what is right and proper. This image differs strikingly from that of the self-interest models which dominate current thinking in law. . . .

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paragraph of this section will make this conduct seem worthwhile, but more often with most clients one would think not.[72]

These stopping places suggest that the lawyer may be able to wear two hats for her sole client, the insured. Even in the same letter the lawyer might (1) provide an objective assessment of the matter which might well lead the company to believe that settlement should be rejected and (2) provide an argument that refusing to settle, although perhaps objectively justifiable, places an unjustifiable risk on the insured unless the company is willing to cover the insured for that risk. Assume the situation hypothesized above where judgment in excess of the policy limits is extremely unlikely and an objective assessment suggests any liability is unlikely, but the client reasonably prefers settlement to the remote risk of an excess judgment. In addition to providing the objective assessment, ought not a lawyer representing the insured suggest that a refusal to settle should be accompanied by the insurance company assuming responsibility for any excess judgment? Insurance company agreement to such responsibility seems reasonable and fair for the following reasons: (1) the company is the entity with something to gain by trial; (2) there is little risk of loss; (3) the company is sophisticated and experienced at assessing such risks; and (4) the company has greater resources and repeat experience to absorb the occasional unexpected loss and to balance it with the far more frequent gains.[73]

B. Confidentiality and Scope of Coverage

A second situation where the concern about the adversarial effect of the single client model may arise is when facts which arguably defeat coverage come to the attention of the lawyer who represents the insured.[74] Assume the facts in the well known *Parsons*[75] case: A fourteen year old boy "brutally assaulted" neighborhood children. The lawyer, hired by the

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TOM R. TYLER, WHY PEOPLE OBEY THE LAW 178 (1990). The lawyer's counsel, of course, is likely to influence what the client perceives as "right and proper," and the lawyer should keep this in mind. *See* Pepper, *supra* note 68, at 1598-610.

72. *See supra* text accompanying note 63.

73. *See generally*, Tom Baker, *Constructing the Insurance Relationship: Sales Stories, Claims Stories, and Insurance Contract Damages*, 72 TEX. L. REV. 1395, 1418-33 (1994); *see also* Michael Sean Quinn, *The Advice of Counsel Defense: A Response to Fischer*, 72 TEX. L. REV. 1487, 1497-1504 (1994). That the request is fair and reasonable and that it is foreseeable that many insurance companies would routinely resist or refuse such requests highlights why a joint client model is ethically inappropriate.

74. *See* KEETON & WIDISS, *supra* note 5, § 7.6(a)(2)(ii) & n.19.

75. Parsons v. Continental Nat'l. Am. Group, 550 P.2d 94 (Ariz. 1976).

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insurer to represent the boy and his parents pursuant to the parents' homeowner's policy, discovered a confidential file on the boy. The file had come from the "Paso Robles School for Boys" where he had been confined, which showed that the boy's attack was a "deliberate act" of which he was "fully aware." The lawyer informed the company of these facts, and the company denied coverage on the basis that the policy excluded liability for intentional acts. The reported opinion was a garnishment action on behalf of the injured parties against the insurance company, which was held liable not only for the policy limits of $25,000, but for the entire $50,000 judgment, on the basis of the lawyer's wrongful revelation of confidential information.[76]

What ought the lawyer to have done? Those who argue for the "two client" model would say that the lawyer must either withdraw from representing both clients, or at the least withdraw from representing the company. What concerns many is that such a withdrawal functions as a warning to the insurance company that something is amiss, and thus violates the lawyer's obligations of confidentiality.[77] The lawyer has

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76.

> When an attorney who is an insurance company's agent uses the confidential relationship between an attorney and a client to gather information so as to deny the insured coverage under the policy in the garnishment proceeding we hold that such conduct constitutes a waiver of any policy defense, and is so contrary to public policy that the insurance company is estopped as a matter of law from disclaiming liability under an exclusionary clause in the policy.

Id. at 99.

77.

> When the usually harmonious dual-client relationship is disrupted by the appearance of an insured/insurer conflict of interest, there ensues an elaborate minuet. The dance is nerve-racking for defense counsel and often severely prejudicial to the insured. . . When the conflict of interest issue arises and defense counsel resigns, the insurer is alerted to the need for further investigation. Often, without any additional disclosure by defense counsel, the insurer will discover the facts that are prejudicial to the insured.

Robert E. O'Malley, *Ethics Principles for the Insurer, the Insured, and Defense Counsel: The Eternal Triangle Reformed*, 66 TUL. L. REV. 511, 516 (1991). The *Parsons* court cited A.B.A. and state bar authority for the proposition that:

> [A]n attorney that represented the insured at the request of the insurer owes undivided fidelity to the insured, and, therefore, may not reveal any

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functioned essentially as a spy in the insured's camp, turning on him at a crucial time. For a sophisticated insured who understood the option of hiring or demanding independent counsel and did not do so, such a result may be understandable. Applied to an unsophisticated insured who almost surely did not understand such a risk, or the alternatives, it seems intolerable.

Yet for the lawyer to remain silent concerning facts which arguably defeat coverage is also troubling. The insurance company did not contract to cover damages resulting from intentional conduct and the insured did not pay for such coverage.[78] The lawyer by her silence is assisting in coverage beyond that provided by the contract.[79] (Moreover, part of that coverage which is not supported by the contract involves payment by the insurance company to the lawyer.)

If the lawyer represents only the insured (the single client model) and is guided by the law, she need not reveal or withdraw. Even if the insured's conduct is a breach of the cooperation clause (which it may not be)[80], it is

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> information or conclusions derived therefrom to the insurer that may be detrimental to the insured in any subsequent action. . . .

Parsons, 550 P.2d at 97. The court appears, however, to assume that the lawyer was *also* representing the company. Therefore, despite the fact that this would function as revealing confidential information, the Court opined that the lawyer

> should have notified [the insurer] that he could no longer represent them when he obtained any information (as a result of his attorney client relationship with Michael) that could possibly be detrimental to Michael's interests under the coverage of the policy.

Id. at 98.

78. For the moment we can elide the issue of whether or not the "facts" in the file defeat coverage. There are at least two doubts on this score. First, a finder of fact might conclude the conduct was not "intentional" as meant in the policy despite the conclusion to the contrary of the person who wrote the remarks in the file. Second, the parents might be liable for negligence in supervision of their child, and this might be covered under the insurance contract even if the child's conduct was intentional.

79. It is also true that the nature of the claim ought to suggest to the insurance company the possibility of an intentional conduct defense to coverage. As long as the company understands that they should not expect the lawyer for the insured to reveal damaging confidential information to them—that is, as long as the model of "one client" representation is clear—they ought to have the resources available to undertake an independent investigation if they think it worth the cost.

80. Substantial case law appears to hold that when a coverage dispute arises, privilege protects communication between insured and lawyer, and the cooperation clause does not require the insured to reveal facts which defeat coverage. *See, e.g.,* Carey-Canada Inc. v. Aetna

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probably not fraud. At this stage neither lawyer nor client is making an affirmative misrepresentation to the insurance company. They are merely not revealing a piece of evidence which arguably defeats coverage. Pursuant to Rule 1.2(d), the lawyer is prohibited from assisting a client in fraud, or counseling a client to commit fraud, but the line seems not to be crossed here. Assume, however, that the client in an auto accident case admits to his lawyer that he was not driving the vehicle, and that this fact defeats coverage. Here the client must have at some time affirmatively asserted that he was driving in order to invoke coverage. For the lawyer to continue representation under these circumstances would appear to assist the client in a fraud on the insurance company (and possibly the court, if the matter goes to trial and the client testifies). The lawyer would have to withdraw, and thus indirectly alert the company to a possible coverage problem. (Rule 1.6 would prevent the lawyer from explicitly revealing the conduct.)[81]

Has the law drawn this line in the correct place? Is the insurance coverage obtained in excess of that contracted and paid for sufficiently substantial that we should alter the rules of lawyer allegiance and confidentiality that apply to all other lawyer client relationships? The sophistication of the insurance company and its ability to investigate in situations where it ought to know coverage may be dubious (*Parsons* type situations, for example), balanced against the lack of sophistication and vulnerability of the client, lead me to believe that we ought to be hesitant in crafting special ethical exceptions for the insurance defense situation. (Note that such an exception in the insurance defense context would function to favor the powerful sophisticated institutional party at the expense of the unsophisticated individual.)

Thus, in both examined situations, evaluation of the case and confidentiality in relation to scope of coverage, it would seem that the insurance companies are not likely to be substantially harmed in the aggregate by a one client model of insurance defense representation. In each situation the insurance company appears to have sufficient means of reasonably efficient self protection. This is particularly true if lawyers and companies are clear about the obligations created by single representation—for example the ethical obligations of the lawyer in regard

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Cas. & Sur. Co., 118 F.R.D 250 (D.D.C. 1987); Rockwell Int'l Corp. v Superior Court, 32 Cal. Rptr. 2d 153 (Cal. Ct. App. 1994); Pittston Co. v. Allianz Ins. Co., 143 F.R.D. 66 (D.N.J 1992); *but cf.* Waste Management, Inc. v. International Surplus Lines Ins. Co., 579 N.E.2d 322, 328 (Ill. 1991); EDO Corp. v. Newark Ins. Co., 145 F.R.D. 18, 23 (D. Conn. 1992).

81. *See* California State Bar Ethics Op. 1995-139.

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to objective legal evaluation as opposed to legal argument, or on what kind of information an insurance company ought to expect a lawyer not to reveal—and also clear on whether the representation is single or joint.

V. TWO VERSIONS OF THE JOINT CLIENT MODEL

Before concluding, I will consider two quite different versions of the "joint client" model. One common understanding of insurance defense sees a modified joint client relationship—the tripartite relation among lawyer, insured, and company—under which the insured is the client to whom the lawyer owes primary allegiance should a conflict arise.[82] This "primary allegiance" understanding is quite different than the ordinary obligations of the lawyer under a joint client arrangement. In fact insurance defense practice is the only situation where such an understanding is common. We will turn to this model briefly at Section B below. Recently, however, it has been suggested that the appropriate model should be an "ordinary" joint client relationship, in which neither client has preference over the other. This possibility will be examined next.

A. Ordinary Joint Clients and the Lawyer as Double Agent

Professors Silver and Syverud appear to believe that liability insurance is more costly than it ought to be, and possibly that it is used more extensively than it ought to be.[83] Although they recognize the potential conflicts always involved in joint representation of insured and company, they believe that single representation of the insured is too expensive:

> One simple solution to problems in which counsel perceives a potential conflict of interest between the insured and the company is to require separate counsel for each routinely, with the company paying for both lawyers to represent zealously their separate clients' interests. This solution, while admirably removing most ethical dilemmas for defense counsel, imposes significant costs on insureds and insurance companies. A proliferation of lawyers on the

82. *See, e.g.*, MODEL CODE OF PROFESSIONAL RESPONSIBILITY EC 5-17 n.23 (1983) (stating that a lawyer's primary loyalty is to the insured when the lawyer is hired by an insurance company); *see also* KEETON & WIDISS, *supra* note 5, § 7.8(b)(2), at 885-86; MALLEN & SMITH, *supra* note 20, § 28.3, at 489-92.

83. *See* Silver & Syverud, *supra* note 2, at 362-63; Kent D. Syverud, *On the Demand for Liability Insurance*, 72 TEX. L. REV. 1629 (1994); Counsel Connect interchange, *supra* note 14.

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> defense side substantially increases the expense of lawsuits, and this in turn is reflected in insurance premiums.[84]

This seems odd, for it appears to envision that the company would hire two separate outside lawyers. It ignores the fact that insurance companies have staff lawyers hired already, and that they have claims personnel with substantial paralegal training. To suggest that companies would routinely "hire" a separate lawyer to represent their interests if the defense lawyer were understood to represent only the insured seems disingenuous, particularly in relatively routine cases with unsophisticated, non-corporate insureds. It ignores the fact that insurance companies are repeat players, ordinarily able to protect their interest through relatively efficient purchases and management of internal legal services. (This is not to deny that the single client model might be more costly. But the implication that it would require *doubling* the outlay for legal expenses, as this passage does, appears quite inaccurate.) It also ignores the fact that in jurisdictions which clarify that the lawyer represents the insured either exclusively or primarily no such routine doubling of lawyers has occurred.[85]

This concern with expense, supported in no greater depth and with no empirical data, is the primary base for Professors Silver and Syverud's elaborate view of insurance defense ethics and conduct. On the basis of this concern they proceed to a fundamental "working hypothesis" on which the rest of their analysis is based: "ordinary" joint representation is the proper format for the tripartite relation from the initiation of representation until the point at which a conflict requires withdrawal.[86] In preference to the clear rules protecting lawyer, client/insured, and company under either a single client model or the common "primary client" joint representation model,[87] they suggest that ordinarily the lawyer ought to represent both the insured and the company. On those frequent occasions when potential conflicts ripen into actual conflicts, "[u]fortunately, it is defense counsel who often must sort out these disagreements . . . ."[88] What this amounts to, as we shall see, is the placement of a double agent in the camp of the

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84. Silver & Syverud, *supra* note 2, at 268.

85. Michigan and Colorado come to mind. *See* Atlanta Ins. Co. v. Bell, 475 N.W.2d 294 (Mich. 1991) (in ordinary tripartite relationship, the insurance company is not a client of the lawyer); Colorado Ethics Op. 91 (1993) (the better rule is that the lawyer's client is the insured and not the carrier).

86. *See* Silver & Syverud, *supra* note 2, at 264-69.

87. The "primary client" understanding of joint client status, unique to insurance defense, is discussed in the following sub-section, Part V.B, *infra*.

88. Silver & Syverud, *supra* note 2, at 267.

insured; a lawyer obligated to betray the client/insured due to its obligations to the company. In Professors Silver and Syverud's model this occurs without the insured being notified in advance or providing consent.[89] Under their view, the potential conflicts apparently are not great enough (or perhaps specific enough) to require consultation or consent at the initiation of the representation.

In fact, under this remarkable understanding, the "retainer agreement" is between the company and the lawyer; the insured is not even a party to the agreement which creates the joint client relationship. "It is up to the lawyer and the company that retains the lawyer to decide whether the lawyer will represent only the company, only the insured, or both. Their agreement settles the matter . . . ."[90] This is apparently possible because the insurance contract "bleeds into" the retainer agreement. This transmutation of one agreement into another occurs despite the fact that (1) the lawyer is not a party to the insurance contract and has obligations under the Model Rules clearly in addition to what might be in that contract;[91] (2) the insured is not a party to the retainer agreement; (3) the consultation and consent required by the Model Rules—1.7(b), 1.2(c), 1.4(b)—clearly do not occur as part of the insurance contract, as part of the sales discussion prior to that contract, or as part of the "retainer agreement."[92] This "bleeding" is quite a remarkable trick and quite essential for the "ordinary joint client" view to make any sense. And yet it is obviously quite extraordinary, both from the perspective of the ordinary understanding of how contractual obligations come into being, and from the view of professional ethics.

Consider the impact of this view on the conduct of the lawyer. Assume that the client/insured has changed his story: the lawyer believes that he is now lying and was telling the truth before and believes that it is best for the client-company that the insured's testimony (actual or prospective) be impeached. The law, of course, will not permit such conduct by the lawyer for the insured defendant, so Professors Silver and Syverud indicate how the lawyer should proceed in this difficult situation: they provide a page of suggested advice that counsel give to deter the client/insured from lying. One piece of that advice:

> Defense counsel should remind the insured that the insurance company will be able to discover all information

89. *See id.* at 326-31.

90. *Id.* at 279.

91. MALLEN & SMITH, *supra* note 20, § 28.3, at 491-92.

92. *See supra* Part I.B.

> defense counsel possesses relating to the truthfulness of the insured's testimony in a subsequent coverage dispute between the company and insured because there is no attorney-client privilege between former co-clients who become adverse.[93]

If we have the "ordinary" joint client relationship, this is true. The client/insured does not enjoy the ordinary protections of confidentiality, yet was never warned that this was the situation, and never consented to it. This is the consequence of (1) assuming at the outset an ordinary joint client relationship, with (2) insufficient potential conflict to trigger Rules 1.7(b), 1.2(c) and 1.4(b), and (3) consent, such as it is, somehow bleeding from the insurance contract (which has no provision concerning either a joint client status or waiving the confidentiality of the lawyer/client relation) to the "retainer agreement"—which is itself normally unwritten and unarticulated.

For the insured to perceive betrayal here does not seem inaccurate; for the insured to see the company as the "primary" client does not seem inaccurate. (It is also true that the quoted advice is misleading in relation to the general rule as it is currently understood for the tripartite relationship. Even if the lawyer represents both, she may not reveal damaging information about the insured to the company: "ordinary" joint client rules do not apply to insurance defense.)[94]

Another segment of the suggested counsel from Professors Syverud and Silver:

> If the insured is unwilling to follow either course [suggested by counsel], defense counsel should explain that *the insured has no authority to control the defense* of the liability claim, that defense counsel will nonetheless refrain from impeaching the insured against the insured's wishes, but that *defense counsel will have to withdraw if the insured persists in refusing*.[95]

In regard to withdrawal, the situation is parallel to confidentiality. If the lawyer were representing only the insured it is by no means clear she

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93. Silver & Syverud, *supra* note 2, at 323.

94. *See* KEETON & WIDISS, *supra* note 5, § 7.6(a)(2)(ii). This is the holding of the well known *Parsons* case. *See supra* notes 75-76 and accompanying text.

95. Silver & Syverud, *supra* note 2, at 323-24 (emphasis added).

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would have to withdraw,[96] and the client was never informed of and did not consent to this disadvantage of joint representation. In addition, however, the lawyer is giving the client misleading advice in the first emphasized portion of this passage. The insured *does* have the authority to control the defense. He has, in addition, a contractual obligation to cede that control to the insurance company. But how that obligation will be enforced, and what the insured's obligations are in relation to that obligation, would involve far more complex counseling than Professors Silver and Syverud contemplate.[97] And what they don't tell, here, arguably indicates a rather biased approach to the situation.

There is more partial and misleading advice along this line: "Defense counsel should tell the insured that, by testifying falsely, the insured may forfeit insurance coverage by breaching the cooperation clause."[98] Note that the lawyer does not explain that ordinarily this would only occur through a subsequent lawsuit. The insured also is not informed that insurance companies ordinarily do not pursue enforcement of the cooperation clause and, if they do pursue it, might well be unsuccessful given the obstacles the law has created.[99]

Similar questionable advice is given for a less dramatic conflict. Assume the insured does not want to testify because it would reveal that he was with a woman other than his wife on the night of the accident. In counseling concerning the conflict which has arisen, the following advice is suggested:

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96. That would depend upon how certain the lawyer is that the new story is a lie, and not the old, and what options are available regarding the testimony.

97. *See supra* Part IV.A.

98. Silver & Syverud, *supra* note 2, at 323.

99. It is also important to note that Professors Silver and Syverud have earlier stated that coverage advice should be outside the scope of the duties for the defense lawyer, pursuant to the retainer agreement they imagine. Suddenly, however, coverage advice is inside the scope under this scenario. Now that it is to the benefit of the company, the lawyer may advise the insured on the contract. Also, the "may forfeit coverage" advice becomes a good deal stronger in the final paragraph of suggested advice:

> If the insured still refuses to correct the prior testimony or to submit to impeachment, defense counsel should explain the *likely consequences* of withdrawal for the insured and the steps the lawyer will take to protect the insured's interests. The likely consequences include the loss of insurance coverage for liability and defense costs.

Id. at 324 (emphasis added).

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> The cost to the insured of waiving the conflict is that insured must continue to bear the risk of being asked to testify, if needed to defend the liability suit effectively. The benefit to the insured is that the insured can continue to receive the services of defense counsel at the company's expense.[100]

If the insured is represented by a lawyer unconstrained by the joint client obligations, then the insured can both refuse to testify and quite possibly receive the benefits of insurance. Ordinarily, the insurance company's remedy for failure to cooperate is a subsequent suit in which prejudice must be proved. Whether the company would choose to sue, or refuse payment and await a suit, involves many variables. None of this advice is given to the insured, nor is he informed that the presence of a conflict gives him a basis to demand counsel unconstrained by an attorney-client relationship with the insured.[101]

I think it fair to say that the advice of counsel suggested by Professors Silver and Syverud in these two situations is at best partial and one-sided, and at worst misleading and manipulative. It appears to be designed to serve the interest of one client (the company) to the possible detriment of the other client (the insured). They appear to believe that such constrained and misleading advice and such drastic limits on the ordinary allegiance an insured would receive under a normal attorney-client relationship are justified by the savings in defense lawyer costs to the liability companies. The companies, however, have experienced in-house legal and para-legal personnel capable of monitoring cases. They have a volume business to spread out any losses caused by lawyer allegiance to the insured. Nonetheless, in this model the burden is to be put upon unsophisticated insureds and upon lawyers exposed to malpractice liability[102] and ethics violations rather than upon the insurance companies. It would take a

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100. *Id.* at 330.

101. *See* Silver & Syverud, *supra* note 2, at 326-31.

102.

> Having said that a lawyer can defer educating the clients, we must observe that a lawyer does so at his peril. It is too late to have a conversation about the baseline [of no confidentiality between joint clients] after one of the clients has given the lawyer relevant information and asked that it be withheld from the other. Once the cat is out of the bag, it cannot be returned. . . With the aid of hindsight, it will usually appear that the lawyer should have educated the client about the baseline before the client spoke.

Id. at 358.

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substantial savings to the economy to justify turning upside down the ordinary understanding of the underlying professional ethic. Professors Silver and Syverud want to put the risks and the costs of this "ordinary two client" view on the least sophisticated and least powerful parties.

I will mention one further example of what I perceive to be a remarkable bias in favor of insurance companies. In regard to scope of coverage, Professors Silver and Syverud suggest that ordinarily the defense lawyer represents the insured in regard to defense of the lawsuit narrowly construed, and therefore ought to provide the insured no advice on the many possible attendant issues.[103] The company, to the contrary, should ordinarily be represented on all matters relating to "investigation, defense and settlement."[104] Here, again, the unsophisticated client, without benefit of informed consent, receives the distinctly short end of the joint client stick. The company, with vast legal resources, gets the benefit of full service representation. The unsophisticated insured, although promised a lawyer to represent him, is denied legal advice concerning settlement or the obligations of the parties under the insurance contract. If he wants those, he has to go pay for them himself—a prospect quite unlikely unless the insured has significantly greater resources than most individuals.

It may be that part of the motivation for the authors' position is a belief that the underlying substantive law excessively favors insureds over insurance companies, and a consequent effort to ameliorate the effects of that law by avoiding having the insured learn of it. For example, Professor Silver once asked me if the defense lawyer ought to be allowed to "set up" the company for a judgment in excess of the policy limits on the basis of "bad faith" failure to settle.[105] The answer, in my view, depends upon what baggage comes with the phrase "set up." If (1) the facts and the applicable law arguably support such a claim, and (2) if lawyers' ethics as applied to a lawyer representing only the insured would allow such advice, then the answer is a clear "yes." Professor Silver's real argument here, I believe, is with the underlying law of "bad faith" liability for excess judgments, as is revealed by his usage of the derogatory phrase "set up." One must presume that the courts of the jurisdictions which have created and accepted this body of law disagree. And if the law has been created for the benefit of insureds, it will only be effectuated for unsophisticated insureds if their

103. *But see supra* note 99 and text accompanying note 95.

104. Silver & Syverud, *supra* note 2, at 296, 301.

105. Counsel Connect Interchange, *supra* note 14.

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lawyers inform them and act upon it.[106] Professors Silver and Syverud appear to prefer that the insurance companies be protected from effectuation of the substantive law by limiting what the lawyer can do through the device of the "ordinary joint client" relationship; in essence they want to provide unsophisticated insureds with one-half a lawyer.[107] But the insured never bargained for, accepted, or understood that this is what he was buying with his insurance contract.

Excessive cost is not the usual argument made in favor of a joint client understanding for insurance defense representation. Two rather different reasons are more frequently put forward. The first concerns control over the litigation by the insurance company. As discussed above, the insurance contract allocates control to the company. Effectuation of this provision, however, does not require joint representation, nor does joint representation facilitate control in any substantial way.[108] The second concern is malpractice liability to the company. If the lawyer is incompetent in defending the insured, but the insured is not harmed because the insurance company is obligated to pay the judgment, malpractice liability to the company is problematic if the company is not considered a client of the defense lawyer. Theories of subrogation and third party beneficiary are sufficient to remedy this genuine problem.[109] To the extent states have not recognized them, the proper remedy is expansion of this aspect of malpractice law, rather than subversion of the lawyer's ethical obligation to the insured by usage of an "ordinary" joint client model.

The "ordinary" joint client model is a quite radical suggestion, as opposed to the commonly accepted modified joint client model (primary client model) discussed in Section B below. If Professors Silver and Syverud are correct that there are substantial economies to be gained by

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106. It is also possible that by "set up" Professor Silver intends to suggest that the lawyer is engaging in some sort of wrongful or unlawful conduct. Perhaps he believes that the lawyer, in the guise of an objective opinion letter assessing the merits of settlement, will in fact be advocating a particular position and result. As noted in Part IV, *supra*, a lawyer is prohibited from such misleading conduct. Perhaps Professor Silver is suggesting that the lawyer would be assisting the client in a fraud. Under Rule 1.2(d), as also noted in Part IV, *supra*, this too would be prohibited.

107. *See* Silver & Syverud, *supra* note 2, at 362.

108. *See supra* Part I.B. *See also* Morgan, *supra* note 61, at 56; Morgan & Wolfram, *supra* note 59, at 44-45.

109. *See* Morgan, *supra* note 61, at 31-33; Atlanta Int'l Ins. Co. v. Bell, 474 N.W.2d 294 (1991); RESTATEMENT OF THE LAW OF LAW GOVERNING LAWYERS, Council Draft No. 13 § 215, cmt f (1997).

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such a model, the question arises as to who should pay the costs associated with these savings. Should the costs fall on the ordinary consumer clients who happen to be injured when the entirely foreseeable, albeit relatively uncommon, conflicts arise? In other words, should the costs be externalized in a relatively haphazard way to fall as major losses on individuals and small businesses? Or should such costs be absorbed and spread by the insurance companies, as a fair quid pro quo for the substantial advantages Professor Silver and Syverud assert accrue from "ordinary" joint client status? A simple answer is available. In return for joint client status, the insurance companies ought to waive any policy defenses they learn of after the lawyer has been assigned the matter. In addition, they ought to assume responsibility for any liability assessed over the policy limits. These primary risks of joint client status ought to be assumed by the companies in return for the benefit. In other words, if so much is to be gained for the industry (and insureds as a group) by routine use of an ordinary joint client arrangement, then the companies ought to indemnify the ordinary, unsophisticated insured for any losses suffered as a result of the arrangement. If, as suggested toward the end of Part I.A. above, companies are unwilling to do so, either the efficiencies of joint client status must not in fact be much greater than the costs, or conflicts must be much more likely and pervasive than Professors Silver and Syverud suggest.

B. Modified Joint Clients: The "Primary Client" Model

Many jurisdictions, perhaps the majority, characterize both the insured and the company as clients of the defense lawyer in the absence of a specific conflict of interest. When a conflict arises, however, they indicate that the lawyer owes "undivided" allegiance to the insured, and cannot harm the insured to benefit the company.[110] The *Parsons* case[111] is typical in this regard, disallowing the lawyer from revealing damaging confidential information to the company, yet recognizing the company as a client. This is quite different from the ordinary situation of joint clients. There is usually no confidentiality as between joint clients; and the very nature of the situation is one of limited allegiance: what one can do for one client is limited by one's obligations to the other. It would seem inaccurate to characterize that as a situation of "undivided" loyalty; quite the contrary.

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110. *See* MALLEN & SMITH, *supra* note 20, § 28.3, at 489-90.

111. *See supra* notes 75-76 and accompanying text.

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Professors Silver and Syverud call this the "primary client rule ("PCR")."[112] In light of their insistence on an ordinary joint client model for insurance defense representation and the extent to which that "working hypothesis" is a premise for their questionable positions on the defense lawyer's conduct and obligations, they make a quite extraordinary admission regarding the rival PCR view:

> When presenting drafts of this report, we have been repeatedly struck by the extent to which defense lawyers, general counsel for insurance companies, and claims personnel have internalized PCR. Although we did not expect to have to do so when we undertook this project, a major part of our effort has been to convince company-related constituencies that defense lawyers can have duties of loyalty to insurance companies, not just to insureds.[113]

In other words, the interests of insurance companies which in the view of Professors Silver and Syverud so clearly and forcefully require an ordinary joint client approach (including economies related to both the number of lawyers providing legal services and the extent of their duties) are not manifest to those insurance companies or their lawyers. The primary client model is acceptable to the insurance industry, and Professors Silver and Syverud are off on a quest of their own making.

The primary client model differs very little from the single client model. In both the lawyer must not harm the insured and can serve only the insured's interests if a conflict arises.[114] The model has the advantages of clarifying that the company is a client for purposes of malpractice liability[115] and of making defense lawyers more comfortable at the outset of the relationship (and for the duration of those many representations in which no actual conflict arises). The lawyers can think of the entity who selects and pays them and on whom they depend for repeat business as the client. If in fact they will serve the interest only of the insured in the event a conflict arises, it is also arguable that the type of informed consent required under Rule 1.7(b) and discussed in Part I above might not be required, or at the least might be much less elaborate.

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112. Silver & Syverud, *supra* note 2, at 335-36.

113. *Id.* at 338 n.196.

114. *See* Morgan, *supra* note 61.

115. *See* MALLEN & SMITH, *supra* note 20, § 28.3.

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The downside is that a lawyer might be required to withdraw from representing the company when a conflict arises, and possibly the insured as well, even though the insured is the primary client. This appears to have been the view of the *Parsons* court.[116] As noted above, a withdrawal alerts the company to the presence of a conflict and thus functions as a revelation of confidential information.[117] The foreseeability of such a required withdrawal would probably move us back to Rule 1.7(b), and a requirement that this risk be explained to the insured to attain sufficient "consultation."

There is a simple remedy available for these disadvantages: In combination with understanding the insured as the primary client, the company could be considered to have the status of a "defeasible client." Under this model the company would be considered as a client up to the point at which a conflict arises. In terms taken from Rule 1.7(b), at the point in time at which the lawyer's representation of the insured would be "materially limited" by its representation of the company, then the latter would cease. Under this view, the lawyer's obligation in the case of conflict would indeed be "undivided," as the law of most jurisdictions now requires. At that point the insured would become the sole client. This automatic defeasibility would mean that the lawyer would not need to notify the company. Moreover, the principle underlying the defeasible client model—that the vulnerable, non-repeat player client ought not to be harmed by the joint representation—would suggest that the lawyer ought to be prohibited from notifying if it would harm the insured.[118] The

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116. *See Parsons*, 550 P.2d at 98.

117. *See supra* Part IV.B.

118. Robert O'Malley, Vice Chairman and Loss Prevention Counsel for Attorneys' Liability Assurance Society, Inc., has suggested to me that silent defeasance of client status may go too far in regard to fairness to the company. O'Malley appears to suggest a bifurcated client status: as against the world (for conflicts and malpractice purposes) the company is a client; but in regard to representation of the insured, the company is not a client. In his quite sensible and comprehensive nineteen suggested guiding principles, he includes:

> 2. As a general proposition, an insurance company is a client of its designated defense counsel vis-a-vis the entire world of nonclients.
>
> * * *
>
> 5. Assuming the insured agrees to be represented by the insurer's designated defense counsel, *for all purposes as to that particular matter the insured is the only client of that lawyer.*

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companies would not be unduly prejudiced because they would know the rule in advance and would know that the need to investigate possible conflicts would lie with them, not the lawyer hired to represent the insured. In addition, in the common situation where no conflict arose they would gain the benefits (if any) of joint client status.

The defeasible client model is close to the articulated law of many, perhaps most, jurisdictions. It is also quite close to the generally understood ethical obligations of a lawyer with a single client, the insured. It is thus a model which might bring some clarity and consensus to a common but ethically difficult area of legal practice.

The downside of the "defeasible client" model is that it has no precedent in lawyers' ethics; it would be a unique understanding crafted specifically for the tripartite relation. The single client view, to the contrary, accords better with the general understanding of the purposes of lawyers' professional ethics, and with the Model Rules. As between a "defeasible client" model and the "single client" model the question is close, and may depend on which can be more effectively integrated into current law in most jurisdictions.

CONCLUSION: A BRIEF REPRISE ON THE SINGLE CLIENT MODEL

The four elements set out below describe and structure the situation facing an insurance defense lawyer, restating in a nutshell the difficult problem explored in this article.

> (1) The lawyer has been hired to represent the insured in a liability lawsuit. That much is irreducible. The lawyer owes the insured the obligations due a client and is bound by the rules of ethics in effect in the relevant jurisdiction which provide the client/insured many protections.
>
> (2) The client is both benefitted and encumbered by a pre-existing contract with the insurance company. That contract obligates the insured to cooperate with the company in the defense, and to cede control of the defense. Those obligations are not self-executing, however, and are not directly binding upon the lawyer.
>
> (3) The contract obligates the insurance company to provide a defense, pursuant to which the lawyer has been hired, and it obligates the company to pay any judgment

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O'Malley, *supra* note 77, at 521-22 (emphasis in original).

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> within the policy limits. The company thus has a definite, concrete interest in the litigation. It has both the right and obligation to manage the defense, and will be liable for most judgments.
>
> (4) The lawyer is paid by the insurance company, and depends upon the insurance company for repeat business. The company is a repeat player in such matters, knowledgeable and sophisticated in legal matters related to litigation and to the obligations and enforcement of contracts.

These are the parameters defining the insurance defense relationship. The contract creates a dual interest and dual relationship in the litigation which is unique, and which leaves the lawyer in a situation of considerable ethical difficulty. Element (3) might well suggest enough of an interest for the company to be considered a joint client in the litigation. Unfortunately, however, the interests of the two "clients" are sufficiently distinct as a result of the contract that potential conflicts are clearly foreseeable. That makes joint representation, as it is ordinarily understood, very risky both for the lawyer and for the unsophisticated insured.[119]

Single representation presents its own difficulties. The contract in element (2) is so closely connected to the conduct of the litigation, and so interwoven with the relationship of insured, company, and lawyer, that to construe the lawyer's representation as excluding any advice about the meaning, content and relevance of its obligations seems quite artificial. Normally a lawyer is expected to assume that the scope of representation includes all that is material to the matter and to protect a client (particularly a legally unsophisticated client) from perceiving "the matter" from too narrow a perspective. Denying the client relevant information about the contract which so defines the situation would seem unjustifiable. At the least, Rule 1.8(f)(1) requires some "consultation" regarding the insurance contract and its role in the hiring of and obligations on the lawyer. Also, Rule 1.2(c) would seem to require specific informed consent to narrowing the scope of representation to exclude all advice concerning the contract.

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119. *See supra* Part I for a discussion of the warning and consent requirements, and for the suggestion that a well informed and advised client-insured would be unlikely to consent to joint representation. Moreover, nothing in the insurance contract requires the insured to accept such limited representation.

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Of perhaps greatest difficulty is the extent and timing of advice in regard to element (2), the insured's obligations under the contract and how those obligations might be enforced if breached. Ordinarily, assuming (a) initial indications of full coverage, (b) assurances of confidentiality to the insured (which could not be given if the company is considered an "ordinary" joint client), and (c) no facts suggesting a particular conflict will arise in the course of defense, such advice might be quite minimal. Lawyers are aware, or ought to be, of the extent to which advice about the law can shape client behavior. Under these assumptions there is little reason to think the client will benefit from perceiving the insurance company as an adversary, and thus there would seem to be little reason to provide an incentive for the client/insured to perceive a conflict. On the other hand, there may well be facts which the lawyer does not yet know which would make such advice more relevant. More elaborate advice about the contract, its enforcement, and options in conducting the litigation might either (1) create conflict where none is necessary or useful, or (2) draw out facts indicating such advice is indeed salient to the insured's particular situation.

It is not unusual for lawyers' work to entail this kind of difficult judgment. There is often no single "correct" answer as to how to proceed, and the range of correct answers is determined by the specific situation, even in common, repeat situations such as insurance defense. To some extent the answer depends upon the proclivities, preferences, and personalities of the individual lawyer (and of the individual client, as well.) This is part of what we mean when we speak of the wide range of professional judgment ordinarily open to a lawyer. In the particular situation we have been examining, insurance defense, a major part of the underlying problem is the pull on that wide range of discretion created by the fact that the insurance company is paying, and from the lawyer's perspective, preferably will be a repeat payor in the future.

Even assuming a single client model, it is possible that leaving these judgments in the hands of individual defense lawyers—subject to the bias created by the economic power of the insurance companies which pay them on the one hand, and the arguable ethical obligation to assist the insured *against* company, on the other—is an unsatisfactory conclusion. A better alternative does not seem available at the moment, however. Both lawyer and client have substantial reason not to treat the insurance company as an adversary unless the facts in combination with the substantive law create a genuine conflict. In such cases, it would seem that the underlying substantive law is the problem, if there is a problem, rather

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than the lawyer's single allegiance to the client/insured. The fact that the insurance company is paying ought not mean that the client/insured is screened from access to the relevant substantive law, even if it is likely to raise a conflict with the insurance company.[120] In regard to concern that the lawyer will undermine the insured to benefit the insurance company because of the lawyer's own financial interests, the "single client" model ought to function as a substantial counterbalance to the lawyer's self-interest, thus fulfilling to some extent the underlying purpose of professional ethics.

120. A suggestion, or warning, from the lawyer that the client ought to seek advice from a second lawyer on coverage issues because it is beyond the scope of the assigned lawyer's responsibilities (or ethically prohibited under a joint representation) does not seem realistic in the situation of ordinary, unsophisticated insureds without substantial assets. *See supra* note 1 and accompanying text. Such clients are likely to believe that they do not have the resources to pay for this advice on their own, and would be reluctant to seek it given their outsider status in regard to legal matters.

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INSURANCE DEFENSE ETHICS AND THE LIABILITY INSURANCE BARGAIN

*William T. Barker**

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INTRODUCTION

In commenting on Professor Pepper's paper,[1] I will concentrate primarily on areas of disagreement, as discussion of those points will be most informative to others. But before disagreeing, I want to say that I found his paper the best and most thoughtful presentation I have seen of the challenge to the traditional understanding of the insurance defense

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1. Stephen L. Pepper, *Applying the Fundamentals of Lawyers' Ethics to Insurance Defense Practice,* 4 CONN. INS. L.J. 27 (1997).

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community regarding the ethical obligations of insurance defense counsel.[2] Moreover, he has offered some insights, notably regarding the distinction between a brief and an objective evaluation,[3] which I consider important advances in thinking about these problems. Responding has forced me to clarify and refine my own thinking in significant ways, and I thank him for doing so.

Professor Pepper begins his analysis of insurance defense ethics at the point where an insured has presented a claim and the issue of representation (and informed consent, to the extent required) must be addressed. The existence and general terms of an insurance contract are assumed. But the general approach is to maximize the insured's options, including the option to breach the contract if that appears advantageous.

I begin at an earlier point, where the insurance bargain is being formulated. While insurance contracts with the sort of unsophisticated customers under consideration are adhesion contracts, market forces may still have produced a fair bargain which serves the legitimate interests of both insurers and insureds. A fair bargain is enforceable in accordance with its terms, even in an adhesion contract. I would also argue that those terms may legitimately be construed in light of their functions in the structure of the bargain, but that need not be debated here.[4] For present purposes, I will assume an ideal insurance contract which perfectly implements the structure of the bargain I describe. Equivalently, one could assume that the relevant jurisdiction has authoritatively construed an existing standard form to have the proposed effect.

While an adhesion contract cannot itself constitute informed consent, it can structure the options presented when consent is sought. If the insured is asked whether counsel jointly representing insurer and insured is

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2. Only after writing this sentence did I read Professor Tom Baker's equally impressive paper, *Liability Insurance Conflicts and Defense Lawyers: From Triangles to Tetrahedrons*, 4 CONN. INS. L.J. 101 (1997). But because that paper challenges only relatively modest portions of the traditional understanding (though providing fresh insights as to the reasons why the traditional structure, at least in modified form, serves the relevant interests), the sentence in text remains true. My primary assigned responsibility is to comment on Professor Pepper's paper, but I shall address Professor Baker's paper to the extent that my time permits.

3. *See* Pepper, *supra* note 1, at 16-18 nn.40-43.

4. After presenting this paper, I had a chance to read Professor Robert H. Jerry II's paper, *Consent, Contract, and the Responsibilities of Insurance Defense Counsel*, 4 CONN. INS. L.J. 153 (1997), which has stimulated me to add a section debating this point, after all. *See infra* text accompanying notes 54-58.

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acceptable, the choice looks different depending on whether the alternative is (1) defense by separate counsel, paid for by the insurer but not representing it, followed by indemnification of any covered liability established or (2) loss of all benefits of the insurance policy (acceptance of joint counsel being a valid condition of any benefits).[5] (Of course, these are polar extremes and there may be additional or different options.) An insured faced with the first choice might be altruistic to accept joint counsel to save money for all insureds. But an insured contracting for insurance serves her own interests in cost minimization by requiring herself and all others to make the second choice rather than the first, when and if a claim arises.

Moreover, focusing on the design of the insurance bargain changes the question posed. Professor Pepper asks, in essence, what design of the insurance bargain and the representation will best protect the interests of an insured who at least may have interests divergent from those of the insurer. I ask, instead, what structure will best effectuate the joint contractual purposes of the parties, and is that structure one which professional responsibility law permits to be implemented? The contractual analysis suggests that certain types of interests which an insured may have on a particular claim need not be protected, because they are inconsistent with the insurance bargain. And, obviously, a contract may be structured to promote compliance (and monitoring of compliance), rather than to facilitate breach. For example, it may be in the interest of an insured, ex ante, to bond compliance by permitting placement of a spy in his camp, even if, ex post, the presence of the spy may prove unwelcome.

If the resulting contractual design creates complexity for defense counsel retained pursuant to the contract, that will raise costs in some respects. Defense counsel must be paid to cope with the complexities, and some liability costs will flow from the inevitable errors in doing so. But if the costs of the complexities are less than the savings from the structure which creates them, those costs would be justified. Thus, the mere existence of complexity is not a sufficient argument for simplification.

The fact that insurers continue to employ (and remain strongly attached to) a complex structure suggests that that structure is cost-justified. As will

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5. For purposes of this illustration, I assume that the facts presented and the coverage issues raised, if there are any, do not create the sort of conflict which, under generally applicable law, entitles the insured to independent counsel. *See* William T. Barker, *Reservation of Rights and Conflict of Interest: When Does the Insurer Lose the Right To Control the Defense?*, 58 DEF. COUNS. J. 469 (1991).

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be argued here, that structure seems fair to all parties. That logic is supported by the fact that even sophisticated insureds, with bargaining power to obtain different terms if willing to negotiate for them and pay any additional costs, commonly buy liability insurance policies using the standard terms offered to unsophisticated buyers.[6]

I. STRUCTURING THE INSURANCE BARGAIN

All insurance begins with aversion to risk. Liability insurance begins with aversion to risks associated with claims of liability. In attempting to transfer those risks, insureds will commonly wish to minimize the premium for the transfer, even if more expensive arrangements might be useful in some circumstances. In handling claims, insurers will be driven almost exclusively by cost minimization, and it is in the interests of both parties to adopt a contractual design supporting such minimization, unless there is an identifiable population of insureds desiring more expensive terms.

For example, most policies authorize the insurer to minimize costs by settling whenever it deems that to be expedient, even if the insured would prefer continued litigation to protect reputational interests.[7] Most insureds are not prepared, ex ante, to pay for the ability to protect their own

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6. Sophisticated insureds do sometimes contract in different ways. As an alternative to traditional liability insurance, where the insurer has the right to control the defense, some commercial policies simply indemnify against both defense costs and liability. For reasons developed *infra* notes 7-9, one would expect such insurance to be more expensive than traditional liability insurance. But if the net benefits of that structure ordinarily exceeded its additional cost, one would not expect the liability insurance form to be used at all with sophisticated customers.

The observed pattern suggests that the indemnity form is cost-justified only in specialized circumstances. One such circumstance may be legal malpractice insurance, as lawyers are more able to manage litigation than most insureds. But this may also be a situation where lawyers are willing to pay extra for control of the defense, either due to reputational concerns or simply because lawyers tend to be "control freaks." Indemnity insurance is also commonly used for directors' and officers' insurance where the normal case involves multiple insureds with substantial possibilities of conflicts among them. This may merely recognize that independent counsel would almost always be required in any event.

7. This opportunity for cost-minimization is not provided by indemnity policies unless the insured's desire for settlement exceeds any desire for vindication, for it is the insured which initiates or initially responds to settlement proposals, though the insurer must agree before its money can be committed. This aspect of the indemnity policy thus tends to increase costs unless insurers are unduly willing to settle (judged purely in terms of claim cost).

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reputational interests or to be pooled with the few insureds who would pay for such protection. Many doctors, on the other hand, are willing to pay for professional liability insurance affording such protection. This creates a market for higher-cost policies precluding settlement without the insured's consent.

Where a sufficient market exists for non-cost-minimizing insurance, insurers generally supply the appropriate product at a suitable premium. Persistence of largely unvarying policy terms which support cost-minimization suggests that there is no market for more expensive forms of coverage for most types of liability risks.

Liability insurers offer defense coverage for two reasons. First, the cost of defense is a significant economic risk, which insureds wish to shift. Second, and (I think) more importantly, defense is an important tool for minimizing the liability awards that must be indemnified. So, the insurer reserves the right to defend, as well as assuming the duty to do so.

But, ex ante, it is in no one's interest (except that of prospective defense counsel) to spend more on defense than the expenditure will save in liability costs. This supports not only the insurer's right to settle, but also its right to direct and control the defense so as to limit defense expenditures which would not be cost effective.[8] It does not matter, when a claim is presented, if the insured would now prefer a more expensive defense (unless the insured is then willing to pay the extra cost).

Insurer control and direction of the defense also tends to minimize liability costs. Liability insurers are in the business of managing litigation. If they are inefficient in doing so, competition from more efficient managers will either undercut their prices or limit their returns to investors to a below-average return. Either result will tend to drive the least efficient from the market. Insureds generally lack the incentives and opportunity to develop efficiency in this regard.[9]

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8. An insured under an indemnity policy lacks the incentive to minimize defense costs, which is another reason why indemnity policies are likely to be more expensive than liability policies.

9. Volume purchases of defense services also permit insurers to minimize costs. But that benefit could be obtained without permitting insurer direction of counsel, once hired. Thus, this consideration does not directly support insurer control. However, granting the insurer the right to select counsel without the right to control would leave considerable opportunity for exercise of influence generated by counsel's desire for selection in future cases. Such influence is not a particular concern where the insurer is entitled to control, at least so long as there is no conflict with the interests of the insured as to the matters to be controlled.

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Just as there is usually no market for liability insurance designed to protect reputational interests, so there is none for insurance designed to protect other collateral interests of the insured, such as economic interests in protecting family members, goodwill interests in satisfying claims of customers, and humanitarian interests in compensating those one has injured. Such interests are protected, if at all, by first-party insurance, such as medical payments or personal property coverages. On liability claims, an insurer is entitled to treat every claimant as an adversary and to subject the claim to full adversarial testing.[10] It is entitled to ignore collateral, uninsured impacts on the insured and simply minimize direct economic costs.

Moreover, the insured is obliged to cooperate with the insurer to achieve cost minimization. Of course, this means that the insured must provide information, testify at trial, and otherwise participate in the defense, if so requested. But it also means that the insured must not obstruct or render more expensive the exercise of the insurer's contractual rights, an obligation also flowing from the duty of good faith. For example, defense counsel's duty of loyalty to the insured prevents counsel from effectuating a settlement over the insured's objections, even if the insurer has the contractual right to settle.[11] While the insurer can settle using other agents, it is wrongful for the insured to force it to do so if

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10. Thus, an insured has no right to have settlement of a claim expedited to preserve the goodwill of a claimant-customer. *See* Coil Anodizers, Inc. v. Wolverine Ins. Co., 327 N.W.2d 416, 418-19 (Mich. Ct. App. 1982); Eureka Inv. Corp. v. Chicago Title Ins. Co., 530 F. Supp. 1110, 1116-17 (D.D.C. 1982), *aff'd in part and rev'd in part*, 743 F.2d 932 (D.C. Cir. 1984). That is not to say that the insured might not have a claim for loss of goodwill resulting from *improper* delays in adjustment. *See* Bodenhamer v. Superior Court, 238 Cal. Rptr. 177 (Cal. Ct. App. 1987).

In general, the claimant has no right to anything more than adversarial honesty in the adjustment of the claim against the insured. *See, e.g.*, California State Auto. Ass'n Inter-Ins. Bureau v. Superior Court, 788 P.2d 1156 (Cal. 1990); Moradi-Shalal v. Fireman's Fund Ins. Cos., 758 P.2d 58 (Cal. 1988), *overruling* Royal Globe Ins. Co. v. Superior Court, 592 P.2d 329 (Cal. 1979); Allstate Ins. Co. v. Watson, 876 S.W.2d 145 (Tex. 1994). A few jurisdictions impose statutory duties to make reasonable efforts to settle, at least where liability is reasonably clear. *See* Lough v. Insurance Co. of N. Am., 789 P.2d 576 (Mont. 1990); Fode v. Farmers Ins. Exch., 719 P.2d 414 (Mont. 1986); Klaudt v. Fink, 658 P.2d 1065 (Mont. 1983); Jenkins v. J.C. Penney Cas. Ins. Co., 280 S.E.2d 252 (W. Va. 1981), *overruled on other grounds* State ex rel. State Farm Fire & Cas. Co. v. Madden, 451 S.E.2d 721 (W. Va. 1994). I regard the latter rule as unwise, but that does not matter here, for we are discussing only the rights of the insured, not those of the claimant.

11. *See, e.g.*, ABA Standing Comm. on Ethics and Professional Responsibility, Formal Op. 96-403 (1996) [hereinafter Formal Op. 96-403].

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defense counsel is the cheapest means of settling. Thus, the insured should be obliged (when the problem arises) to waive any objection to use of defense counsel for this purpose.

If the insurance policy had neither monetary limits nor definitional limits (e.g. coverage only for bodily injury or property damage), all of the insurer rights described could be unfettered. But policies generally do have monetary limits, so an insurer faced with a claim beyond limits may have an incentive to refuse settlements that the insured would prefer to have accepted. As a matter of insurance law, that problem is addressed, not by denying the insurer's right to control,[12] but by subjecting it to liability if it fails to act in a way designed to minimize the total costs (both within and beyond limits).[13] Similar analysis would seem to apply where the monetary

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12. A few jurisdictions shift control of settlement to the insured, subject to some constraints, when the insurer has reserved the right to deny coverage for claims outside the definitional limits of the insurance. *See* United States Aviation Underwriters, Inc. v. Olympia Wings, Inc, 896 F.2d 949 (5th Cir. 1990) (applying Texas law); Cay Divers, Inc. v. Raven, 812 F.2d 866 (3d Cir. 1987) (applying Virgin Islands law); Ideal Mut. Ins. Co. v. Myers, 789 F.2d 1196 (5th Cir. 1986) (applying Texas law); Rhodes v. Chicago Ins. Co., 719 F.2d 116 (5th Cir. 1983) (applying Texas law); Cessna Aircraft Co. v. Hartford Acc. & Indem. Co., 900 F. Supp. 1489, 1517-18 (D. Kan. 1995); Gates Formed Fibre Prod., Inc. v. Imperial Cas. & Indemn. Co., 702 F. Supp. 343 (D. Me. 1988); United Services Auto. Ass'n v. Morris, 741 P.2d 246 (Ariz. 1987); Taylor v. Safeco Ins. Co., 361 So. 2d 743 (Fla. Dist. Ct. App. 1978); Miller v. Shugart, 316 N.W.2d 729 (Minn. 1982); Ranger Ins. Co. v. Rogers, 530 S.W.2d 162 (Tex. Civ. App. 1975); Public Util. Dist. No. 1 v. International Ins. Co., 881 P.2d 1020, 1029 (Wash. 1994). In contrast to *Ranger*, another Texas court has held that even absolute denial of coverage does not free the insured to make a settlement binding on the insurer so long as the insured had not been denied a defense because, at the time of the settlement, no lawsuit had been filed and no defense requested. *See* Charter Roofing Co. v. Tri-State Ins. Co., 841 S.W.2d 903 (Tex. App. 1992).

I have criticized the decisions supporting such a shift of control elsewhere. William T. Barker, *Reservation of Rights and Control of Settlement, in* INSURER'S DUTIES: A COVERAGE PERSPECTIVE (Donald J. Hirsch ed., 1995). Based on that criticism and the fact that this is a distinct minority rule, I will ignore it for purposes of this paper.

13. *See* ALLAN D. WINDT, INSURANCE CLAIMS & DISPUTES § 5.01 (3d ed. 1995); STEPHEN S. ASHLEY, BAD FAITH ACTIONS: LIABILITY & DAMAGES § 3:19-20 (2d ed. 1997); Kent D. Syverud, *The Duty To Settle*, 76 VA. L. REV. 1113 (1990). In determining whether to accept a settlement, the insurer is obliged to consider exposure in excess of the monetary limits of the insurance, but not that beyond its definitional limits. *See* Magnum Foods, Inc. v. Continental Cas. Co., 36 F.3d 1491 (10th Cir. 1994) (applying Oklahoma law); Zieman Mfg. Co. v. St. Paul Fire & Marine Ins. Co., 724 F.2d 1343, 1346 (9th Cir. 1983) (applying California law); Camelot by the Bay Condominium Owners' Ass. v. Scottsdale Ins. Co., 32 Cal. Rptr. 2d 354 (Cal. Ct. App. 1994).

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limit creates possible incentives to skimp on defense costs.[14] By the same token, where part of the claim lies beyond the definitional limits of coverage, the insurer would seem obliged to expend defense resources calculated to minimize *total* claim costs, including the uncovered exposure.[15]

While such liability rules can provide remedies for most forms of misuse of control to benefit the insurer at the expense of the insured, there are some situations in which it has been found necessary to divest the insurer of some aspect of control. In particular, the way in which the defense is conducted sometimes has the potential to shift liability from a covered basis to an uncovered basis, rather than defeating or minimizing such liability. Such shifting may be difficult to detect, and, more importantly, its effect may be impossible to quantify. Consequently, the insurer is generally deprived of control when this problem arises.

This exception to the right of control may be viewed as an implied exception, because control cannot be exercised solely in the common cost-minimization interest. Alternatively, it can be viewed as a limit on enforcement of an adhesion contract in circumstances which would render full enforcement unfair. Regardless, I accept the propriety of this limit and recognize that, as the modern cases uniformly hold, the insured in such a case has a right to independent counsel, with no duty of loyalty to the insurer.[16]

The fact that the major function of the right and duty to defend is to aid in cost minimization suggests limits to the scope of that duty. Providing

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With respect to uninsurable punitive damages, some courts have gone further and declared it contrary to public policy to allow them to be indemnified even in the form of compensatory damages for a refusal to settle which was improper considered only in light of the exposure within the policy's definitional limits, but beyond its monetary limits. *See* Soto v. State Farm Ins. Co., 635 N.E.2d 1222 (N.Y. 1994); Lira v. Shelter Ins. Co., 913 P.2d 514 (Colo. 1996); PPG Indust., Inc. v. Transamerica Ins. Co., 56 Cal. Rptr. 2d 889 (Cal. Ct. App. 1996), *review granted* 927 P.2d 1174 (Cal. 1996). The latter courts go a step beyond the authority in the prior paragraph, and it is irrelevant to the argument here whether they are correct in doing so (the grant of review in *PPG Industries* deprives it of precedential effect in California. *See* CAL. SUP. CT. R. 976(d).).

14. *See* William T. Barker, *The Tripartite Relationship and Protection of the Insured: Beyond Professional Responsibility*, 18 INS. LITIG. RPTR. 528, 530-31 (1996).

15. To the extent that some efforts required by the uncovered claim would be unnecessary were only the covered claims asserted, the insurer might be able to allocate some of those costs back to the insured. *See* Continental Cas. Co. v. Board of Educ., 489 A.2d 536 (Md. 1985). This point and its implications are not considered here.

16. *See* Barker, *supra* note 5.

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advice to either insurer or insured regarding coverage does not serve to reduce total claim cost: it affects only division of that cost between insurer and insured. Moreover, the need for such advice is significantly variable from insured to insured, depending in part on collateral stakes which they may have in the litigation. It is hard to pool that sort of risk. Finally, if a joint representation of insurer and insured is desirable in the action against the insured, joint counsel cannot advise either with regard to disputes between them. For all of these reasons, it makes sense not to include coverage advice within the services which the insurer is obliged to furnish the insured in connection with a claim. Certainly, that is the universal understanding of every liability insurance policy known to me.[17]

II. IMPLICATIONS OF THE BARGAIN FOR THE STRUCTURE OF THE ATTORNEY-CLIENT RELATIONSHIP

Clearly, the bargain requires that the insurer be permitted to exercise control of the defense and settlement of the claim, and to receive the information necessary to do so intelligently. There are two ways in which that might be accomplished. The traditional approach has been to treat the insurer as one of two clients of defense counsel. As one of two joint principals of a common agent, the insurer would have a full right to instruct defense counsel, absent contrary instructions from the insured. Instructions by the insured should not be a problem, because the insured is not supposed to issue instructions. If issued, the insurer would be alerted, either by disclosure based on the lack of confidentiality between co-clients or by withdrawal (at least from representation of the insurer) based on the conflict created by the instructions.

Likewise, as a client, the insurer would normally have direct access to all of the information it is entitled to know about the underlying claim, for each client is entitled to full information about everything within the scope of the representation. (This would not include information, however obtained, which had no relevance to the claim against the insured. Thus, information relevant *only* to coverage issues ought not to be disclosed.) Efforts to withhold such information would either be ineffective, due to the lack of confidentiality between joint clients, or force counsel to withdraw from joint representation.

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17. Professor Baker agrees that this should be the rule. *See* Baker, *supra* note 2, at 138 n.77.

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The alternative offered is to make only the insured a client, forcing the insurer to function as the agent of the insured in controlling the defense. Critical reliance would then be placed on the insured's duty to cooperate to assure that the insurer would be given the control called for in the policy. This would facilitate the ability of the insured to conceal information from the insurer, by invoking attorney-client confidentiality, and to breach the contract covertly (by issuing instructions to defense counsel). In particular, it would permit the insured to invoke uninsured collateral interests to use the attorney's duty of loyalty to trump any effort by the insurer to engage in simple cost-minimization. It would also permit, even encourage, counsel to invoke duties to the insured to resist efforts to minimize defense costs, resistance which also serves counsel's own interests (even if not consciously motivated by those interests).

In all of these ways, the proposed restructuring of the relationship to eliminate the insurer's status as a client would tend to increase claim costs in furtherance of interests which were excluded by the insurance bargain. While extremely convenient for an insured who has been subjected to a claim (especially if that insured has collateral interests), I see no reason to believe that insureds collectively would want, when contracting, to structure the contract in a way which would generate extra costs to protect such interests.

While Professor Pepper seemingly seeks to allow insureds the opportunity to exploit the weakness of insurer remedies for breaches of duty by the insured, I submit that such weakness argues precisely for making the contractual obligations as nearly self-executing as possible. (The consistency of the suggested contractual structure with the law of professional responsibility must be addressed, but I am still ignoring that question in the interests of defining the content of the insurance bargain.)

Additionally, the bargain excludes any duty of the insurer to provide counsel to advise the insured on coverage or other matters of dispute with the insurer. Even if the insurer were not a client, so that defense counsel were free to render advice to the insured on such subjects, such services should be rendered at the cost of the insured, not the insurer. Were counsel forced to advise on such subjects and were insureds usually unwilling to pay the cost (as I suspect would be the case), then the cost of providing such services would inevitably be factored into the prices charged for the defense proper. That would make them part of the cost structure of the insurance, which the bargain was designed to prevent. So even if the insurer were not a client, it should be established, if possible, that defense

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counsel may exclude all such matters from the scope of the representation unless the insured credibly undertakes to pay for such advice personally.

If such matters can be so excluded when the insurer is not a client, the fact that making the insurer a client forces their exclusion should create no obstacle to making it a client. The insured who is willing to pay for such services can purchase them from other counsel, just as the insurer will be required to do for its own part. Use of separate counsel to provide coverage advice to the insured will deny the insured the cost savings which would attend use of counsel already familiar with the case. But granting the insured those economies would convert an asset (defense counsel's knowledge of the case) intended for joint benefit into one which the insured may appropriate personally, while denying the insurer equal benefit.

I conclude that what Professor Pepper describes as an "ordinary" joint client representation best serves the purposes of the insurance contract.[18] The bargain ought, therefore, to be construed to require the insured, in most instances, to accept such a relationship as a condition of receiving policy benefits. As I have already noted,[19] an insured is not required to do so when that would create opportunities, difficult to detect and remedy, for the insurer to manipulate the defense to advantage it in the division of claim cost with the insured, where that division is in issue. It may be possible to identify other situations requiring alteration of the usual allocation of control and loyalty. But this should be done by considering such situations in light of the contractual purposes of both parties to the insurance agreement, not merely by focusing on the relationship between the insured and defense counsel, viewed in isolation.[20]

What I have said so far is certainly open to debate, the opportunity for which I welcome. But that debate is dominantly one about insurance law, contract construction, and the actual desires and expectations of participants in insurance markets, rather than about the law of lawyering.

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18. What Professor Pepper describes as a "modified" joint-client representation is preferable in this regard to a representation in which the insurer is not a client at all, but it still tends to increase claim costs in ways which do not seem to correspond with what prospective insureds are interested in paying for. *See* Pepper, *supra* note 1.

19. *See supra* note 5 and accompanying text.

20. Professor Baker takes a similar approach, though for different reasons. I argue that insurance law permits certain interests of the insured to be disregarded because protection of those interests is outside the bargain. Professor Baker argues that the insurer's duty of good faith demands that some protection be extended to those interests, even though he agrees that they are not within the protection the insurer contracted to provide. I address his arguments *infra* notes 35-53.

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The issue for the latter is whether (and how) the proposed contractual structure, if adopted (as I would argue it has been), can be implemented consistently with the obligations of attorneys to their clients. It is to that which I now turn.

III. HOW FREQUENT ARE CONFLICTS BETWEEN INSURER AND INSURED?

At the outset, any discussion of conflicts in insurance defense representations must consider the frequency of such conflicts. The mere possibility that a conflict might arise at some point in the representation does not preclude the representation or require waiver unless there is a "substantial risk" that the representation of the client will be impacted by such a conflict.[21] This is not a high threshold, but it requires that the risk be "significant and plausible," rather than a "mere possibility."[22]

The point is important because the scholarship on the subject, of which Professor Pepper's paper is representative, tends to assume that such conflicts are endemic, such that no insurance defense representation can be even begun without extensive consideration of their likely effect. Based on conversations with those who regularly do insurance defense work and insurance claims personnel who supervise defense counsel, it is my distinct impression that such conflicts arise only infrequently. Scholars may be misled by the fact that the unusual cases in which there is a conflict generate significant reported case law, while the ones in which there is no problem never result in litigation.

The person who must, in the first instance, evaluate the need for action to deal with a potential conflict is the defense counsel whose representation may be affected by that conflict. If that lawyer shares my perception of the probability of conflict in a randomly selected insurance defense representation, that may permit later and less frequent action than assumed by Professor Pepper, based on his perception.

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21. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 201 (Prop. Final Draft No. 1, 1996) [hereinafter RESTATEMENT].

22. *Id.* § 201cmt. c(iii).

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IV. WHEN IS INFORMED CONSENT NECESSARY?

Professor Pepper argues that the insured must give informed consent to any potential or actual conflicts which might eventually arise between insurer and insured regarding the defense representation *before* counsel can ethically undertake a joint representation.[23] I disagree.

Professor Pepper relies on Model Rule 1.7(b): "A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client . . . unless . . . (2) the client consents after consultation." I suggest that this does not mean that a lawyer cannot undertake a joint representation (absent consent) merely because of some foreseeable potential conflict between insurer and insured. For me, the key issue is whether there will be adequate opportunity to address any such conflict before it adversely affects either client.

Suppose an insured tenders defense of a claim to an insurer on the eve of a potential default. The insurer calls a lawyer seeking to have an appearance entered to prevent a default. The lawyer sees a potential for conflict which would arise upon filing an answer. But there is no conflict as to the filing of the appearance itself. I suggest that the lawyer could properly undertake a joint representation of insurer and insured (if that were requested), so long as the insurer were advised of the problem and of the potential need for substitution of other counsel if the conflict problem is not resolved prior to the time at which an answer must be filed.[24] After the appearance is filed, the problem could be explored and, if it proved genuine, both clients could be consulted about any necessary consent (if consent were otherwise appropriate). If consent were necessary and not available, the joint representation could be terminated and new counsel obtained.

This does not challenge the proposition that significant disclosures and consents may be required early in the relationship. But it does show that the relationship may come first and the disclosures and consent later, so

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23. *See* Pepper, *supra* note 1, at 28-33 nn.2-13.

24. In the example given, joint representation is probably unnecessary in terms of either protecting the insured or minimizing claim costs. But if professional responsibility rules do not forbid such representation, it should not matter that it is not strictly necessary. Besides, the example is deliberately unrealistic, and more complicated examples could be constructed where (initial) joint representation would serve claim cost minimization purposes.

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long as that sequence creates no foreseeable risks to the insured of a magnitude sufficient to require conflict avoidance measures.

V. INITIAL CONSULTATION ABOUT LIMITATIONS ON REPRESENTATION

Assuming that a joint representation has been permissibly undertaken, counsel must quickly identify all aspects of that representation requiring consultation and consent.[25] While both clients must consent, I assume that insurer representatives will readily understand and consent to all matters requiring consent. Indeed, at least as to the most common subjects, such consent would likely be provided on a standing basis, not requiring individual review on each new case. But the insured is assumed to be both ignorant of all such matters and unsophisticated as to legal matters generally. Careful attention must be given to the initial disclosures required to obtain an informed consent from the insured.

These disclosures must observe another limitation. As Professor Pepper correctly notes,[26] if counsel represents both insurer and insured, counsel cannot advise either regarding the rights and duties between them. Thus, even if it were entirely clear that the insured is obliged to consent to everything which is presented in a particular situation, counsel could not take that position in advising the insured about such consent.[27] The cure

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25. One point on which Professor Pepper criticizes Professors Silver & Syverud is their suggestion that the scope of representation by defense counsel might be made asymmetric, including representation of the insurer regarding settlement and excluding such representation of the insured. *See* Pepper, *supra* note 1, at n.67, criticizing Charles Silver & Kent D. Syverud, *The Professional Responsibilities of Insurance Defense Counsel*, 45 DUKE L.J. 255, 296, 301 (1995). While generally in agreement with Professors Silver & Syverud, I have yet to conclude that the scope of representation they suggest would satisfy the insurance contract (Professor Baker's paper goes some distance in satisfying my prior doubts (*see* Baker, *supra* note 2, at 140-42 nn.90-94), but I have not yet reached a conclusion on this point). Unless and until I satisfy myself on that point, I need not defend the arguments which they advance regarding the consequences of so defining the relationship.

26. *See* Pepper, *supra* note 1, at 51-52 n.62.

27. If it were clear that the insured need *not* give such consent and *must* be provided with independent counsel upon request, knowledge of that would seem to be necessary for a valid consent to joint representation. Should the insurer wish to seek such a consent (rather than simply agreeing to independent counsel), it probably would have to consent to having counsel so inform the insured. (It is my impression that insurers more frequently just offer independent counsel where the insured is entitled to that, but that when they do seek the insured's consent to joint representation in such cases, they have counsel inform the insured

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for this problem, however, is simple: counsel can communicate to the insured the insurer's position on any potentially disputed issue, can state that counsel cannot advise the insured on that issue, can note the possible utility of consulting other counsel about the subject, and can indicate that any disagreements must be resolved between insurer and insured without involving defense counsel. (The desirability of having a defined insurer position for counsel to communicate is a hitherto unnoted reason why it is desirable for insurers to have standardized retainer agreements and guidelines for defense counsel.[28])

So, for example, counsel can communicate a key limitation on the representation as follows:

> [Insurer] has asked me to defend you against the claim asserted by [plaintiff]. You should understand that I will be working only to defeat or minimize that claim, and that is the only thing [insurer] has agreed to pay me to do. I will not be representing or advising either you or [insurer] as to any questions which may arise [or have arisen] regarding your respective rights and duties under the insurance policy. I also will not be representing or advising you as to any claim you may have against [plaintiff]. When any question arises where I think you might find assistance of other counsel useful, I will point that question out to you and explain its significance and, if not apparent, the reasons you might wish to obtain such assistance. If you want me to, I will offer suggestions about who you might wish to consult. But, as I understand [insurer's] position, it will not agree to pay for the services

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of the available options.) But, if the issue is at all doubtful, joint counsel (with a personal interest) is not the best person to provide an evaluation.

28. In this way, any "bleeding" of the insurance policy into the relationship with defense counsel, *see* Silver & Syverud, *supra* note 25, at 271-73, can be made explicit in the retainer agreement. *Cf.* Jerry, *supra* note 4, at 162-64 nn.40-43. (criticizing propriety of reliance on such "bleeding," absent assent by the insured); Pepper, *supra* note 1, at 35-36 nn.22-25 (challenging same point). Consent of the insured can then be obtained as part of the initial consultation, insofar as any of the terms of the retainer require such consent.

The "bleeding" might take place implicitly, where both insurer and defense counsel understand that the insurer is acting on the basis of a particular understanding of the insurance policy and the relationship with defense counsel. But the insured would still need to be informed of anything requiring consent (or bearing on whether to give it).

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> of counsel you might consult on such issues. So you will either have to make arrangements to pay such counsel yourself or, if you think [insurer] is obliged to pay for such counsel, you will have to take that question up with [insurer] yourself, possibly with the assistance of counsel you personally retain.[29]

This is a limitation on the objects of the representation, to which the insured's consent is necessary. But the result of a refusal to consent is not an unlimited representation: rather, it is a dispute between insurer and insured which must be resolved before the representation may proceed. Few insureds seem likely to refuse consent in these circumstances, presumably requiring retention of personal counsel. Insureds who do refuse should be advised, by their own counsel, that the insurer is within its rights in so limiting the representation for which it will pay. Issues regarding counsel's expectation that the insurer will be permitted to direct the defense and direct counsel to settle (at its expense)[30] may be addressed similarly. So, too, may be the fact that the insurer takes the position that the only thing which matters is minimizing claim costs and demands the insured's assistance in doing so, even if the insured would like to have the claimant succeed, fears exposure of embarrassing facts, or wishes vindication even if settlement is cheaper.

Assuming that the non-confidentiality rule applicable to ordinary joint representations applies (or that the insurer takes the position that it does), that rule (and its implications on the facts known to counsel) should be explained at the outset, before the insured can make any disclosure under a mistaken expectation of confidentiality.[31] As before, the insured should be

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29. If coverage issues or potential affirmative claims are (or later become) apparent, their existence and significance would need to be addressed specifically. For example, it would be necessary to point out the implications of statutes of limitation and compulsory counterclaim rules as they affect the timing of consultations with other counsel regarding affirmative claims regarding the events which are the subject of the tort action. Likewise, if there appears to be a "substantial" risk (in the sense used by the Restatement) of exposure in excess of the monetary policy limit, the risks associated with that would need to be discussed. *See generally* William T. Barker, *Defense Counsel & Policy Limits Settlement Offers: Another View*, 6 BAD FAITH L. REP. 141 (1990).

30. *See* Formal Op. 96-403, *supra* note 11.

31. If counsel has not made this disclosure to the insured and receives information subject to disclosure under the ordinary joint representation rule but which the insured does not want disclosed, counsel may have inconsistent duties. Counsel may be liable to the

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informed that any concerns about potential disclosure to the insurer should be explored with personal counsel and any disputes taken up with the insurer. Here, of course, personal counsel will have better arguments that the insurer is overstepping its rights, though I would argue that it is not.[32] Of course, the insurer might choose to limit any disputes by renouncing or limiting any claim to disclosure of information the insured does not want disclosed.

I should note that the right of each client to full information about the representation benefits the insured in at least one way. The insured is entitled, if she so desires, to be kept fully informed of any information, recommendations or instructions communicated between the insurer and defense counsel. Thus, the insured (or personal counsel) can monitor the conduct of the representation and object to decisions she believes improper or unwise. If pressed, such objections will create an impasse precluding

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insured if disclosure is made and to the insurer if it is not. It is not necessary for either of these duties to trump the other: counsel simply compensates whoever is injured.

32. *See* Silver & Syverud, *supra* note 25, at 343-50. *But see* Parsons v. Continental Nat. Am. Group, 550 P.2d 94 (Ariz. 1976).

Parsons might be explained on the basis suggested in the prior note: counsel failed to advise the insured that such matters would be disclosed, so counsel was liable to the insured for doing so. To be sure, the liability at issue was that of the insurer, but most jurisdictions make insurers vicariously liable for mishandling of the defense. *See* Smoot v. State Farm Mut. Auto. Ins. Co, 299 F.2d 525, 530 (5th Cir. 1962), and cases collected in 3 RONALD J. MALLEN & JEFFREY M. SMITH, LEGAL MALPRACTICE § 28.4, at 495-96 & nn.9-12 (4th ed. 1996). It is only a short step to holding it liable for deficiencies in obtaining consent to the ground rules for the relationship. In any event, I have never seen *Parsons* read so narrowly, and that reading did not occur to me until after the initial presentation of this paper.

If *Parsons* does not depend on a defect in the initial consent and is still rightly decided, it must be based on an unexplained (though not necessarily implausible) conclusion that the insurer's apparent rights under the insurance contract must be conditioned on a limitation of the normal rights of a co-client to disclosure of all matters bearing on the joint representation. No other source of the unique rights which *Parsons*, so read, grants to insureds is apparent. So the issue presented by *Parsons* would not be primarily one of the law of lawyering (which usually dictates an opposite rule, *see* RESTATEMENT, *supra* note 21, § 112, cmt. *l*), but rather one of insurance law.

This view was evidently accepted by the Reporters in agreeing to an amendment, of which I was a principal author, to comment f to Section 215 of the Proposed Final Draft No. 1 of the Restatement. The comment, if so amended, would have taken no position on whether *Parsons* is rightly decided, but would have characterized that question as one of insurance law. The amendment itself was not adopted by the ALI membership and § 215 was recommitted to the Reporters for further study. Council Draft No. 13 no longer makes this statement, though one might argue that it is implicit in other statements which are made. At a minimum, support for the *Parsons* rule is somewhat qualified.

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action by joint counsel. If the insurer's actions are improper, then the interference with its control of the defense will not forfeit contractual benefits.

I am currently inclined to believe that the subjects just described embrace almost all of the commonly encountered problems requiring informed consent. At least some of them may not need to be addressed in the consultation with the insured, absent facts suggesting a non-speculative prospect that they will become relevant. For example, only in highly unusual cases will insureds be interested in promoting recovery by plaintiffs with whom they have no preexisting relationship. Consequently, such a relationship may be treated as a "conflict clue" triggering the need to discuss this problem.[33] In the absence of such a clue, this subject may not need to be discussed unless and until the insured indicates a desire to promote the plaintiff's recovery.

VI. DO MODEL RULES 1.8(F) AND 5.4(C) RESTRICT JOINT CLIENT REPRESENTATIONS?

One final topic must be addressed before concluding that the traditional understanding of the tripartite relationship may properly be implemented (after obtaining appropriate consents from the insured, consents which the insurance policy obliges the insured to give). Model Rules 1.8(f) and 5.4(c) restrict the ability of third party payors to direct, regulate or interfere with the lawyer's independent professional judgment on behalf of the non-paying client.[34] Are those restrictions consistent with a co-client

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33. *See* Silver & Syverud, *supra* note 25, at 332-33.

34. Model Rules of Professional Responsibility Rule 1.8(f) also requires informed consent of the non-paying client and protection of information relating to the representation "as required by Rule 1.6." MODEL RULES OF PROFESSIONAL RESPONSIBILITY Rule 1.8(f) (1983) [hereinafter MODEL RULES]. Because Rule 1.6 presumably incorporates the right of co-clients to full information, without confidentiality *inter se*, it poses no obstacle. On the same basis as the foregoing discussion, consent should be available if insurance benefits are validly conditioned on the giving of such consent. But the restriction on influence or control by the third-party payor is arguably independent of consent.

Model Rule 1.8(f) provides that:

> A lawyer shall not accept compensation for representing a client from one other than the client unless:
>
> (1) the client consents after consultation;
>
> (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and

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representation in which the insurer exercises independent authority to direct counsel (so long as the insured does not object to those directions)?

I see two paths to an affirmative answer. First, a lawyer's professional judgment remains independent so long as the lawyer is free to advise on the course most advantageous with respect to the agreed objectives of the joint representation (here, claim cost minimization). A single client does not impair the lawyer's independence of professional judgment by rejecting the lawyer's advice and directing that the lawyer proceed in some other manner. The same is true of a joint client who does so, so long as the co-client does not object to the course directed, though the lawyer may need to assure that the silent client fully understands the implications of such direction. On that basis, the rules can be considered applicable, but consistent with the traditional tripartite relationship.

If that reading is not accepted, then I think the rules must be understood to apply only to non-client third-party payors (which I think has been the traditional view, albeit taken only implicitly). When there is a joint representation of paying and non-paying clients, the interests of the two are almost always intertwined. The paying client must have the ability to direct *its own* representation, and the interrelationship will mean that any such direction will impact on the non-paying client's representation. So, unless the reading suggested in the last paragraph is accepted, these rules (if applicable) would effectively prohibit all joint representations in which one client pays and the other does not. Such representations are rather common, so it is unlikely that the Model Rules would have prohibited them without any notice of the necessary change to existing practices. Accordingly, they should either be interpreted to permit them (as suggested above) or simply not to apply where the payor is a co-client.

> (3) the information relating to the representation of a client is protected as required by Rule 1.6.

Id. at Rule 1.8(f).

Model Rule 5.4(c) provides that:

> A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services.

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VII. TETRAHEDRONS AND THE LIABILITY INSURANCE BARGAIN

Because Professor Baker and I both approach these issues in terms of the insurance contract and the implied obligations created by insurance law, he has no occasion to address directly any of the issues specific to the law of lawyering. But we do see the contract rather differently.

Before taking up those of my differences which can be addressed in the time I have available, I want to commend Professor Baker for an insightful analysis and presentation. His tetrahedral analysis makes explicit many issues which always lurk in the background of these problems but may not be obvious to those without extensive experience in dealing with them. It also points out that the insured sometimes receives protection from an unexpected source: the plaintiff.[35] It is a real contribution to the methodology of addressing these issues.

But I see the protection provided by the insurance policy as somewhat narrower than does Professor Baker, both in terms of existing law and in terms of what I think best suits the demands of insurance markets. For these purposes, I will divide that protection into three types. First, there is the strict duty of indemnification, which is subject to all of the definitional and monetary limits stated in the policy. Second, there is the duty to defend, which extends to non-covered claims joined with covered ones. While this is broader than indemnity coverage, I still see it as limited to what Professor Baker refers to as "judgment risk."[36] While the insurer must take reasonable steps to prevent or minimize any judgment against the insured, it need not protect against other types of "claim risk," such as reputational harm. Third, there is what I will describe as "quasi-coverage," generated by the insurer's duty to settle, a category requiring more elaboration.

That duty requires an insurer presented with a settlement opportunity to consider not only the portion of the potential judgment within the monetary limits of the policy, but also any amount in excess of that limit. The insurer must act as if it alone would be liable for the whole judgment, rather than only for the part within the monetary limits. Thus, for settlement purposes, the quasi-coverage of the policy extends to settlement values up to the policy limit, even though part of such values is attributable to exposure which the insurer would not have to pay were it reduced to judgment.

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35. *See* Baker, *supra* note 2, at 118-19 nn.33-35, 123-24 nn.51-52, 148 nn.107-08.

36. *See* Baker, *supra* note 2, at 105 n.8.

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Only these three types of protection are recognized by current law. An insurer need not pay a settlement or defense cost "premium" based on the insured's exposure to liability outside the definitional limits of coverage or on the insured's reputational or customer goodwill interests.[37] The requirement of "equal consideration" simply does not extend to those interests because they are deliberately excluded from the protection of the insurance bargain. Absent compelling reasons consistent with or overriding that bargain, those interests ought not to receive indirect protection where the effect will be to increase claim costs (and, so, premiums). Professor Baker recognizes that some of his proposals have the inevitable effect of protecting uncovered interests,[38] but defends such protection as reflecting an "equal consideration" duty broader than I think the law does or should recognize.[39]

I will clarify my differences with Professor Baker by commenting on his hypotheticals. Before getting into the individual hypos, I want to make a point applicable to several of them. One of the risks Professor Baker notes is that the insurer will shirk the defense duty by investing inadequate resources in the defense of claims it will or may not have to pay (at least in their entirety). I suggest that it is a sufficient response to this to hold the insurer liable for shirking. All of the insurer's instructions to defense counsel, including any budgetary restraints, will not only be discoverable in subsequent litigation, but may be monitored while the defense is ongoing, if monitoring is deemed advisable. Defense counsel has every incentive to point out the advantages of a more vigorous defense, as that will increase defense counsel's fees. If defense counsel fails to do so, that can be a basis of malpractice liability, which most jurisdictions will require the insurer itself to satisfy.[40] Finally, determination of whether the defense was shirked will be made "in hindsight, after the bad result, by a jury unlikely to be favorably disposed to insurers who have overruled counsel's advice [to spend more]" or who simply failed to see that adequate amounts were devoted to the case.[41] So I do not consider this risk to support any limitation of an insurer's control.

I will now comment on the specific hypotheticals. First is the "Low Limits Case," where the insured's exposure substantially exceeds the

37. *See supra* text accompanying note 7, and cases cited *supra* notes 10,13.

38. *See* Baker, *supra* note 2, at 131, 138-39, 146-47 nn.67, 84-85, 102-03.

39. *See id.* at 146-48 nn.103-08.

40. *See* sources cited *supra* note 32.

41. *See* Barker, *supra* note 14, at 531.

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policy's monetary limits.[42] This is already addressed by existence of the insurer's duty to settle, which I see as an adequate response. Professor Baker notes the possibility of defense shirking, which (as just explained), I would also address by a liability rule. Finally, he is concerned that the insurer might make the duty to settle harder to prove by instructing defense counsel not to make a settlement evaluation. But such an instruction should become known, before or after the excess judgment, and would be damning evidence of bad faith. Even if it were successfully concealed, mere failure to evaluate a dangerous case would be a basis for malpractice liability (and the case will surely appear dangerous in hindsight, once an excess verdict has resulted). So liability rules seem a sufficient response. The "Multiple Victim Case"[43] is a mere variation, also properly handled by liability rules.

In the "Misrepresentation Case,"[44] coverage is uncertain because the insured made an application misstatement which may void the policy. As to defense shirking, liability rules remain adequate. As to settlement, I urge that the insured (rather than the insurer) is the one who should settle any portion of the risk which reflects uncovered liability or the prospect of uncovered liability.[45] Because insurer and insured have independent ability and responsibility to settle their own respective portions of the risk[46] and each has the incentive to act appropriately in so doing, the conflict of interest regarding settlement simply dissolves.

The "Separation Assault"[47] is a case where current law shifts control of defense to the insured, and I accept that result.[48] I would argue that control of settlement should follow the model proposed for the Misrepresentation

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42. *See* Baker, *supra* note 2, at 114-18 nn.30-38.

43. *See* Baker, *supra* note 4. at 118-21 nn.39-46.

44. *See id.* at 121-25 nn.47-54.

45. *See* Barker, *supra* note 12, at 27, 32-33.

46. Professor Baker notes that insureds almost never contribute to such settlements. *See* Baker, *supra* note 2 at 123 nn.48-49. While true, I suggest that this is an inappropriate extension of practices relating to within limits settlements based on excess exposure. *See id.* at 123 n.50. To protect other insureds against sharing risks they did not agree to share, insureds should be required to contribute to elimination of risks of uncovered damages. And the difference in law between the duty to contribute to elimination of excess exposures and the lack of any duty to contribute to elimination of uncovered exposures ought to permit insurers to insist on this. I do not say that I would now advise an insurer to rely heavily on the assumption that the law would protect it in so insisting, given the still limited number of cases so limiting the duty to contribute regarding uncovered exposures.

47. *See id.* at 125-27 nn.55-59.

48. *See* Barker, *supra* note 5, and *see supra* text accompanying note 19.

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Case. I will comment on the suggestion that exclusion of coverage in such cases is primarily for the purpose of controlling moral hazard.[49] Many insureds would be sufficiently confident that they would never find themselves in a situation like the Separation Assault that they would strongly resist inflation of their premiums by inclusion of this risk in the pool. Some of them would even find it personally offensive that their premiums were going to indemnify such conduct. So this risk would likely not be covered even were there no problem of moral hazard.

The "Softball Case"[50] is one where defense counsel discovers information, certainly relevant to the tort claim, suggesting that the insured inflicted the harm on the plaintiff intentionally rather than accidentally. That fact, therefore, renders coverage questionable. This is a variation of the *Parsons* case.[51] In principle, I see much to be said for holding that this information, like anything else bearing on the defense, should be disclosed to the insurer (so long as the insured has been properly advised at the outset).

But I don't regard that question as very important on a practical level. *Parsons* is unique in the annals of American jurisprudence, and situations with a concealed coverage problem also bearing on liability appear quite uncommon. What I would object to is adoption of the *Parsons* rule as part of the law of lawyering, without full analysis of the entire insuring relationship, rather than just the relationship between defense counsel and the insured.[52]

The "Food Poisoning Case"[53] is one where the insured has reputational concerns not covered by the policy. I would argue that such an insured should hire personal counsel to advise on those concerns, might wish to offer to supplement the amount the insurer would spend on defense (to

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49. While this suggestion appeared in the original version of Professor Baker's paper, it seems to have disappeared from the final version. But my response is more important in explaining my approach to the issues at hand than the original suggestion was to his approach. So I have retained the response. For a more elaborate development of similar ideas on coverage for intentional injuries, see Ellen S. Pryor, *The Stories We Tell: Intentional Harm and the Quest for Insurance* Funding, 75 TEX. L. REV. 1721, 1741-43 (1997).

50. *See id.* at nn.59-61.

51. *See* Parsons v. Continental Nat. Am. Group, 550 P.2d 94 (Ariz. 1976). *See also* discussion and sources cited *supra* note 32.

52. This was the reason why I proposed the amendment of the Restatement described *supra* note 32.

53. *See* Baker, *supra* note 2, at 129-31 nn.63-68.

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assure a more vigorous or higher quality effort), and might wish to supplement any amounts the insurer does or should offer in settlement. But the reputational concerns are outside the liability insurance bargain and ought not to be indirectly protected, except to the extent the duty of defense against judgment risk tends to protect them.

VIII. THE BARGAIN V. THE CONTRACT

Professor Jerry challenges the received learning that liability insurers *are* entitled to control the defense.[54] He argues that, especially in light of revisions made in converting the policy forms to more easily readable language, those forms do not, if they ever did, create such a right of control. In his analysis, he relies heavily on the customary rules for construction of policies against the insurer. I lack the time to develop a full response, but I can offer a sketch which could be used as a basis for developing one.

In my view, adhesion contract analysis is designed to prevent unfairness and oppression. So, if the dominant party drafts a fair contract, in light of the objectives sought at the time of contracting by the adhering party, the various pro-adherent rules will not and should not be so strongly applied when the adhering party later discovers other objectives which he now wishes the contract would also satisfy. Similarly, such a contract should be construed in light of its structure and the functions served by its various terms in effectuating the objectives of the parties as of the time of contracting. Structure and function may clarify language which in and of itself might not fully convey the message, particularly as the adhering party is normally ignorant of that language when the contract is made.

I have no quarrel with Professor Jerry's supposition that most consumers think of liability insurance only in terms of indemnification.[55] To me, the conclusion to be drawn from that is that consumers expect (or would expect, if they thought about it) that the insurer (and its defense counsel) are seeking only to protect against the risk of a judgment, rather than also pursuing other objectives (e.g. protection of reputation). (I would also suggest that these other objectives would not be given much weight by insureds unless they first felt protected against the financial risk of liability.)

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54. *See* Jerry, *supra* note 4.

55. *See id.* at 172-73.

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As I see it, most insureds may be assumed to have two objectives at the time of contracting: to secure protection against the risk of covered liability up to the limits selected (a term as to which the insured makes an express choice) and not to spend any more money than necessary to get that protection. Consequently, they generically assent to fair "procedural" terms reasonably designed to minimize the cost of providing the desired protection, without any need to know the specifics of those terms (whose ramifications they probably would not understand even if the terms themselves were explained). On my analysis, the actual "procedural" terms of standard policies may be interpreted in light of these purposes if they have a structural function in minimizing cost, so long as those "procedural" terms do not undercut any of the "substantive" protection promised by the policy.

As I argue here, I find the terms granting the insurer control of the defense and the right to ignore uninsured interests (such as reputation or customer goodwill) to be both fair and structurally important in minimizing the cost of the insurance. For me, this tips the balance against Professor Jerry's reading of even the relatively inexplicit terms of the current personal lines policies. I suggest that it also accounts (perhaps in combination with Appleman)[56] for the continued adherence to interpretations formulated in older times, when policies were much more specific, if harder to read.[57]

For purposes of the law of lawyering, this is a secondary point. If the contract does not currently implement the most efficient bargain, the contract language can and will be changed to the extent required.[58]

CONCLUSION

The traditional two-client view of the tripartite relationship best effectuates the purposes of the insurance policy, except in circumstances where the equities between insurer and insured require the insurer to be denied control. If the insurer's rights within that relationship must be limited to protect the insured in unusual situations, that protection should

56. *See id.* at 182 nn.94-95.

57. To clarify, I agree that, while an insurer need not spend extra money to protect the insured's reputation, it is not entitled to make or insist that the insured make reputation-injuring admissions, any more than it can reduce the liability asserted by trading away the insured's affirmative claim. *See id.* at 160-61 nn.27-28.

58. Professor Jerry does not argue that it would be undesirable for the policy language to grant a right of control. He simply argues that it presently does not do so.

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be provided by construing the insurance contract to require the insurer to accept such a limitation, rather than by imposing special rules of professional responsibility applicable only to insurance defense relationships. Professional responsibility law permits a relationship with this contractual structure to be implemented so long as the insured gives informed consent prior to any apparent "substantial risk" of adverse effect on the insured. Should the insured refuse to give such consent, a contractual issue is created between insurer and insured, which should be resolved between them without involvement of defense counsel. When such questions are resolved, the resolution should respect the limits of the liability insurance bargain.

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LIABILITY INSURANCE CONFLICTS AND DEFENSE LAWYERS: FROM TRIANGLES TO TETRAHEDRONS

*Tom Baker**

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* Copyright 1997 Tom Baker, Connecticut Mutual Professor and Director, Insurance Law Center, University of Connecticut School of Law. This article was written at the Hebrew University of Jerusalem during a research leave provided by the University of Miami School of Law. Thank you to both institutions for their support and to James Fischer, Robert Jerry and Stephen Pepper for comments on an earlier draft.

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INTRODUCTION

> *One problem in thinking through the lawyer's responsibilities in triangular relationships is that the relationship may not be continuously triangular. . . . Conceptualizing both the 'relevant others' as clients, and the lawyer as engaged in multiple representation, seems entirely natural when the triangular relationship is in its normal state. The question is whether there are reasons for refusing to conceptualize it in this way.*
>
> *–Geoffrey Hazard*[1]

The conflicts of interest that can arise when liability insurance companies control the defense and settlement of claims filed against their insureds have long concerned members of the tort defense bar,[2] as well as specialists in the fields of insurance[3] and professional responsibility.[4] I approach these conflicts from an insurance perspective, and I begin with the following observation: Whatever else can be said about the relationship between a defense lawyer, an insurance company and an insured, that relationship exists only because the company issued the insured a liability insurance policy. Most liability insurance policies assign the company the "duty" and "right" to defend the insured whenever the insured requests a defense against a defined set of claims. Ordinarily, the company fulfills that duty and exercises that right by retaining a lawyer to defend the insured. In that situation, the scope of the lawyer's representation of the insured will include all that is encompassed within the company's duty to defend.

This article explores the scope of the defense lawyer's representation of the insured by thinking about the lawyer as the means for fulfilling the company's duty to defend. A basic—and I think new—insight is that the conflicts of interest that draw our attention to the insurance defense lawyer arise out of an incomplete transfer from insured to company of what I will call "claim risk." I focus on the incomplete transfer of claim risk because

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1. Geoffrey C. Hazard, Jr., *Triangular Lawyer Relationships: An Exploratory Analysis*, 1 GEO. J. LEGAL ETHICS 15, 35-38 (1987).

2. *See, e.g.*, Brooke Wunnicke, *The Eternal Triangle: Standards of Ethical Representation By the Insurance Defense Lawyer*, FOR THE DEF., Feb. 1989, at 7.

3. *See, e.g.*, Robert E. Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136 (1954).

4. *See, e.g.*, CHARLES W. WOLFRAM, MODERN LEGAL ETHICS 38, 42 (1986).

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it tests the company's duty to defend. When the company bears all the important claim risk, we hardly need to think about the company's duty to defend, because the company has every incentive to attend to the defense. In that situation, the interesting issues concern the company's *right* to defend and what the insured must do to cooperate in that defense. It is only when the company's incentive begins to wane that the duty to defend becomes interesting.

A second basic insight concerns the importance of looking beyond the familiar triangle of the lawyer, the insured and the company when analyzing liability insurance conflicts. The triangle is a useful metaphor, but it leaves out a crucial participant: the plaintiff who brings the liability claim. A relationship between a defense lawyer, an insurance company and an insured exists only in relation to—that is, in a relationship with—a plaintiff. For that reason, we cannot understand the dynamics of the professional responsibility triangle without also considering the plaintiff.

Accordingly, when thinking about insurance defense lawyers I prefer to picture the liability insurance relationship, not as a simple triangle, but rather as the set of triangles that exists between four points—a tetrahedron. When looking at any particular face of a tetrahedron, it can appear to be a simple triangle, just as when looking at any one aspect of the liability insurance relationship, it can appear to involve only three parties. But, there is always the "hidden" fourth party, whose relationship with these three parties will affect their relationships with each other.

Figure 1 on the following the following page depicts one view of the liability insurance tetrahedron. As figure 1 reflects, the professional responsibility triangle is not the only interesting face of the tetrahedron. There is also the jury triangle, composed of the three parties that a jury deciding the liability claim would see: the lawyer, the insured, and the plaintiff. There is the settlement triangle, composed of the three parties who, ordinarily, negotiate toward settlement of the claim: the lawyer, the company, and the plaintiff.[5] And there is a final, very interesting triangle composed of the plaintiff, the insured and the company that I will have a great deal to say about. Each of these faces of the liability insurance tetrahedron can seem to form a three way relationship. As with the

5. *See* Charles Silver & Kent D. Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 DUKE L.J. 255, 293-96 (1996) (on "ordinary" case).

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professional responsibility triangle, our understanding of these relationships can be deepened by considering the fourth party.[6]

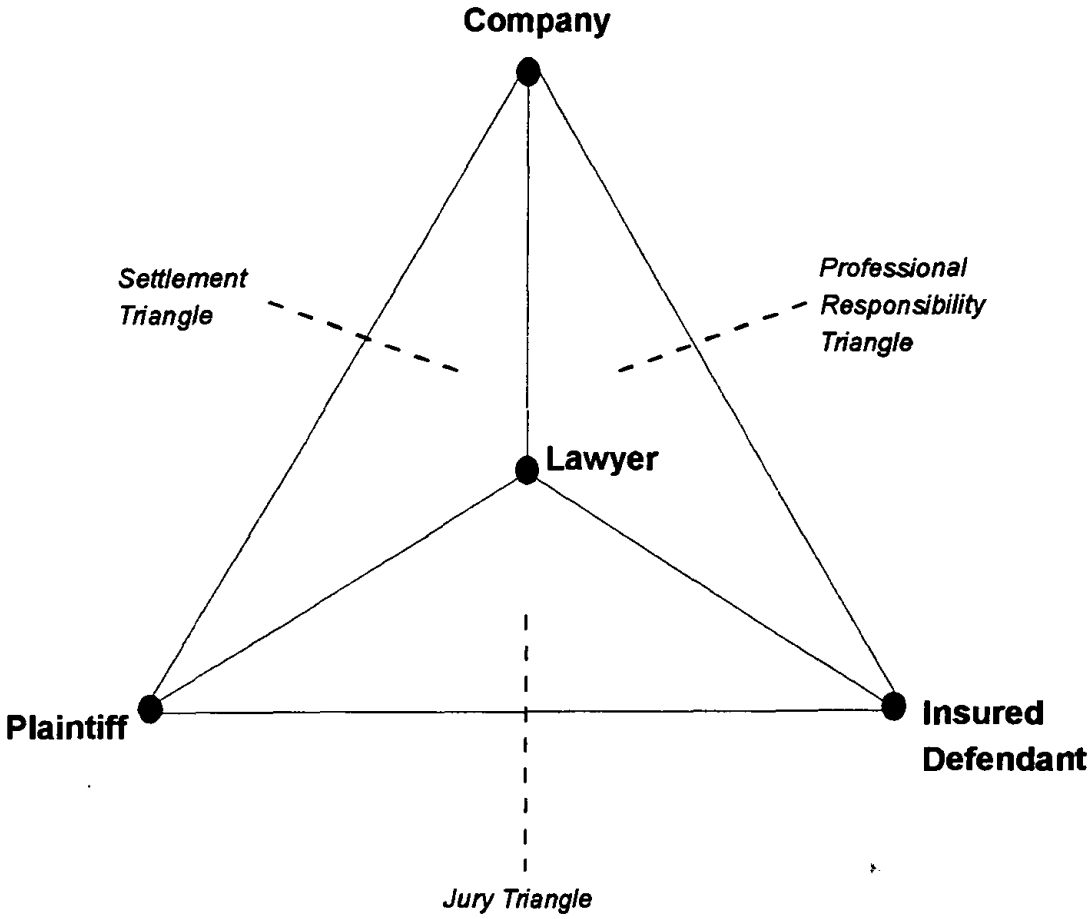

FIGURE 1

Part I of this article introduces this tetrahedron framework. Part II then explores the framework in the context of three sets of hypothetical cases involving the incomplete transfer of claim risk: one set in which the risk is shared because of dollar limits on the insurance coverage; a second set in which the risk is shared because of uncertainty about insurance coverage for the case; and a third set in which the risk is shared because the plaintiff has the potential to cause the insured a kind of harm that is not covered by

6. In all of this I readily acknowledge that I have collapsed the plaintiff and the plaintiff's lawyer into a single unit, even though these two parties do not always have identical interests. It is my working hypothesis that, at least as respects the professional responsibilities of insurance defense lawyers, nothing of analytical importance is lost as a result.

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the insurance policy. My goal is to use the tetrahedron framework to explore the conflicts in these cases and also to use these cases to explore whether that framework is a useful analytical tool.

Part III then addresses the role of the defense lawyer in fulfilling the company's duty to defend in shared claim risk situations. I begin with the conclusions reached by Professor Charles Silver and Dean Kent Syverud in their recent analysis of the professional responsibilities of insurance defense lawyers in full coverage cases[7] and then extend those conclusions to encompass the shared claim risk situations presented in my hypothetical cases. For reasons that will be explained, I agree on insurance law grounds with their conclusion that the insurance company is entitled to limit the scope of the defense lawyer's representation of the insured to minimizing what I will call the "judgment risk"[8] at issue in the claim.

Where I disagree with Silver and Syverud is with respect to the company's responsibility for what I will call the "non-judgment risk" faced by the insured. I locate this responsibility in the company's good faith obligation to give equal consideration to the interests of the insured, and I conclude that this obligation requires the company to retain the defense lawyer to give primary consideration to the interests of the insured in conflict situations when "equal consideration" is an impossibility. Thus, I ground what is sometimes called the primary client rule,[9] not in professional responsibility law, but rather in insurance law.

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7. *See* Silver & Syverud, *supra* note 5.

8. *See* Silver & Syverud, *supra* note 5, at 296-301. Silver and Syverud do not use the claim risk framework, but I think they would agree with this characterization. "Judgment risk" is the risk of having to pay all or part of a judgment entered in a claim. "Non-judgment risk" is every other kind of claim risk; it includes the risk that the claim is not covered (which I will call "coverage risk"), the risk that the company will not settle the claim (which I will call "settlement risk"), and the risk of consequences other than judgments, such as reputational harm (which I will call "other non-judgment risk"). Non-judgment risk also includes defense costs, but because the company is conducting the defense in the cases explored in this paper, defense costs are not part of the insured's non-judgment risk in these cases.

9. *See* Silver & Syverud, *supra* note 5, at 335 (criticizing the primary client rule and proposing an alternative, non-subordination rule).

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I. A FRAMEWORK FOR ANALYZING INSURANCE DEFENSE CONFLICTS: SHARED CLAIM RISK AND THE LIABILITY INSURANCE TETRAHEDRON

Under the prevailing norms of insurance practice, the company's obligations to the insured are analyzed within the framework of contract law, as that law has been developed in the context of standard form insurance policies.[10] Within that framework, the point of departure is the insurance policy. Whatever else the company's obligations may be, those obligations include what was promised in the form contract the company chose to use.

With respect to the company's obligation to defend, most liability insurance policies provide little more than the following:

> We will pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies. We will have the right and duty to defend any "suit" seeking those damages. We may at our discretion investigate any "occurrence" and settle any claim or "suit" that may result.[11]

In addition, these standard form policies contain provisions requiring the insured to cooperate with the company and prohibiting the insured from settling an insured claim without the company's consent.[12] These provisions constitute the whole of the language in the typical insurance policy directly relating to defense obligations.[13]

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10. *See* Tom Baker, *Constructing the Insurance Relationship: Claims Stories, Sales Stories and Insurance Contract Damages*, 72 TEX. L. REV. 1395 (1994).

11. ISO CGL 1986. The wording in the standard automobile and homeowners' insurance policies is essentially the same.

12. "You and any other involved insured must . . . [c]ooperate with us in the investigation, settlement or defense of the claim or "suit" . . . No insureds will, except at their own cost, voluntarily make a payment, assume any obligation, or incur any expense, other than for first aid, without our consent." *Id.*

13. The remainder of the policy principally addresses limits on the company's duty to indemnify and claiming conditions. Because the "duty to defend" applies only to suits seeking damages for which the company would be obligated to indemnify the insured, these other provisions do relate indirectly to the duty to defend.

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Taken together, these standard form provisions mean that (in the ordinary case) the insurance company selects the lawyer who will represent the insured, directs that lawyer's handling of the case, and controls the investigation, negotiation and settlement of the case.[14] Indeed, an insured who interferes with the insurance company's right to defend or discretion to settle risks losing insurance for that case.[15] These provisions also mean, however, that the company has both a "duty to defend" and—although this is not explicitly stated in the policy—a "duty to settle."[16] Thus, the insurance contract clearly contemplates the defense and settlement of the insurance claim as the prerogative of the company, but it also grants the insured a right to a defense and, in the appropriate circumstance, to a settlement of the claim. If these latter rights are to have any meaning, they must—and do—set some limits on the insurance company's right to defend and settle.

A. Shared Claim Risk

In every case, the interests of the company and the insured diverge to the following degree: absent reputational or some unusual concern of the insured, she would prefer a company-funded settlement over further litigation, no matter how unreasonable the plaintiff's demand; and, if there is no settlement, the insured would prefer the company to spend more on defense. This is an example of what economists call ex post moral hazard: because the insurance company is paying for the settlement and defense, the insured's incentives regarding the consequences of an allegedly harmful event differ from what they would be if there were no insurance.[17]

The insurance contract provisions granting the company control over defense and settlement address that incentive problem. A rational *prospective* insured would prefer a liability insurance contract giving the

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14. *See* Silver & Syverud, *supra* note 5, at 265. This typical practice was also confirmed to me in a series of interviews of South Florida personal injury lawyers. For a description of these interviews, see Tom Baker, *Transforming Punishment Into Compensation: In the Shadow of Punitive Damages*, 1998 WIS. L. REV. (forthcoming Spring 1998).

15. *See, e.g.*, Steen v. Underwriters at Lloyd's, 442, N.W.2d 158 (Minn. Ct. App. 1989).

16. *See generally* Kent D. Syverud, *The Duty to Settle*, 76 VA. L. REV. 1113 (1990) (explaining the company's duty to make reasonable efforts to settle a case within the policy limits in order to protect the insured from a judgment in excess of the policy limit).

17. *See generally* Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237, 269-70 (1996) (describing ex ante and ex post moral hazard).

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company some such control, just as a rational prospective insured would prefer a health insurance policy with a deductible or copayment provision and some degree of oversight of the medical treatment.[18] Otherwise, the insured would demand at the point of claim a level of defense that she would not be willing to pay for at the time of purchasing the policy.[19]

Indeed, from an insured's perspective, a liability insurance policy that shifts the control over the defense and settlement of the claim to the company is much less threatening than a health insurance policy that shifts control over health treatment. In the ordinary liability case, the defendant's primary (and often exclusive) concern is avoiding or minimizing the cost of an adverse judgment. That concern easily can be transferred to an insurance company by a contract that makes the company liable for paying the judgment. In contrast, the "health" that is the primary concern of someone who buys health insurance cannot so easily be transferred by contract.

As this suggests, insurance company control presents difficult problems when the insurance contract does not transfer to the company all the important risk affected by that control. That is necessarily the case in health insurance; no contract can ever transfer all the important risk affected by control over health treatment. That is not necessarily the case in liability insurance; liability insurance can come much closer to transferring all the important risk affected by the company's control over the claim. Yes, there are deductibles, and there can be difficulties associated with being a defendant that are not eliminated by liability insurance. But, those deductibles and difficulties usually are relatively insignificant, as least as compared to the risk of paying a judgment.[20]

I call the risk that can be affected by the company's control over the claim the "claim risk." Claim risk is the risk associated with a claim once an event that may give rise to the claim has occurred. It includes all the possible consequences of a claim, such as defense costs, payment to the plaintiff, and loss of good will or reputational harm.

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18. For an analysis of the insurance/control nexus, see Tom Baker, Torts, Insurance and Social Control in the Age of Managed Care (unpublished manuscript on file with author).

19. *See* Baker, *supra* note 17, at 268.

20. Where the deductible is very high, as is increasingly the case in the major corporate liability context, the insurance agreements do not transfer control over defense and settlement to the company. This paper does not address that context. It is concerned solely with traditional liability insurance policies that transfer control to the company.

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An insurance contract does not (and cannot) transfer all the important risk of an injury-causing activity, but it can (and sometimes even does) transfer all the important claim risk. For example, in the automobile context the risk of driving includes the risk of harm to the insured driver. That is a risk that not even the most generous insurance policy can transfer completely to an insurance company, because money simply cannot fully compensate an insured for injury to his or her body. But, by agreeing to cover all the costs of defense and to pay any liability claims, an automobile liability insurance policy can transfer essentially all the important *claim risk* associated with driving.[21]

Of course, the fact that the liability insurance company can bear essentially all the important claim risk does not mean that it always does so. The insured can retain significant claim risk for at least three reasons: dollar limits on the amount of coverage provided by the insurance policy, uncertainty over insurance coverage for the claim, and the potential for the plaintiff to cause the insured a significant kind of harm that is not covered by the insurance policy, such as reputational harm or, in some states, punitive damages.[22] In these shared claim risk situations, the company's control over defense and settlement can provide the opportunity to shift claim risk to the insured. Thus, unlike the paradigm liability insurance defense situation—where the ex post moral hazard we worry about is that of the insured—shared claim risk cases present a dual moral hazard problem.[23]

B. The Liability Insurance Tetrahedron

In teaching and thinking about insurance, I find it helpful to use geometric figures. The triangle below represents the liability insurance relationship when the company faces all the important claim risk in the case, which is understood to be the usual case.[24] In this situation, we can think of the interests of the company and the insured as having merged.

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21. The possible exception is the risk of future premium increases under an experience-rated insurance policy.

22. *See* Tom Baker, *Reconsidering Insurance for Punitive Damages*, 1998 WIS. L. REV. (forthcoming Spring 1998).

23. *See* Baker, *supra* note 17, at 274 n.181 (collecting dual moral hazard literature).

24. *See* Silver & Syverud, *supra* note 5, at 263.

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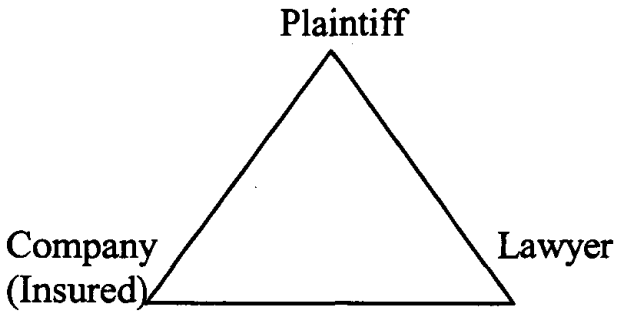

FIGURE 2

In this relationship, we usually think of the company and the insurance defense lawyer allied against the plaintiff; thus, some readers may resist thinking of this relationship as triangular. Yet, as any insurance defense lawyer or insurance adjuster can attest, the relationship between the company and the lawyer can involve conflict even in a case in which the company bears all the claim risk.[25]

The conflict principally revolves around defense fees. The company has an interest in reducing defense costs that is not shared by the lawyer. The plaintiff can use that interest to obtain a settlement that reflects, not only the risk of an adverse judgment, but also the costs of defense. Thus, this relationship presents an opportunity for the company and plaintiff to benefit at the "expense" of the lawyer.

There is also a potential community of interest between the plaintiff and the defense lawyer. Both plaintiff and lawyer have an interest in the continued existence of a claim: the lawyer to bill the file,[26] and the plaintiff to keep alive the possibility of payment. In the normal situation, we expect this potential community of interest to be overwhelmed by the lawyer's interest in proving her or his worth to the company by dispatching

25. *See, e.g.,* Anonymous, *What Many of Us Really Think but are Afraid to Say*, FOR THE DEF., July 1993, at 2 ("From an economic standpoint, your law firm's interests are not necessarily the same as the insurance carriers. Where a case can be settled to eliminate your bill, they are going to do it."); Donald W. Rees & Robert F. Hall, *Communicating with the Insurer Consumer*, FOR THE DEF., Sept. 1994, at 4.

26. This interest assumes an hourly fee arrangement. Paying lawyers on a capitation or flat fee basis changes the incentives present in the relationship. This paper focuses exclusively on the incentive associated with hourly fees and does not address different fee arrangements or the incentives associated with those arrangements.

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the claim. Nevertheless, this potential alliance appears to have resulted in fraud on the company.[27]

When the insured and the company share claim risk, the picture is more complicated. Instead of three relevant parties with potentially conflicting interests, there are four: the company, the insured, the defense lawyer and the plaintiff. The figure below shows the triangle from above "opened up" to reflect the conflict between the company and insured that results from the shared claim risk.

27. *See* Peter Carbonara, *Fleecing Insurance Companies, California-Style*, AM. LAW., Apr. 1990, at 52 (describing alleged fraud by a group of lawyers known as "the Alliance"); Alfred G. Haggerty, *Fireman's Fund, Allstate Settle with Three RICO Suit Lawyers*, NAT'L UNDERWRITER, Nov. 5, 1990, at 4 (reporting settlement by three alleged members of the alliance). This example involves independent counsel selected by the insured pursuant to California's Cumis statute. CAL. CIV. CODE § 2860 (West 1993). The conflict between lawyer and company is less acute when the company chooses the defense lawyer, but it does not go away. *See* Anonymous, *supra* note 25, and Rees & Hall, *supra* note 25.

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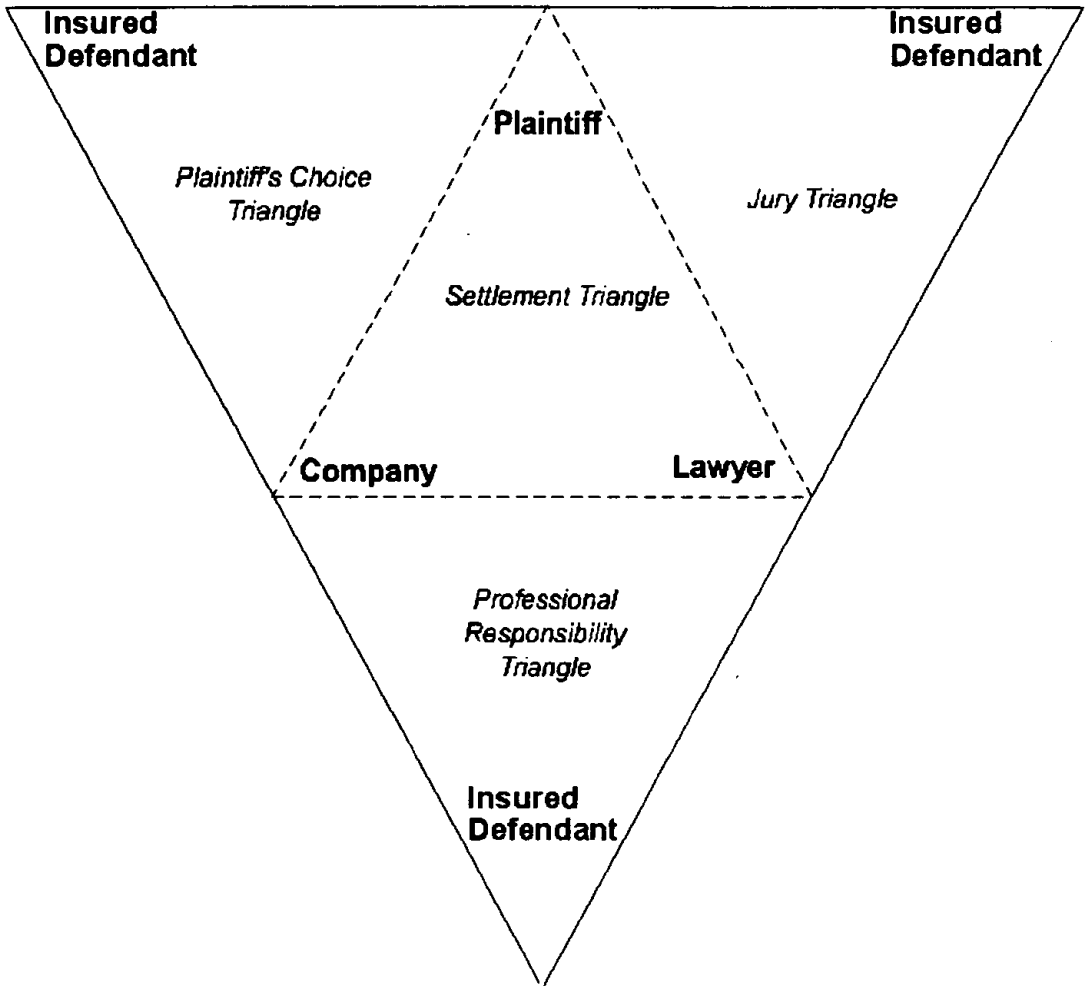
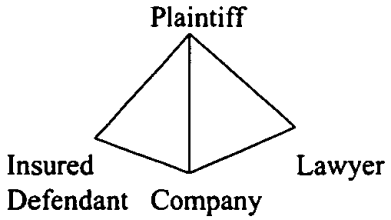


FIGURE 3

If we plot the relationships between these four in three dimensions, the geometric figure that results is a tetrahedron—which I think of as a three dimensional triangle (and which I visualize by thinking of a pyramid with a triangular base).[28] Appendix A shows the liability insurance tetrahedron in

28. The following picture is a three-dimensional representation of the liability insurance tetrahedron:



a form that can be copied, enlarged, and then cut out and assembled into a three dimensional tetrahedron for individual use.

Each of the four faces of the tetrahedron represents a facet of the liability insurance relationship. The "professional responsibility triangle" represents the relationship between the company, the lawyer, and the insured. The "jury triangle" represents the relationship between the three parties that a jury deciding a liability claim would see: the insured, the plaintiff and the defense lawyer. The "settlement triangle" represents the relationship between the three parties that, ordinarily, are directly involved in the settlement of the case: the company, the plaintiff, and the defense lawyer.[29] And the "plaintiff's choice triangle" represents the relationship between the company, the plaintiff and the insured. Each of these components of this relationship is characterized by the kinds of tensions that I began to explore in discussing the company-lawyer-plaintiff triangle above.

II. EXPLORING THE LIABILITY INSURANCE TETRAHEDRON THROUGH PATTERN CONFLICT CASES

The liability insurance paradigm—in which the company controls the defense and settlement of claims using a single lawyer who represents both the company and the insured—is based on the assumption that in most cases the interests of the company and the insured do not fundamentally conflict. In other words, the liability insurance paradigm is based on an assumption that the company bears all the important claim risk. Liability insurance contracts are theoretically capable of transferring all the important claim risk from the insured to the insurance company. The degree to which existing liability insurance contracts approach this goal is an empirical question to which we do not have a rigorous answer. It is clear, however, that liability insurance contracts do not always transfer all the important claim risk faced by insureds. While we cannot say what percentage of actually filed insurance claims involve shared claim risk, we can identify with some confidence the patterns of these cases according to the reasons underlying the sharing of claim risk.

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29. *See* Silver & Syverud, *supra* note 5, at 295 (stating that the defense lawyer will usually be retained to represent the company at settlement); *see also*, Keeton, *supra* note 3, at 1168-71 (arguing that defense counsel may represent the company and not the insured for settlement purposes).

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There are at least three such reasons: (1) the dollar limits of the insurance policy are less than the potential damages at issue in the claim; (2) substantive limits on the coverage provided by the insurance policy make the company's obligation to pay all or part of the claim doubtful or uncertain; and (3) the plaintiff has the potential to cause the defendant a kind of harm that is not covered by the insurance policy. The analysis that follows explores three sets of hypothetical cases that illustrate these patterns, using the framework developed in Part I.

A. Shared Claim Risk Resulting from Dollar Limits

In the first set of pattern cases, the insured and the company share the claim risk because of dollar limits on the coverage provided by the liability insurance policy.

1. The Low Limits Case

> *An individual insured with a $100,000 limit liability insurance policy cut off a stranger's foot with a lawn mower. The stranger filed suit seeking $1 million and then offered to settle the case for $100,000.*

In the Low Limits Case, the insured bears significant claim risk because the potential damages exceed the limits of the insurance policy. This case presents a well known conflict of interest: in the absence of some insurance law intervention, the company has only its subsequent defense costs to lose when it turns down a policy-limits settlement offer. Courts have described this situation as presenting the company with the opportunity to "gamble with the insured's money."[30]

Courts have attempted to resolve this conflict by requiring the insurance company to act "as if" there were no insurance limits when evaluating a settlement proposal.[31] This duty means that the company has a duty to accept a reasonable settlement offer within the policy limits, and

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30. *See, e.g.*, Twin City Fire Ins. Co. v. County Mut. Fire Ins. Co., 23 F.3d 1175, 1179 (7th Cir. 1994); *see also* Murphy v. Allstate Ins. Co., 132 Cal. Rptr. 424, 426 (1976) ("the duty to settle is implied in law to protect the insured from exposure to liability in excess of coverage as a result of the insurer's gamble—on which only the insured might lose").

31. *See* Syverud, *supra* note 16, at 1122-26 (describing competing standards for evaluating whether company should be held liable for failure to settle a claim). The company may also have the duty to offer the policy limits to settle the appropriate case. *See* Coleman v. Holecek, 542 F.2d 532, 537 (10th Cir. 1976) ("the duty to settle does not hinge on the existence of a settlement offer from the plaintiff").

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if the company breaches that duty, it will be liable for the full amount of any subsequent judgment in the case against the insured.[32] This duty to settle increases the company's incentive to settle a case and, thus, reduces the risk of an uninsured excess judgment. It does not, however, eliminate that risk. There remains the possibility that the company will not settle a case within policy limits and that a jury will conclude that the company made every reasonable effort to do so.

Thus, notwithstanding the insurance law "solution" to the conflict of interest, the company and the insured still share the claim risk in a low limits case. Moreover, when the value of the case exceeds the policy limits, the company lacks the usual incentive to defend the case at a level that is proportional to the damages at stake. Indeed, once it becomes reasonably clear that the company will have to pay the full limits of the policy in the case, the company's indemnity obligation provides little financial incentive to defend the case.

These residual conflicts between the company and the insured have consequences within each facet of the liability insurance tetrahedron. In the context of the plaintiff's choice triangle (company-plaintiff-insured), the conflict has the potential to weaken the usual alliance between the company and insured and to create an alliance between plaintiff and insured in favor of a settlement. The insured wants the case to settle to avoid the risk of an uncovered judgement; the plaintiff would like a quick resolution of the case, preferably at a premium.[33]

In the context of the professional responsibility triangle (company-insured-lawyer), the conflict gives the company an incentive to manage the defense in a way that shifts more of the claim risk to the insured. This can happen in at least two ways. First, the company can use its control over the liability case to strengthen its position in any subsequent failure to settle case. For example, the company could direct the defense lawyer not to arrive at an opinion regarding the value of the case or not to create any documents stating possible verdicts in the case, or the company could instruct the defense lawyer to minimize the value of the case in documents

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32. *See* Syverud, *supra* note 16, at 1120-21.

33. In light of the rule that the company will be liable for excess verdicts when it has the opportunity to obtain a reasonable settlement within the limits, the conflict between the company and the insured is most acute in situations in which a within-limits settlement demand is not clearly reasonable. A rational plaintiff would use that conflict as a pressure point to obtain a settlement at the high end of what is reasonable.

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about the case.[34] Such directions would make it more difficult for the insured to prevail in a subsequent failure to settle case. By inhibiting the defense lawyer's ability to communicate her perspective on the case to the relevant decision makers in the company, such directions may also reduce the probability that the company settles the case.

Second, the company can shift risk to the insured by shirking in the defense of the case. This seems most likely to occur in a case in which the value of the case clearly exceeds the limits of the policy and there is no opportunity to settle within limits. But, even when there is an opportunity to settle (as in the Low Limits case), a company that turns down that opportunity is only contingently liable for all the damages at stake and thus has less incentive to defend the case at the level proportional to those damages than would a solvent, uninsured defendant.

The lawyer's interests in this conflict may at first appear contradictory. On the one hand, the lawyer's interests clearly lie with the insured in favor of a strong defense and against company shirking. On the other hand, the lawyer's interests lie with the company in favor of litigation and against settlement. Of course, it is quite possible for the lawyer to satisfy both these interests: opposing settlement and insisting on a thorough defense of the liability claim.[35]

The conflict between the company and insured also has a potential spillover effect in the jury triangle (insured-lawyer-plaintiff), where it has the potential to create an alliance between the insured and the plaintiff against the lawyer. Both the insured and the plaintiff want the case to settle. The more the lawyer is seen as resisting settlement and siding "with" the company "against" the insured, the stronger the plaintiff-insured alliance. For this reason, plaintiffs' lawyers sometimes prepare demand letters aimed as much at the insured as the lawyer or company.[36] One goal of such letters is to induce the insured to retain personal counsel who may,

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34. In an interview conducted under a condition of anonymity for another project, a defense lawyer reported that he was instructed by an insurance company not to make a written assessment of likely damages or settlement numbers in cases he handles for them, in order to make it more difficult for insureds to prevail in failure to settle cases. Interview with Insurance Defense Lawyer (name confidential), in Miami, Fla. (May 17, 1996). For a description of the interviews, *see generally* Baker, *supra* note 14.

35. This is an example of a situation where an alternative fee arrangement could create a different incentive. Were the law firm paid a flat fee to handle a given percentage of the company's litigated cases, the firm would not have a fee-based incentive to oppose a settlement in a particular case.

36. *See* Baker, *supra* note 14.

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in effect, work with the plaintiff to pressure the lawyer and the company to settle the claim.[37] If the company does not settle the case and a large judgment results, the insured and the plaintiff may then ally against the lawyer in a much more concrete fashion: the insured settles with the plaintiff, assigns to the plaintiff the insured's rights against the lawyer and the company, and then assists the plaintiff in a failure to settle suit against the company. Lurking in the background is a potential malpractice claim against the lawyer.

Considering the jury and professional responsibility triangles simultaneously, we can see how tensions in one facet of the liability insurance relationship can affect another. An important concern with respect to the professional responsibility triangle is that the lawyer's long-term economic dependence on the company gives the lawyer an incentive to favor the company against the insured. This concern plays out in the jury triangle as the wedge the plaintiff uses to attempt to split the lawyer and the insured. At the same time, however, the ability of the plaintiff and the insured to ally against the lawyer in the jury triangle may play out in the professional responsibility triangle by giving the lawyer an incentive not to favor the company over the insured. In the event of a large, uncovered excess verdict, the lawyer is a potential deep pocket target. This personal risk may lead the lawyer to bond more tightly with the insured, and, by extension, even the plaintiff.

The conflict between company and insured also has contradictory potential in the settlement triangle (plaintiff, lawyer, company), assuming, of course, that the lawyer handles the settlement on behalf of the company. Provided that the settlement offer is not clearly reasonable, it is in the interest of both the lawyer and the company to resist settlement: the company to avoid paying more than it is legally obligated to pay, and the lawyer to continue receiving fees for the defense of the case. Two factors mitigate against this alliance between lawyer and company, however. The personal risk of the lawyer described above may lead the lawyer to favor settlement when the company would not. Moreover, to the extent that the resolution of the conflict in the professional responsibility triangle results in a more expensive defense, the company's incentive to settle will closer approach that of the plaintiff's, thus increasing the community of interest

37. *Id.*

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between company and plaintiff "against" the lawyer in favor of avoiding defense costs.[38]

2. The Multiple Victim Case

An insured with an automobile liability insurance policy with a $300,000 per accident limit caused a multiple car accident. Three family members seriously injured in one of the cars filed suit before any of the other victims. The three immediately offer to settle for $300,000.

This case is a variation on a low limits case. I use this case to correct any misimpression that it is always the insured who pushes to settle a low limits case. It would be in the company's interest to exhaust the policy limits by settling and thereby save the costs of continuing to defend the insured. The insured would like to keep the company-paid defense until all the cases arising out of the accident are resolved.

In both this case and the Low Limits Case just considered, the conflict between the company and the insured arises from the lack of adequate insurance. In the Multiple Victim Case, however, the company is the one motivated to settle, not the insured. This difference has consequences within each aspect of the liability insurance relationship.

Consider first the plaintiff's choice triangle. As in the Low Limits Case, the conflict between the insured and the company threatens the usual bond between the company and the insured. This time, however, the potential alliance is between these first three plaintiffs and the company. Now the reason for calling this the "plaintiff's choice" triangle becomes clear. A conflict between the company and the insured provides a plaintiff with a potential ally where, before, there were two opponents. In the Low Limits Case the potential ally was the insured. Here, the potential ally is the company.

Whether the plaintiff chooses an alliance in any particular case and, if so, with whom, depends on the situation. Consider first the Low Limits Case. If the insured has significant, collectible assets, a rational plaintiff would have little interest in an alliance with the insured against the company to promote a within-limits settlement—unless either the

38. This will be especially true when the insured has little or no personal assets, because the lack of assets does not relieve the company of the duty to settle, but it dramatically reduces the plaintiff's interest in an excess judgment. *See* Steele v. Hartford Fire Ins. Co., 788 F.2d 441, 446-48 (7th Cir. 1986) (Posner, J.).

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plaintiff's case on liability is weak or the damages are unlikely to exceed the policy limits.[39] If the insured does not have significant collectible assets, however, a rational plaintiff would have great interest in an alliance with the insured in favor of settlement,[40] regardless of the strength of the case or the size of the damages in relation to the policy limits.

The Multiple Victim Case presents the plaintiff with a similar choice. If the insured has significant, collectible assets, a rational plaintiff would have no interest in an alliance with the company to promote a quick settlement—unless, once again, either the plaintiff's case on liability is weak or the damages are unlikely to exceed the policy limits. But, if the insured does not have significant, collectible assets, a rational plaintiff would have great interest in an alliance in favor of settlement (this time, of course, with the company), regardless of the strength of the case or the size of the damages in relation to the policy limits.

Courts' treatment of settlements in multiple victim cases reflects the dynamics of this "plaintiff's choice." The black letter standard remains what Keeton called the "more rustic rule, 'first come, first served'"[41]—meaning that the company may settle individual claims in a manner that leaves less insurance money for later claimants.[42] Nevertheless, that rule has been qualified over time to protect both the insured and other claimants from opportunistic plaintiffs and companies. When the insured has assets, it is the insured who needs protection from a colluding plaintiff and company; the duty of good faith provides that insured some protection.[43] When the insured does not have assets, it is the other victims who need protection; the mandatory allocation of the available insurance to all victims required in some jurisdictions provides those victims some

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39. In either of those two cases, the plaintiff may believe that an alliance with the insured against the company would make it possible to obtain a more generous settlement than would be possible if there were no insurance.

40. The alliance would seem to be the strongest in cases in which the insured defendant has some assets (and thus some interest in avoiding an excess verdict), but not enough to justify great effort on the part of the plaintiff.

41. *See* Robert E. Keeton, *Preferential Settlement of Liability Insurance Claims*, 70 HARV. L. REV. 27, 38 (1956).

42. *See, e.g.*, Allstate Ins. Co. v. Evans, 409 S.E.2d 273, 274 (Ga. Ct. App. 1991).

43. While the contours of "bad faith" in this context are far from settled, a decision in Massachusetts suggestd that settling quickly with one claimant and leaving the insured to defend remaining cases on its own would constitute bad faith. *See* Voccio v. Reliance Ins. Co., 703 F.2d 1, 3-4 (1st Cir. 1983) (dicta that insurance company could be liable if a settlement with one plaintiff caused an excess verdict by another).

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protection.[44] As in the Low Limits case, then, insurance law resists the detrimental consequences of opportunistic behavior by the company. Nevertheless, insurance law does not (and cannot) eliminate the conflict between the companies and insureds that results from there being too little insurance.

Consider next the professional responsibility triangle (company-lawyer-insured). The conflict in the Multiple Victim Case has at least the potential to strengthen the bond between the insured and the lawyer. Both the lawyer and the insured have an interest in the company continuing to pay to defend the case, an interest which conflicts with the company's interest in terminating its involvement in the claim. This common interest may not overcome the lawyer's economic dependence on the company, but it provides an incentive to manage that dependent relationship in a way that keeps this case alive (for example, by bringing to the company's attention the case law indicating that there is some risk to a company that pursues a settle and exit strategy).

From analyzing just these two pattern conflict cases we can see that the lawyer's position in the professional responsibility triangle is similar in some ways to the plaintiff's position in the plaintiff's choice triangle. The conflict between the company and the insured provides the lawyer with a potential opponent, where before there were two allies. Thus, we might call the professional responsibility triangle the "lawyer's choice triangle" and anticipate that the lawyer's choice, like the plaintiff's, would depend on the lawyer's interest in the situation. "Lawyer's choice" is not, however, a comfortable way of thinking about this situation. Indeed, one of the goals of insurance and professional responsibility law in this situation is precisely to dictate the "choice" that the lawyer must make and to structure the liability insurance relationship in such a way that the lawyer does not have an unobserved opportunity to make a contrary choice.

As in the Low Limits Case, the conflict between the company and the insured in the Multiple Victim Case has spillover effects in the jury

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44. *See, e.g.*, Holtzclaw v. Falco, Inc., 355 So. 2d 1279, 1288 (La. 1977) (interpreting direct action statute to prohibit company from exhausting an automobile insurance policy by settling with less than all the victims of an accident); Dorn v. Liberty Mut. Fire Ins. Co., 401 N.W.2d 662, 663 (Minn. 1987) (interpreting uninsured motorist statute to prohibit company from exhausting the policy by settling with less than all the victims of an accident); *see also* Miller v. Lambert, 464 S.E.2d 582 (W. Va. 1995). This goes some way toward achieving Keeton's preferred solution: a court-ordered allocation of policy proceeds according to the "relative settlement value of all claims." Keeton, *supra* note 41, at 52.

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(plaintiff-lawyer-insured) and settlement (plaintiff-lawyer-company) triangles. In contrast to the Low Limits Case, however, the incentives strengthen the bond between insured and lawyer against the plaintiff in the jury triangle and weaken the bond between company and lawyer against the plaintiff in the settlement triangle. The result is that the lawyer in the Multiple Victim Case has more incentive to advocate for the insured at the settlement table than the lawyer in the Low Limits Case.[45] These spillover effects are further examples of the effect that the dynamics in one component of the liability insurance relationship can have on others. They also illustrate the important point that the self interest of the lawyer may mitigate the effect that the lawyer's long term economic dependence on the insurance company has on the lawyer's relationship with the insured. This may explain the relative paucity of published opinions in which insureds challenge a company's early settlement of a multiple victim case.[46]

B. Shared Claim Risk Resulting from Insurance Coverage Uncertainty

In the second set of pattern cases, the insured and the company share the claim risk because there is some uncertainty whether the potential damages are covered by the insurance policy.

1. The Misrepresentation Case

In investigating a serious, but otherwise routine "slip and fall" involving a repairman at the home of an insured with adequate liability insurance for the resulting claim, the company discovered that the insured had been conducting business at the home, despite having answered "no" to a question in the policy application regarding business at the home. The company undertook the defense of the insured, but reserved the right to contest its obligation to pay any judgment on misrepresentation grounds.

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45. Once again, a lawyer whose fees are not based on the number of hours worked may have a different incentive.

46. None of the cases cited in Annotation, *Basis and Manner of Distribution Among Multiple Claimants of Proceeds of Liability Insurance Policy Inadequate to Pay Claims in Full*, 70 A.L.R. 2d 416 (1960), and in the supplements to that annotation through 1996, were brought by insureds to recover money paid to claimants. Instead, the cases all are brought by victims who were not fully compensated.

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In the Misrepresentation Case, the insured and the company share the claim risk because of the uncertainty over insurance coverage for the claim. Here the interests of the company and the insured in the defense of the liability claim appear to be aligned: both the company and the insured would be better off if the repairman's claim went away; the limits of the policy exceed the damages claimed; and there is no obvious way that the company could use the control over the claim to improve its misrepresentation defense. Thus, the conflict between the insured and the company appears to concern only the coverage for the claim.

Nevertheless, the interests of the company and the insured do conflict in the defense and settlement of the liability claim, because the claim and the coverage defense intersect in the company's valuation of the claim. As a result of the coverage defense, a rational company will value the Misrepresentation Case at a discount. The stronger the company's misrepresentation defense, the larger the discount. The larger the discount, the less incentive the insurance company has to mount a vigorous defense or settle the liability case. Although the company and the insured share the risk of having to pay an actual judgment, the company, alone, controls the settlement process. Accordingly, as in the Low Limits Case, the company has an opportunity to "gamble with the insured's money."

In the Low Limits Case, the company would have none of its own money to lose if it refused to settle (ignoring for the moment both defense costs and the duty to settle). In the Misrepresentation Case, in contrast, the company does risk its own money. If the company is wrong about the value of the liability case and the coverage defense, it will have to pay a judgment in excess of the settlement amount. Using the gambling metaphor, then, we can say that a low limits case offers the company the opportunity to place a bet using only the insured's money, while a coverage defense case requires it to bet some of its own money, too.[47]

Nevertheless, a significant conflict of interest remains. Imagine that there is a 50% chance of a $100,000 verdict and 50% chance of a $0 verdict, so that we can say that the settlement value of the case is $50,000. If we also imagine that there is a 50% chance that the company will prevail in a coverage case, then the company should be willing to pay no

47. Factoring in defense costs reduces the differences between the two types of conflicts. The more significant the defense costs are to the overall cost of the claim, the more the conflict present in a low limits case approaches the conflict present in a coverage defense case like the Misrepresentation Case (i.e., in which there is no factual overlap between the liability claim and the coverage defense).

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more than $25,000 to settle the case (ignoring defense and coverage litigation costs, which complicate the analysis without changing the point). As long as the insured has collectible assets, it would be irrational for the plaintiff to settle the case for that amount. Any resulting three-way settlement negotiation between the plaintiff, the insured and the company presents obvious opportunities for conflict between the company and the insured.

In practice, insureds appear not to contribute to settlements within policy limits, at least outside the realm of large scale corporate insurance coverage litigation (for example, mass products liability or environmental claims).[48] Yet, such cases do settle.[49] Does that mean that plaintiffs ignore defendants' other assets, that insurance companies ignore their coverage defenses, or that there is some other dynamic at work? Empirical research directed at answering these questions would help us better understand the role of liability insurance in tort law-in-action.

Even without such research, however, it is clear that at least one reason for the lack of contributions by insureds to within-limit settlements is the existence of cases holding that it is a breach of the company's duty of good faith to require the insured to pay a portion of a settlement within limits.[50] The apparent concern is that the company will use its lower risk aversion and greater experience at valuing claims to profit at the insured's expense. Playing the settlement and coverage numbers is the company's business, not the insured's. Indeed, the insured's aversion to having to play those numbers is one of the pillars of the liability insurance business.[51]

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48. *See* Syverud, *supra* note 16, at 1156. My interviews with personal injury lawyers corroborated Syverud's report. *See* Baker, *supra* note 14, for a description of the interviews. Not one of the lawyers reported having handled or heard of a personal injury case involving an individual or small business insured in which the insured had contributed to a "within limits" settlement. I am aware of insured contributions to "within limits" settlements in the large scale corporate coverage litigation context from my personal involvement in such cases. The details of the settlements cannot be provided because of confidentiality provisions in the settlement agreements.

49. All of the personal injury lawyers interviewed said that it was common practice for insurance companies in Florida to settle contested coverage cases. *See* Baker, *supra* note 14 (describing the interviews).

50. *See* Syverud, *supra* note 16, at 1153-57.

51. The presence of such settlements in the large corporate context is consistent with this explanation because, in that context, there is much less risk that a court will act in a paternalistic manner to protect the insured.

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For present purposes, we need not decide whether this paternalistic prohibition is good or bad policy.[52] It is enough to realize that, as this prohibition reflects, a coverage defense changes the insurance relationship so that the insured and company become adversaries, not only with respect to coverage, but also with respect to the defense and settlement of the claim.

Structurally, the conflict in the Misrepresentation Case is more like the conflict in the Low Limits Case than the conflict in the Multiple Victim Case. The conflict in the Misrepresentation Case encourages an alliance between the insured and the plaintiff in favor of settlement, leaving the company out in the plaintiff's choice triangle and leaving the lawyer out in the jury triangle. Indeed, because the insurance limits are more than adequate for the claim, this alliance has the potential to exist even when there is a deep pocket defendant. In addition, the conflict encourages an alliance between the insured and the lawyer in the professional responsibility triangle opposing efforts by the company to shirk in the defense and maybe even, for the reasons explored below, in favor of settlement.

In the settlement triangle, the lawyer's interests would seem to run squarely with the company against the plaintiff (and, thus, against settlement unless the plaintiff is willing to reduce the settlement value of the case to reflect the coverage uncertainty). What may weaken the bond between company and lawyer, however, is the lawyer's risk aversion. If the claim results in a large, covered verdict, the lawyer may not receive the next file from the company. If the case results in an uncovered verdict, the lawyer may be on the receiving end of legal proceedings: at best a deposition notice in a failure to settle case against the company; at worst a complaint in a malpractice case.

A settlement ends the case on a less than disastrous note for all the people directly involved: the plaintiff, the defendant, the claims adjuster, and the lawyer. For this reason, some lawyers assert that contested coverage cases are more likely to settle than uncontested coverage

52. At least in the abstract, such settlements could be in the insured's interest, in effect providing the insured the opportunity to purchase insurance against the risk of losing the liability claim and the subsequent coverage case. *Cf.* Syverud, *supra* note 16, at 1157 (observing that contributions by insureds to within limits settlements can be understood in the context of a low limits case as insurance "against the risk of an excess judgment").

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cases[53]—this notwithstanding my earlier observation that the settlement value of the case to the company would seem to be much lower than the settlement value of the case to the plaintiff. True or not,[54] this assertion suggests, once again, that the common assumption that it is in the lawyer's interest to align with the company against the insured may not always hold true.

2. The Separation Assault

> *Following a legal separation in an abusive marriage, the insured regularly stalked his wife. One evening, in a drunken rage, the insured shot his wife's boyfriend and then himself. Both survived. The boyfriend filed suit against the husband, who requested a defense from his homeowners' insurance company. The company agreed to defend the case, but reserved the right to contest its obligation to pay any judgment on the grounds that the husband intended the harm.*[55]

This case presents the same settlement and defense conflicts as the Misrepresentation Case, plus an additional conflict arising from the factual overlap between the liability and coverage aspects of the case. The company would benefit from a factual finding in the liability case that the insured shot the boyfriend with the intent sufficient to meet the standard for the company's intentional harm defense. For the insured, that finding would be a disaster, leading to both a large adverse judgment and the loss

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53. *See, e.g.*, Interview with Insurance Defense Lawyer (name confidential), in Miami, Fla. (May 1, 1996). For a description of the interviews, see Baker, *supra* note 14.

54. This is a question that is ripe for empirical testing. Unlike many such questions, it actually seems testable. Indeed, as long as a company's claim data base contains a field indicating whether a reservation of rights letter was sent and a field indicating whether the case settled before trial, running a simple cross tabulation would be easy.

55. This hypothetical is loosely modeled on State Farm Fire & Cas. Co. v. Wicka, 474 N.W.2d 324 (Minn. 1991). The court in *Wicka* affirmed a judgment against the insurance company, based on a jury finding that the assailant lacked the capacity to form the intent necessary to bring the case within the scope of the expected or intended exclusion. If we understand that exclusion to address the problem of moral hazard—changed behavior attributable to insurance—then a very high standard of intent in such separation assault coverage disputes is good policy, because it is highly unlikely that separation assaults are affected by insurance incentives.

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of coverage.[56] Thus, this case differs structurally from the Misrepresentation Case because there is a potential community of interest between the plaintiff and the company: provided the insured has other collectible assets, both company and plaintiff gain by proving that the insured intended to harm the plaintiff.[57]

In the professional responsibility triangle, the insured and the lawyer share an interest in preventing the company from shirking in the defense, and the lawyer has a long term interest in assisting the company. In this sense, the Separation Assault is no different than the other pattern cases. But, the Separation Case is like the Low Limits Case (and unlike the Multiple Victim and Misrepresentation cases) in that it presents the lawyer with the opportunity to further both interests: receiving fees for a thorough defense of the liability claim while helping the company shift claim risk to the insured.

The Separation Assault case differs from the Low Limits Case, however, in terms of the pressure exerted by relationships outside the professional responsibility triangle. In the Low Limits Case, the potential alliance between the insured and plaintiff against the lawyer tempered the lawyer's interest in helping the company shift claim risk to the insured. Here, in contrast, if the plaintiff prefers an alliance with the company, the plaintiff will not pressure the lawyer to place the insured's interests ahead of the company's. Indeed, the logical extension of the lawyer's economic dependence on the company and the company's alliance with the plaintiff would be for the lawyer in effect to work with the plaintiff against the insured in the jury triangle.

Accordingly, the Separation Assault Case presents the strongest potential constellation of interests against the insured yet seen: two against one in the plaintiff's choice triangle, the professional responsibility triangle and even the jury triangle. And, in contrast to the prior cases, no one may be pressing for a settlement in the settlement triangle.

Thus, it is not surprising that many jurisdictions have adopted a shift in control strategy to assist the insured in this kind of case. In these

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56. Even if the jurisdiction did not permit offensive collateral estoppel, the finding in the first case would affect the settlement value of the coverage case: the fact that one jury found that the insured intended the harm clearly would affect the lawyers' evaluation of whether a second jury would do so and thereby reduce the settlement value of the coverage claim.

57. If the insured lacks significant collectible assets, the likely alliance is between insured and plaintiff, with the result that the interests would more nearly match those in the Misrepresentation Case.

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jurisdictions, when a company raises a coverage defense that turns on issues that are relevant to the liability claim, the company gives up the right to defend the insured.[58] Of course, this means the insured now controls the defense at the company's expense, raising the ex post moral hazard problem that motivated the insurance contract provisions assigning control to the insurance company. Perhaps as a result, insurance law seems to tolerate the company placing some limits on the defense, such as requiring the insured's lawyer to accept payment at the company's usual rate and that the lawyer be experienced in defending civil claims.[59]

If the shift in control is only partial, so that the company retains control over settlement of the claim, a significant settlement conflict remains. As with the defense conflict just discussed, this settlement conflict is more acute than the corresponding conflict in the Misrepresentation Case. Keeping the liability case "alive" in the Separation Assault Case benefits the company in a way that keeping the liability case alive in the Misrepresentation Case does not. As long as the Separation Assault liability case continues, there remains the chance that the plaintiff will reveal or prove facts helpful to the company's coverage defense. Once the plaintiff settles with the insured, however, the plaintiff is no longer adverse to the insured and, thus, will be less helpful to the company's position against the insured. As a result, the company has less incentive in the Separation Case to reach a settlement with the insured and the plaintiff that resolves at least the liability aspects of the case. By contrast, in the Misrepresentation Case, if the parties can agree on the value of the liability claim, it may be in both the company's and the plaintiff's interest to settle that claim and then litigate the real issue: whether there is insurance coverage for the claim.

3. The Softball Case

The company hired a lawyer to defend what seemed to be a routine negligence claim filed by a spectator injured at a high school softball game. During informal interviews, two potential witnesses told the defense lawyer that the insured had deliberately thrown her bat at the plaintiff, who had been heckling the insured. The lawyer talked to

58. *See, e.g.*, CAL. CIV. CODE § 2860 (West 1993); Thornton v. Paul, 384 N.E.2d 335 (Ill. 1978). *See generally* William T. Barker, *The Right and Duty to Defend: Conflicts of Interest and Insurer Control of the Defense*, 1992 A.B.A. SEC. OF TORTS & INS. PRAC. 195.

59. *See, e.g.*, CAL. CIV. CODE § 2860(c) (West 1993).

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> *the insured, who denied the story. When the lawyer next talked to the two potential witnesses, they said they had since spoken to the plaintiff's lawyer, who told them that the plaintiff would prefer to treat the incident as an accident and that they would not be needed as witnesses in the case.*

The Softball Case is a latent Separation Assault Case. The immediate conflict between the insured and the company lies in the use of the information from the potential witnesses. The insured would prefer that the company never learn about these witnesses.[60] The company would prefer to have the information in order to determine whether to make any additional investigation and, eventually, whether to raise a coverage defense.

Here, the plaintiff's lawyer's statement to the witnesses (that the plaintiff prefers to treat the case as an accident) strongly suggests that the plaintiff has chosen an implicit alliance with the insured.[61] Either the insured lacks collectible assets or the plaintiff has decided that it will be easier to obtain a settlement from the company than it would from the insured. As a result, the interests in this case line up much like the interests in the Misrepresentation Case: the plaintiff and the insured allied against the company in the plaintiff's choice triangle and against the lawyer in the jury triangle, with the goal of creating pressure for settlement.

The difference is that, as in the Separation Assault, the company has an enhanced incentive to enlist the lawyer in an alliance against the insured and, thus, a correspondingly greater interest in preventing the lawyer from allying with the insured and the plaintiff. At the same time, however, the lawyer has a significant interest in withholding the information, at least in jurisdictions that adopt the shift in control strategy described above. Providing the information increases the likelihood that the Softball case will become a Separation Assault case, with the likely result that the insurance defense lawyer will lose the file (to an "independent" lawyer

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60. The insured has this preference whether or not she "in fact" intended the harm. Thus, the conflict does not depend on a fraudulent intent on the part of the insured.

61. For a nuanced discussion of the "underlitigation" strategy that follows from such an alliance, see Ellen S. Pryor, *The Stories We Tell: Intentional Harm and the Quest for Insurance Funding*, 75 TEX. L. REV. 1721 (1997).

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selected by the insured).[62] Once again, the self-interest of the lawyer may mitigate the presumed tendency of the lawyer to favor the interests of the company over the insured.

C. Shared claim risk from uncovered harm

In the third set of pattern conflict cases, the company and the insured share the claim risk because the insured faces a kind of harm that is not covered by the insurance policy. In the Food Poisoning Case that harm is damage to the insured's reputation. In the Punitive Damages Case that harm is punitive damages in a jurisdiction in which such damages are uninsurable.

1. The Food Poisoning Case

> *An insured restaurant faces a food poisoning claim. The company's claims manager believes that the plaintiff's case is weak on causation grounds. The restaurant owner believes that litigation of the case would cause negative publicity that would decrease sales. The plaintiff offers a pre-suit settlement of the claim for an amount that is greater than what the claims manager reasonably believes to be the present value of the expected judgment in the case (adjusted for the plaintiff's probability of success) but less than what the restaurant owner reasonably believes to be the sum of that present value plus the reputational harm the plaintiff can cause the restaurant.*

In the Food Poisoning Case, the insured bears claim risk because there is more at stake than a potential judgment. This case is the reverse of the often discussed malpractice settlement conflict.[63] In malpractice cases, insureds sometimes oppose settlement because of reputational concerns.[64] Here, in contrast, the insured prefers settlement because of reputational concerns. The conflict between the company and the insured arises from the nature of the risk transferred by the liability insurance contract. The contract obligates the company "to pay those sums that the insured

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62. *See supra* note 58 and accompanying text.

63. *See, e.g.*, Note, *An Insurer's Right to Settle Versus Its Duty to Defend Nonmeritorious Medical Malpractice Claims*, 16 J. LEGAL MED. 545 (1995).

64. *See, e.g.*, Shuster v. South Broward Hosp. Dist. Physicians' Prof'l Liab. Ins. Trust, 570 So. 2d 1362 (Fla. Dist. Ct. App. 1990), *aff'd*, 591 So. 2d 174 (Fla. 1992).

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becomes legally obligated to pay as damages"[65]; it does not obligate the company to compensate the insured for damaged reputation.

The conflict in the Food Poisoning Case is similar to the conflicts in the preceding cases. Because the company and the insured share the claim risk, the company has less incentive to defend and settle the case than would a defendant without insurance. Indeed, if we analogize the reputational harm at risk in the Food Poisoning Case to a judgment in excess of the insurance policy limits, the interests in this case line up much like the interests in the Low Limits Case. For example, the plaintiff and insured would be allied in favor of settlement against the company in the plaintiff's choice triangle and against the lawyer in the jury triangle.

There is, however, an important difference between the two cases. In the Low Limits Case, the duty to settle requires the company to evaluate the settlement offer as if it bore all the claim risk. In the Food Poisoning Case, in contrast, the duty to settle does not require the company to evaluate the settlement offer as if it bore all the claim risk. Requiring the company to do so would have the effect of eliminating the "as damages" limit and indemnifying the insured for reputational harm.

I do not mean to suggest that the company has no obligation to consider the consequences that its actions may have for the insured, but simply to observe that whatever obligation the company does have, it cannot be required to pay a settlement that takes into account the full reputational harm faced by the insured. Thus, there almost inevitably will be a gap in such a case between what the settlement value of the case would be for a solvent, uninsured defendant and what the settlement value of the case would be to a liability insurance carrier. As a result, if the plaintiff demands a large settlement premium that is based on its ability to damage the insured's reputation (and, providing the insured has assets, what rational plaintiff would not?), the company effectively would be relieved of the obligation to settle the case.

Another difference between the Food Poisoning Case and the Low Limits Case relates to the nature of the claim risk borne by the insured. The claim risk borne by the insured in the Low Limits Case is a risk that the company willingly would have borne had a higher premium been paid. What is at stake in the conflict between the company and the insured,

65. *See supra* note 58 and accompanying text.

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therefore, is simply the amount of a given type of risk that is transferred at a given price.[66]

In the Food Poisoning Case, in contrast, the claim risk borne by the insured is not a risk for which coverage is openly available on the insurance market. There is no "lost profits" endorsement available for purchase in the liability insurance market. Thus, adjusting the incentives in this case could shift to the company a different kind of risk than is typically understood to be transferred by liability insurance. Accordingly, what is potentially at stake in the conflict between company and insured in the Food Poisoning case is the nature of the risk against which liability insurance protection will be available.[67]

In this situation, neither the company's indemnity obligations nor its duty to settle would give the company an incentive to reduce the claim risk faced by the insured. Indeed, if there is a realistic possibility that the risk of reputational harm could lead the insured to decide to take over the case and abandon coverage, the company has an incentive to increase that risk. This creates a potential community of interest between the plaintiff and the company. Although neither the company nor the plaintiff can directly benefit from the reputational harm, each can benefit from the insured's desire to avoid that consequence. The plaintiff increases the settlement price, and the company avoids having to defend and pay the claim.

Like the Multiple Victim Case and the Separation Assault Case, then, the Food Poisoning Case presents an opportunity for a tacit alliance between the company and the plaintiff. Whether the plaintiff chooses that alliance will, of course, depend on such circumstances as the amount of collectible assets held by the insured, the relationship between the value of the likely judgment and the reputational harm in the case, and so forth.

The interests of the lawyer may provide some counterbalance to this tacit alliance. It is in the lawyer's interest that the company reject an early settlement offer, but that the insured not be so threatened that it takes over the case from the company and replaces the lawyer.[68] Thus, it is in the lawyer's interest to manage the case so as to minimize the non-judgment risk faced by the insured.

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66. This is also true of the Misrepresentation Case: the disclosure of the business at home most likely would not have caused the company to reject the application, although it may have increased the premium.

67. This is also true of the Separation Assault Case and the Punitive Damages Case: coverage is not generally openly available for intentional harm or in some jurisdictions for punitive damages. *See* Baker, *supra* note 22.

68. Once again, this incentive assumes an hourly fee arrangement.

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2. The Punitive Damages Case

After leaving a bar at closing, an insured driver drove through a red light and hit a pedestrian in a crosswalk. The driver stopped, backed up, drove around the victim (now lying badly injured in the street), and proceeded to an after hours club, where he was later arrested and charged with driving while intoxicated and leaving the scene of an accident. The victim survived to bring a compensatory and punitive damages claim. Punitive damages are not insurable in the jurisdiction.

On these facts, the victim has a clear right to compensatory damages and a strong claim for punitive damages.[69] The insured bears claim risk because the company is not required to pay a punitive damages verdict. The conflict between the insured and the company concerns the level of defense effort to devote to the case as well as the allocation of any settlement or verdict to these two categories of damages.[70]

From the plaintiff's perspective this case is a combination of the Separation Assault and Softball cases on the one hand and the Low Limits Case on the other. If the insured does not have significant, collectible assets, then the plaintiff has no financial interest in obtaining a punitive damages judgment (just as the plaintiff in the Softball Case appeared to have no financial interest in proving intentional harm). Indeed, because plaintiffs' lawyers commonly believe that a large punitive damages verdict is likely to be accompanied by a smaller compensatory damages verdict than would be the case in the absence of the punitive damages verdict, the plaintiff in a drunk driving case without a "deep pocket" defendant is

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69. Florida personal injury lawyers characterized a driving while intoxicated claim as a good punitive damages case, particularly if the insured left the scene. *See, e.g.*, Interview with Insurance Defense Lawyer (name confidential), in Miami, Fla. (May 17, 1996), quoted in Baker, *supra* note 14.

70. *See* Nandorf v. CNA Ins. Co., 479 N.E.2d 988 (Ill. 1985) (holding that because of the conflict between the insured and the company in a case involving a small claim for compensatory damages and a large claim for punitive damages, the insured is entitled to an independent counsel at the company's expense); *but see* Douglas R. Richmond, *Lost in the Eternal Triangle of Insurance Defense Ethics*, 9 GEO. J. LEGAL ETHICS 476, 501 (1996) (asserting that a claim for uninsurable punitive damages does not create a conflict—without considering the settlement point made in the text above or the conflict addressed in *Nandorf*).

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likely to request little or no punitive damages from the jury.[71] Similarly, if the insured has no substantial assets, the plaintiff is likely to handle the Punitive Damages Case like the Low Limits Case: offering to settle the case within policy limits and then pursuing a failure to settle case in the event of a punitive damages verdict.[72]

If the defendant has substantial other assets, however, the plaintiff's litigation strategy will be quite different. In that event, the interests of the plaintiff and the company may align, much as in the Separation Assault case. If the company's limits are high enough, the best strategy for reducing the company's liability and increasing the plaintiff's recovery may well be to contain the compensatory damages by boosting the punitive damages claim.[73] Thus, provided the insured has assets, the Punitive Damages Case presents the same constellation of interests against the plaintiff as the Separation Assault Case: two against one in the plaintiff's choice triangle, the professional responsibility triangle and even the jury triangle, with no one pushing for settlement in the settlement triangle. And, in contrast to the Separation Assault Case, the insured's claim for

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71. *See* Baker, *supra* note 14. It is worth noting this ability to transform punitive into compensatory damages means that a settlement premium based on the plaintiff's ability to obtain a punitive damages award differs from a settlement premium based on the plaintiff's ability to damage the insured's reputation because the ability to harm the defendant's reputation cannot be used to increase a compensatory damages judgment, whereas the plaintiff's ability to obtain punitive damages can. *See id.* Thus, a settlement premium demanded because of the plaintiff's ability to inflict an uninsured punitive damages judgment should not necessarily relieve the company of the duty to settle the case. *Cf.* Lira v. Shelter Ins. Co., 913 P.2d 514 (Colo. 1996) (majority and dissent review case law on duty to settle a punitive damages claim).

72. *See* Baker, *supra* note 14 (reporting that defense lawyers analogized punitive damages cases to low limits cases for duty-to-settle purposes).

73. This strategy seems most likely to be fruitful in jurisdictions in which the duty to settle does not obligate the company to protect the insured from a punitive damages verdict. *See, e.g., Lira*, 913 P.2d at 516 ("[a]n insurer who has not contracted to insure against its insured's liability for punitive damges has no duty to settle the compensatory part of the claim to minimize the insured's exposure to punitive damages"). In such a jurisdiction, a company that has rejected a policy limits settlement offer would have great incentive to have the jury release its anger on the punitive damages line on the verdict form, not the compensatory damages line. Other jurisdictions appear to require the company to provide at least some protection against a punitive damages verdict. *See* Magnum Foods, Inc. v. Continental Cas. Co., 36 F.3d 1491, 1506 (10th Cir 1994) ("the good faith duty thus requires cooperative efforts by [company] with [insured] throughout to handle and settle the entire case"). In my view, the former approach wrongly ignores the fact that punitive damages can be "transformed" into compensatory damages. *See* Baker, *supra* note 14.

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control over the insurance defense lawyer is quite weak. Indeed, California's "Cumis" statute explicitly states that a claim for punitive damages does not entitle the insured to a company-funded independent defense lawyer.[74]

III. THE DUTY TO DEFEND WHOM AGAINST WHAT?

As the preceding discussion has illustrated, triangularity is a multifaceted feature of the liability insurance relationship. Typically, courts and professional responsibility specialists worry about that triangularity because the insurance defense lawyer's financial interests are so closely tied to the company that the lawyer seems destined to become the company's instrument for shifting risk to the insured.[75] Factoring the plaintiff into the relationship complicates that worry. On the one hand, the concern that the lawyer will sacrifice the insured is increased by potential alliances between plaintiff and company, as illustrated most clearly by the Separation Assault Case and the Punitive Damages Case and also, potentially, by the Multiple Victim Case and the Food Poisoning Case. On the other hand, the potential alliance between plaintiff and insured raises concerns about the lawyer shifting risk to the company, as seems likely in the Softball Case and at least possible in the Low Limits Case and the Misrepresentation Case.

Complicating the question "who is taking advantage of whom" does not change the existence of the conflict between the company and the insured, nor the need to decide the scope of representation that the duty to defend requires. Insurance law plainly does not require the company to engage a lawyer to represent all the interests of the insured potentially at issue in a claim. For example, the company would not be required to retain a lawyer to defend the insured in a criminal proceeding arising out of the Separation Assault, even though the outcome could have obvious relevance both to the value of, and insurance for, the claim.[76] Nor, in either the

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74. *See* CAL. CIV. CODE § 2860 (West 1993). In *Nandorf*, 479 N.E.2d at 988, the Illinois court permitted the insured to hire independent counsel at the company's expense, but the facts in that case were quite exceptional. In the underlying claim at issue in *Nandorf*, only nominal compensatory damages were sought, with the result that the whole case was really about punitive damages. In that special case, the court held that the company cannot be counted upon to provide a defense that is adequate to the risk at stake.

75. *See, e.g.*, CHI of Alaska v. Employers Reinsurance Corp., 844 P.2d 1113, 1116 (Alaska 1993) and sources cited therein.

76. *See* Silver & Syverud, *supra* note 5, at 292.

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Separation Assault Case or the Misrepresentation Case would the company be required to engage a lawyer to represent the insured in any related insurance coverage litigation.[77] The challenge is to define the scope of the defense lawyer's representation of the insured in a manner that provides meaningful guidance to the real people who navigate through the liability insurance tetrahedron.

A. A Judgment Risk Approach to the Duty to Defend

In "The Professional Responsibilities of Insurance Defense Lawyers," Professor Charles Silver and Dean Kent Syverud considered the scope of the insurance defense lawyer's representation of the insured in the context of what they call the full coverage case.[78] By a "full coverage" case they mean a case in which the limits of the insurance policy exceed the damages sought by the plaintiff and in which the company has no present basis for expressing any doubt about the obligation to indemnify the insured against those damages.[79] In such a case, they conclude that the duty to defend obligates the company to retain a lawyer to conduct a defense that minimizes the size and probability of a plaintiff's judgment in the case and, consistent with that primary goal, minimizes the costs of defense.[80] Thus, with respect to the insured—who does not bear the costs of defense—the scope of the lawyer's representation is the minimization of the size and probability of a judgment in favor of the plaintiff. For this reason, I refer to Silver and Svyerud's approach as a "judgment risk" approach to the duty to defend.

In the paragraphs that follow, I use the pattern cases and the concept of claim risk and its components to extend this judgment risk approach beyond the full coverage situations Silver and Syverud considered. This extension is possible because the company and the insured can share the claim risk even in a "full coverage" case of the sort that Silver and Syverud

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77. If the insured is successful in that insurance coverage litigation, the company may well have to pay the insured's legal fees, but the insured bears those fees in the first instance. *See* Baker, *supra* note 10 at 1424.

78. *See* Silver & Syverud, *supra* note 5.

79. *See id.* at 263.

80. The most direct statement Silver and Syverud make on this point is that the company has a duty "to provide a lawyer to defend the insured." *Id.* at 300-01. Nowhere do they succinctly define what they mean by "defend the insured," but a careful reading of their analysis leads me to the judgment risk description. *See, e.g., id.* at 329-31 (discussing scope of lawyer's representation in a case in which there is a conflict between the insured's reputational interest and the company's interest in minimizing the cost of the claim).

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addressed. This risk sharing can occur for one of two reasons: either the claim has consequences for the insured beyond a potential plaintiff's judgment (as in the Food Poisoning Case) or there is the potential for the company later to learn of circumstances that would lead it to express uncertainty about its obligation to pay the claim (as in the Softball case). These two types of cases—both of which Silver and Syverud considered—present all the essential elements of shared claim risk that occur in the other pattern cases.

Indeed, the Softball Case presents most of these elements. These elements can be illustrated by thinking of the insured's claim risk in the Softball Case as the product of the following six factors:

> (1) the probability that the company learns of information suggesting that the insured intended the harm,
>
> (2) the probability that this information would lead the company to reserve its right to litigate coverage for the claim,
>
> (3) the probability that the company would not settle the claim,
>
> (4) the probability of a plaintiff's verdict should the company not settle,
>
> (5) the probability that the insured would lose a subsequent coverage case, and
>
> (6) the dollar amount of the likely plaintiff's verdict in the liability case.

The "judgment risk" portion of this equation is the product of factors (4) and (6): the probability of a plaintiff's verdict multiplied by the likely dollar amount of that verdict.

The portion of that judgment risk borne by the insured is a function of the remaining factors in the equation. Factors (1), (2), and (5) are all part of what I refer to as the "coverage risk" component of the claim risk, and factor (3) is what I call the "settlement risk" component. In Silver and Syverud's analysis, both of these components lie outside the scope of the defense lawyer's representation of the insured.[81] Thus, we might say that,

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81. *See* Silver & Syverud, *supra* note 5, at 343-48 (stating that the lawyer has an obligation to turn over all information relevant to the defense of the case, even if harmful to the insured's coverage case), at 296-99 (stating that the company is not required to retain the lawyer to represent the insured with respect to settlement), and at 293 (stating their

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under a judgment risk approach to the duty to defend, the lawyer represents the insured for the purpose of minimizing the total judgment risk in the case, but not for the purpose of reducing the insured's share of that risk.

Silver and Syverud did not directly address limited coverage cases. Nevertheless, the claim risk faced by insureds in limited coverage cases is essentially the same as the claim risk presented in a latent limited coverage case like the Softball Case.

In the Separation Assault Case and the Misrepresentation Case, the insured's claim risk is the product of factors (3) through (6) from the Softball Case above: the judgment risk (factors (4) and (6)), the settlement risk (factor (3)), and the risk that a court will determine that the claim is not covered (factor (5)). In the Low Limits Case and the Punitive Damages Case, the insured's claim risk is the product of four similar factors:

> (a) the probability that the company will not settle the case,
>
> (b) the probability of an excess or punitive damages verdict if the company does not settle,
>
> (c) the probability of losing a subsequent failure to settle case, and
>
> (d) the size of the excess or punitive damages verdict that the insured would have to pay as a result.

Factors (b) and (d) from this list are part of the judgment risk; factor (a) is the same as the settlement risk present in the preceding cases; and factor (c) is a form of coverage risk. As in the Softball Case, the judgment

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"preliminary conclusion" that the lawyer does not represent the insured with respect to coverage and should not provide coverage advice).

As Silver & Syverud are careful to make clear, deciding that these factors lie outside the scope of the defense lawyer's representation would not mean that the lawyer would have no professional responsibilities with respect to those factors. For example, if the insured directed the defense lawyer not to supply the information in the Softball Case to the company, Silver & Syverud would agree that the lawyer could not do so. Under the canons of professional responsibility, a lawyer has a duty of loyalty to the client that precludes disobeying instructions. The proper course for the lawyer under Silver & Syverud's approach would be to inform the insured that the lawyer's duty of loyalty to the company requires the lawyer to provide the information to the company, unless the insured instructs the lawyer to the contrary, and that, if the insured did instruct the lawyer to the contrary, the duty of loyalty to the company would require the lawyer to withdraw from the case. *See id.* at 359-61.

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risk approach would assign the lawyer to represent the insured with respect to the judgment risk, but not the settlement or coverage risk.

In the Food Poisoning Case (and in the analogous case addressed by Silver and Syverud[82]), the damages sought by the plaintiff are well within the limits of the policy, and there is no doubt that the claim is covered by the policy. As a result, the insured does not bear any judgment risk. All the risk the insured bears is non-judgment risk, and under a judgment risk approach to the duty to defend, the company would have no obligation to retain the defense lawyer to represent the insured with respect to that risk.[83]

Looking at these pattern cases together, we can see that the judgment risk approach to the duty to defend leaves the insured on its own with respect to three kinds of claim risk: settlement risk, coverage risk, and a catch-all category I call "non-judgment risk" that is illustrated by the reputational risk in the Food Poisoning case.

If we understand the company's duty to defend as derived from the duty to indemnify,[84] then excluding both the coverage risk and the other non-judgment risk from the scope of the lawyer's representation makes good intuitive sense. (I will address settlement risk in a separate section below.) The duty to defend does not encompass coverage risk because, by definition, the company has no duty to indemnify a non-covered claim. Similarly, the duty to defend does not encompass non-judgment risk because the insurance policy limits the company's indemnity obligation to "pay those sums the insured is legally obligated to pay as damages," which does not include collateral harm to the insured (as opposed to a third party) resulting from a claim. Thus, the duty to defend is broader than the duty to indemnify, but the duty to defend is broader only in the sense that the

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82. In Silver & Syverud's hypothetical the insured is concerned that litigation of the case would reveal his marital infidelity. *See id.* at 327.

83. *See id.* at 327-31.

84. This is the way standard liability insurance policies define the duty. *See supra* note 11 ("We will pay those sums that the insured is legally obligated to pay as damages . . . We will have the right and duty to defend any suit seeking those damages."). It is also the way that courts describe the duty to defend. *See, e.g.*, Burd v. Sussex Mut. Ins. Co., 267 A.2d 7 (N.J. 1970) ("[t]he sense of the covenant is to defend claims which the carrier would be required to pay if the claimant prevailed in the action. . . . The obligation to defend 'groundless, false or fraudulent' claims does not mean that the carrier will defend claims which would be beyond the covenant to pay if the carrier prevailed"); Gray v. Zurich, 419 P.2d 168, 176 (Cal. 1966) ("[a]n insurer, therefore, bears a duty to defend its insured whenever it ascertains facts which give rise to the potential of liability [i.e., an obligation to indemnify the insured] under the policy").

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company must defend the case as if there were no doubt about coverage, unless and until non-coverage is conclusively proven. [85]

B. Defense Lawyers and Settlement Risk

As I have just described, excluding coverage risk and other non-judgement risk from the scope of the defense lawyer's representation of the insured can be justified by reference to limits on the duty to indemnify and the derivative nature of the duty to defend. That justification cannot be used to exclude settlement risk from the scope of representation. Indeed, the company's duty to settle exists precisely because the company's duty to indemnify is limited. If the company's duty to indemnify were unlimited, the insured would face no risk from the company's failure to settle and, thus, there would be no need for a duty to settle. Accordingly, limits on the duty to indemnify provide no logical basis for concluding that settlement lies outside the scope of the duty to indemnify or its derivative, the duty to defend.

Moreover, it is historical happenstance that the duty to settle evolved out of the duty to indemnify. The duty to settle can also be seen as an extension of the duty to defend. After all, what better way is there to minimize the judgment risk than to settle the case? Furthermore, because settlements are also a means of avoiding defense costs, it is not hard to erode the defense - settlement distinction. [86]

This does not mean, however, that the scope of the defense lawyer's representation of the insured should include settlement. In the ordinary

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85. There is a useful symmetry between the proposition that the duty to defend requires the company to defend the claim "as if there were full coverage" for any resulting judgment and the proposition that the duty to settle requires the company to evaluate settlements "as if there were no limits" on the dollar amount of coverage. Both propositions simplify, in a helpful way, some of the complexities of the liability insurance relationship. Both, at least in theory, help contain the conflict between company and insured. And both are likely in fact to provide significant protection to the insured, because both also benefit another party to the liability insurance relationship. The plaintiff stands to benefit from the duty to settle and, for that reason, has an incentive to construct its case in a manner that protects the insured's right to a settlement within limits. The defense lawyer stands to benefit from the requirement that the company defend the case "as if" it were fully covered and, thus, has an incentive to defend the case in that manner.

86. This may explain why there are, at least to my knowledge, no liability insurance policies that provide only defense coverage. For an argument that there should be such liability insurance defense-only policies, see Alan Widiss, *Abrogating the Right and Duty of Liability Insurers to Defend Their Insureds: The Case for Separating the Obligation to Indemnify from the Defense of Insureds*, 51 OHIO L.J. 917 (1990).

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case it is the company that controls settlement and, therefore, an insured wishing to settle a case must convince the company to do so.[87] As a result, including settlement in the scope of the lawyer's representation of the insured is problematic from the perspective of preserving the "triangular relationship [between insured, lawyer and company] in its normal state."[88] If the defense lawyer represents the insured with respect to settlement, the defense lawyer would become the insured's advocate to the company. In that setting, it is very difficult to think of the insured and the company on an equal footing in a "normal" triangular relationship. Instead, the insured would be the lawyer's "friend" and the company, the lawyer's "enemy".[89]

Thus, one reason to exclude settlement from the scope of the defense lawyer's representation of the insured is to minimize the frequency of overt conflicts in the professional responsibility triangle. Indeed, because an insured almost always would prefer a settlement, even when the insured bears essentially no claim risk, including settlement within the scope of representation of the insured would seem to make client conflicts the usual, rather than the exceptional, lot of the insurance defense lawyer.

Ultimately, however, this reason is unsatisfactory because the lawyer's responsibilities in the face of the conflict can easily be addressed by directing the lawyer to privilege one or the other client in settlement conflict situations. Indeed, in practice this appears to be exactly what happens. Insurance defense lawyers typically represent the company, and not the insured, with respect to settlement.[90] Including settlement in the scope of the lawyer's representation of the insured would simply reverse that situation, so that the insurance defense lawyer would represent the insured, not the company, with respect to settlement. In that event, we can expect a rational insurance company either to retain a second lawyer to

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87. The qualification in this sentence reflects the fact that in disputed coverage situations insurance law may permit the insureds to settle directly with claimants and then litigate coverage with the company. *See, e.g.*, Thornton v. Paul, 384 N.E.2d 335 (Ill. 1978).

88. Hazard, *supra* note 1, at 38.

89. *See id.* at 21 (citing Charles Fried, *The Lawyer as Friend: The Moral Foundations of the Lawyer-Client Relationship*, 85 YALE L.J. 1060 (1976)).

90. *See* Silver & Syverud, *supra* note 5, at 295. *Cf.* Keeton, *supra* note 3, at 1168-71 (arguing that this arrangement is proper). The defense lawyers interviewed in connection with my punitive damages study, *see* Baker, *supra* note 14, confirmed this practice. The exception to the general rule occurs not when the insurance defense lawyer represents the insured with respect to settlement, but rather when the lawyer does not handle settlement for either client— because an adjuster or company counsel (who does not represent the insured for any purpose) is handling the settlement.

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handle the settlement or to expand the duties of the claims adjuster to include settlement. Both seem likely to increase the company's cost of handling claims. The question is whether this extra cost would be so clearly outweighed by benefits to insureds that legal intervention to change the current practice appears justified.

For defendants with significant assets to protect, including settlement within the scope of the insurance defense lawyer's representation of the insured would seem to provide very little benefit. For the reasons explored in Part II, a defendant with significant assets to protect in a shared claim risk situation is unlikely to conclude that a lawyer selected and controlled by the company would be sufficiently loyal to serve as the insured's sole representative for settlement purposes. As the liability insurance tetrahedron makes clear, in a shared claim risk situation there are simply too many opportunities for the interests of the company and the plaintiff to intersect for a wise insured with assets to protect not to seek personal counsel. Once the insured retains personal counsel, there is little need for the insurance defense counsel to serve as the insured's settlement advocate.

Defendants with few or no assets to protect have little need for settlement representation and, thus, little reason to pay extra to obtain it.[91] Indeed, it is the plaintiff, not the judgment proof (or near-judgment proof) defendant who bears the real settlement risk.[92] For defendants without significant assets, the best protection against all aspects of the claim risk is the plaintiff's interest in constructing the case so that the company will settle as favorably as possible.

The "unsophisticated" insured with personal assets to protect presents the most difficult case, because that insured may not easily appreciate the need to obtain independent advice about settlement. In my view, obligating the lawyer to make sure that that insured in fact comes to appreciate that need[93] provides better protection than a rule that requires

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91. Perhaps the most persuasive evidence that most individual insureds feel little need to pay extra for less settlement risk is the prevalence of low limit insurance policies.

92. *See, e.g.,* Steele v. Hartford Fire Ins. Co., 788 F.2d 441 (7th Cir. 1986) (Posner, J.).

93. Silver and Syverud ground that obligation in professional responsibility law. *See* Silver & Syverud, *supra* note 5 at, 311-13 (grounding obligation to inform client in the duty of loyalty). I would also ground it in insurance law. *See, e.g.,* Myers v. Ambassador Ins. Co., 508 A.2d 684 (Vt. 1986) (obligating insurance company to advise insured of the existence of a conflict of interest so the insured can determine whether to retain personal counsel); *see also* Steele v. The Hartford Ins. Co., 788 F.2d 441 (7th Cir. 1986) (illustrating

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the lawyer to act on the insured's behalf against the lawyer's interests.[94] Fulfilling that obligation is likely to require the lawyer to provide the insured much of the same information that a lawyer representing the insured for settlement purposes would provide, but with the additional disclosure that the lawyer is prohibited from undertaking that representation because of the conflict between the company and the lawyer.

Moreover, all insureds benefit from the common practice of the company using the insurance defense lawyer to handle the settlement on behalf of the company. Under the duty of good faith and fair dealing, the company has the obligation to consider the interests of the insured in all aspects of the claim, including settlement. This obligation is implemented not by an abstract entity, but rather by real people who have limited access to information and competing demands on their time. Of all the people available to handle settlement on behalf of the company, the insurance defense lawyer is the person most likely to know and understand the situation of the insured and, therefore, best able to take into account the insured's interests. If insurance or professional responsibility law were to obligate the insurance defense lawyer to represent the insured for purposes of settlement, the real people to whom companies will assign settlement responsibilities will be company counsels and adjusters. Neither company counsel nor an adjuster will know and understand the insured's situation as well as the insurance defense lawyer. Thus, the higher liability insurance premiums that would likely result from requiring the lawyer to represent the insured for purposes of settlement seem unlikely in practice to purchase additional protection for insureds.

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the extent of measures insurance defense lawyers are expected to undertake to ensure that individual insureds understand the nature of conflicts of interest).

94. The "lawyer's interests" I am referring to here are not simply the interest in obtaining more fees from avoiding a settlement, but also the interest in obtaining additional business from the company by favoring the company over the insured in the context of settlement. The clearest examples of cases in which the conflict between company and insured would make it difficult for the lawyer to be the insured's loyal settlement advocate are those in which the interests of the company and the plaintiff potentially overlap: the Separation Assault, Food Poisoning, and Punitive Damages cases. Even in cases in which the interests of company and plaintiff do not overlap, however (the Low Limits, Misrepresentation, and Softball cases), there are many scenarios in which resisting settlement would be in the company's interest.

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C. Conflicts in the Judgement Risk Approach

The judgment risk approach holds out the potential for preserving the triangular relationship between the lawyer, the insured and the company in its normal state. The judgment risk approach would do this, not by eliminating the conflict between the company and the insured, but rather by removing the lawyer from the middle of that conflict and thereby eliminating the lawyer's choice between company and insured.

In the Misrepresentation Case, and only in that case, the judgment risk approach realizes most of that goal. In the Misrepresentation Case, the conflict between the company and the insured relates only to the coverage for the claim and the related effect that uncertainty over coverage has on the company's commitment to the defense and settlement of the claim. By making clear that the scope of the lawyer's representation of the insured includes neither coverage nor settlement risk, the judgment risk approach takes the lawyer out of the middle of those two conflicts.

The lawyer does remain in the middle of the conflict over the amount of effort to devote to the defense of the case, but the judgment risk approach contains that conflict by reducing the company's ability to shirk in the defense. The judgment risk approach charges the company—and by extension the lawyer—with the responsibility of defending the claim as if there were no coverage dispute.[95] Opposing company efforts to shirk in the defense is in the lawyer's self-interest, and, because the lawyer's participation in such shirking would be grounds for a malpractice claim, the judgment risk approach empowers the lawyer to resist company efforts to shirk.

In all the other pattern conflict cases, the judgment risk approach leaves the lawyer firmly embedded in the conflict between company and insured. In each of these other cases, the company has an opportunity to manage the defense lawyer's representation of the insured in a way that shifts claim risk to the insured. In the Low Limits Case, the company can manage the defense so as to make it more difficult for the insured to later

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95. A court surely would imply in the retainer agreement between the company, lawyer and insured those requirements from the liability insurance contract that benefit the insured. The company has actual notice of such requirements, the lawyer has constructive notice, and the insured has a reasonable expectation that a retainer agreement formed in an effort to fulfill the requirements of the liability insurance contract will not reduce the insured's rights under that contract.

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prove that the case could have been settled within the policy limits. In the Multiple Victim Case, the company can direct the lawyer to represent the insured only with respect to the first claim, pay that claim and terminate the representation. In the Separation Assault Case and the Softball Case, the company can use the defense to gather information helpful to the coverage case and, absent a shift in control, even to shape the outcome of the liability case to its benefit.[96] In the Food Poisoning Case, the company can instruct the lawyer to handle the case in a manner that exacerbates the potential reputational harm, thus increasing the likelihood that the insured settles at its own expense to avoid that harm. And in the Punitive Damages Case, the company can instruct the lawyer to handle the case in a manner that exacerbates the risk of punitive damages.

All this is review from Part II above. The significant point here is that the judgment risk approach to the duty to defend does not eliminate the "lawyer's choice" in these other pattern cases. Thus, unless the law constrains that choice, it seems likely to be governed solely by the interests I explored using the metaphor of the liability insurance tetrahedron.

Silver and Syverud unapologetically would constrain that choice in favor of obligating the lawyer to protect the company's interest in minimizing the judgment risk. Thus, in the Softball Case they would obligate the lawyer to inform the company of the information that may threaten the insured's coverage.[97] And in the Food Poisoning Case they would obligate the lawyer to withdraw from the case once there is a concrete action that implicates the conflict, unless the insured agrees to sacrifice its reputational interest in favor of reducing the company's claim risk.[98] By extension, they would require the lawyer to follow the company's instructions regarding the handling of the insured's defense in the Low Limits, Multiple Victim, Separation Assault and Punitive

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96. For example, if the plaintiff includes both a negligence and an intentional tort count in the complaint, the company could manage the defense in a way that made if more likely that the liability case would result in an outcome that would be more helpful to the company in avoiding coverage. The company could do this by, for example, instructing the defense lawyer to request a special verdict form rather than a general verdict form. This could assist the company in avoid coverage because a special verdict form would ask the jury to consider the negligence and intentional tort counts separately. If the jury finds the defendent liable under the intentional tort, the company may not have to pay the claim (depending on the collateral estoppel rules of the jurisdiction and the particular facts of the case). If the jury answers a general verdict, there will be no finding of intent.

97. *See* Silver & Syverud, *supra* note 5, at 343-48.

98. *See id.* at 328.

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Damages cases, even when those instructions would further the company's interests against the insured in a later failure to settle or coverage case.[99]

This does not mean that Silver and Syverud would obligate the lawyer *in fact* to carry out such instructions. Under the norms of professional responsibility they describe, the lawyer would have a duty of loyalty to the insured that would require the lawyer to explain the existence of a conflict and to obey contrary instructions of the insured. In the face of such contrary instructions, the lawyer would not be obligated *in fact* to carry out either the instruction of the company or the instruction of the insured, but rather would be obligated to withdraw from the case.[100] If the insured continued to issue the same instructions to the replacement defense lawyer, that lawyer would also be required to withdraw, as would the next lawyer, and so on. The result would be that the insured would not receive a defense.[101] Thus, Silver and Syverud would allow the company to condition the provision of a defense on the insured agreeing to allow the defense lawyer to favor the company's interests over the insured's.

Nevertheless, I do not read Silver and Syverud as saying that the company can "do no wrong" in the handling of these cases. Indeed, I have no doubt that they would condemn a company that crudely profited at the insured's expense. Their approach simply takes away from the lawyer the need to decide whether the lawyer is obligated to honor any particular instruction from the company and leaves the policing of the company's conduct to a subsequent bad faith suit between the company and the insured.

This approach has the great benefit of simplicity and predictability. It gives the defense lawyer a clear objective: reducing the judgment risk. It prohibits the lawyer from allying with either the insured or the plaintiff

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99. I should be clear that they do not reach these issues and, thus, may disagree. It is possible that they would conclude in the Separation Assault Case that, in jurisdictions where there is no shift in control, the conflict between the insured and the company is so acute that, as a matter of professional responsibility law, the lawyer may not represent both company and insured. Once the lawyer represents only the insured, the duty of loyalty upon which they base the lawyer's obligation to provide the information to the company would no longer apply.

100. *See* Silver & Syverud, *supra* note 5, at 359.

101. If the instruction relates to information (as in a Softball-type case), a particular conflict may be resolved in a contrary manner, because the new lawyer may not receive that information. For example, if the first defense lawyer withdraws in the Softball case, the second lawyer may not learn about the first lawyer's conversations with the potential witnesses.

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against the company. It reduces the likelihood that the insured will place mistaken trust in the lawyer and the company. And, provided the lawyer fully discloses the limited scope of the representation, it encourages the insured to retain a separate lawyer whose loyalty will be unconflicted. While this approach may seem to disadvantage an insured without substantial assets, that insured will receive at least some protection from the plaintiff, who has the greatest interest in structuring the case to maximize the company's claim risk.

D. Leavening the Judgement Risk Approach

From an insurance law perspective, however, Silver and Syverud's approach (at least as I have understood and extended it) goes too far in limiting the duty to defend. The core problem is that their approach obligates the person most immediately in charge of the defense—the defense lawyer—to harm the insured, either by providing harmful information to the company or by defending the case in a manner intended to advantage the company over the insured in a subsequent or pending dispute. Granted, this will only happen in a limited set of circumstances, and in some of those circumstance the insured may even "deserve" the harm. Indeed, in many cases the insured will either have chosen to buy an insurance policy with an absurdly low limit[102] or will have committed a serious wrong.

Nevertheless, insurance law requires insurance companies to give "equal consideration" to the interests of insureds in handling liability claims.[103] Thus, even though the source of the shared claim risk may be

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102. My current favorite examples are obstetricians and cardiac surgeons with $250,000 malpractice policies (a common practice in South Florida). I doubt many of these doctors have liability limits this low in their automobile or homeowners' insurance policies.

103. *See, e.g.*, Coleman v. Holecek, 542 F.2d 532, 537 (10th Cir. 1976) (explaining the equal consideration principle in the duty to settle context in which it originated). As the Coleman court recognized, the equal consideration principle applies when the company has control over decisions in which there is a conflict between company and insured. As that broad description of the principle suggests, it applies to the duty to defend as well. *See, e.g.*, Bennett v. Conrady, 305 P.2d 823 (Kan. 1957) ("[b]ecause of possible conflicts of interest between an insurance company and its insured in the defense or settlement of claims against the insured there is a mutual fiduciary relationship whereby each owes the other the duty to exercise reasonable care in conducting such defense or settlement"). Indeed, the Washington Supreme Court has stated that the company's duty goes beyond equal consideration when defending a case under a reservation of rights. *See* Tank v. Public Employees Mut. Ins. Co., 715 P.2d 1133, 1137 (Wash. 1986) ("the potential conflict of

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the insured's negligence in purchasing insurance (the Low Limits and Multiple Victim cases), or a strong likelihood that the insured acted with sufficient culpability to satisfy either the intentional harm exclusion or the standard for punitive damages (the Separation Assault, Softball and Punitive Damages Cases), the company nevertheless may not manage the defense of the claim in a way that exploits the risk faced by the insured to reduce the risk faced by the company.

Retaining a defense lawyer on terms that require the lawyer to betray the insured when the company so requests is unlikely to be seen as consistent with the equal consideration principle. As I have explored elsewhere, betrayal is a potent theme in insurance law discourse that insureds have often used to constrain insurance company behavior.[104] The fact that, under norms of professional responsibility law, the lawyer may not be obligated in fact to carry out those instructions if the insured objects,[105] does not insulate the company from the insured's complaint. It will remain the case that the insured will be required to choose between betrayal and a defense.

That choice is hardly consistent with the insurance law vision of the insurance company as the insured's protector.[106] Indeed, it takes very little imagination to see that the Silver and Syverud approach would transform the lawyer in the Softball case from the insured's shield into the company's sword. That is how I see it, and, while I acknowledge that shields and swords, like triangles and tetrahedrons, are only metaphors and that there may be other ways of understanding that situation, I predict this is also how judges will see it.

Thus, although I conclude with Silver and Syverud that a company can fulfill its duty to defend by retaining a lawyer to minimize the judgment risk associated with the claim (and therefore that a company has no

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interests between an insurer and insured inherent in this type of defense mandates an even higher standard").

104. *See* Baker, *supra* note 10, at 1395-96, 1418-20, 1423.

105. *See* Silver & Syverud, *supra* note 5, at 351.

106. *See* Baker, *supra* note 10, at 1403-07, 1419-20. A recent print advertisement for a new form of directors and officers liability insurance portrays this vision in striking terms. The advertisement consists of a large photo of a pair of well worn business shoes, over the caption: "The First D&O Coverage With "Duty To Defend" For Public Companies. It Puts Carriers Where They Belong." BUS. INS., Jan. 13, 1997, at 40; NAT'L UNDERWRITER PROP. & CAS./RISK & BENEFITS MGMT. ED., May 19, 1997, at 22. A company that hires a defense lawyer on terms that require the lawyer to betray the insured is hardly standing in the shoes of the insured.

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obligation to retain a lawyer to represent the insured with respect to coverage, settlement or other non-judgment risk), I also conclude that the duty to defend requires the company to retain the lawyer to represent the insured first in a conflict situation. This "primary client" rule arises from the company's duty of good faith, as expressed by the equal consideration principle and by cases requiring the insurance company to give up control over the defense when the conflict between the company and the insured is severe.

Because the duty to defend is implied (whether "in fact" or "in law") in the retainer agreement, the lawyer is so obligated whether the company explicitly instructs the lawyer or not.[107] For example, the lawyer should not provide information to the company that increases the uncertainty of insurance coverage for the claim, the lawyer should not conduct the defense in a manner that unnecessarily harms the reputation of the insured,[108] and the lawyer should not refrain from providing his or her best judgment about the value of the liability case to the company and the insured.

Like the duty to evaluate settlement possibilities as if there were no dollar limits in the insurance policy, and like the duty to defend as if there were no doubts about coverage for the claim, the duty to retain the lawyer to represent the insured first in a conflict situation should provide real protection to insureds because that duty benefits other participants in the liability insurance relationship. The duty to represent the insured first in a conflict situation benefits the defense lawyer by reducing the likelihood of the lawyer being conflicted out of a case and by clarifying the lawyer's obligations in a way that reduces the likelihood that the insured will feel betrayed by the lawyer. The duty also benefits the plaintiff by providing a

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107. Silver & Syverud conclude that under established norms of professional responsibility the liability insurance contract "bleeds into" the retainer agreement. *See* Silver & Syverud, *supra* note 5, at 271. I agree, though I would like to register a small contracts teacher's complaint. Contracts do not "bleed" into one another. Instead, terms from one contract are, in the appropriate circumstance, implied (in fact or in law) into another because of a course of dealing, trade practice or other appropriate reason.

108. I recognize the failure of analytical imagination that requires the use of the word "unnecessarily" in this situation. The harm that this standard is seeking to prevent is that of the company exploiting the insured's vulnerability in order to spend less money on a claim than it would if the insured did not have that vulnerability. The lawyer presented with an instruction from the company that has the potential to cause significant harm to the insured's reputation (or other non-judgment stake) is best served by drawing that potential to the attention of the insured, so that the insured will retain independent counsel to negotiate with the company over the direction of the defense.

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potential avenue for relief in the event of a verdict in excess of the policy limits or outside the policy. In other words, the obligation to regard the insured as the primary client is an obligation lawyers likely will fulfill, both because it is in their long term interest to do so and because plaintiffs (more accurately, plaintiffs' lawyers) are in a position to discover and act upon breaches of that obligation that result in harm to insureds.

It is important to emphasize, however, that the practical effect of my "primary client" approach would differ only slightly from that of the "non-subordination" approach of Silver and Syverud. In a limited set of conflict situations, a primary client rule would require the lawyer to ignore an insurance company instruction, where a non-subordination rule would require the lawyer to ask the insured to waive the conflict and to withdraw if the insured refuses. Regardless which of us turns out to be "right" (in the sense of best predicting what courts will decide), the most significant service the defense lawyer provides an insured in conflict situations is one that we seem to agree about. That service consists of a direct statement that a conflict exists, a clear explanation of the decisions that the insured needs to make as a result of the conflict, and forceful advice that the insured retain a personal lawyer to assist in making those decisions. This advice matters most in connection with settlement, where personal counsel can advise the insured whether to limit the potential loss by first settling the case and then disputing coverage.

CONCLUSION

In concluding, I want to emphasize that this article reflects a positive, not a normative, analysis of the duty to defend. I have described the liability insurance relationship and insurance law as I see them. As the liability insurance tetrahedron helps to demonstrate, there are tradeoffs in any definition of the scope of the duty to defend. It is my judgment that the equal consideration principle of insurance law requires the company to provide the insured a space in the relationship with the insurance defense lawyer in which the insured's interests are primary. But I am not prepared to claim that granting the insured that space will always make the world a better place.

If we intend to ground tort law in deterrence—and much of the recent academic writing and many judicial opinions assert that is the case—then we should be concerned that insureds can and will use that space to cooperate tacitly with plaintiffs and induce companies to pay claims that, from a pure deterrence perspective, companies perhaps should not pay. My view, however, is that liability insurance law is no more distinct from

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tort law than "law" is distinct from "practice," and that this application of insurance law's equal consideration principle is only one of many legal phenomena that demonstrate that tort law-in-action is not grounded primarily in deterrence.

Indeed, working through the liability insurance tetrahedron provides further evidence that victim compensation is at least as important to tort law-in-action as deterrance. In each of the pattern cases that presented a real "plaintiff's choice" (which is to say, all but the Misrepresentation Case), that choice turned in part on the ability-to-pay of the insured. When the insured has no assets, the liability insurance relationship presents the plaintiff with the opportunity to ally tacitly with the insured against the company and, in effect, to expand the insurance available for the claim. But, where the insured has assets, the liability insurance relationship presents the plaintiff with the opportunity to ally tacitly with the company against the insured and, in effect, to narrow the insurance available for the claim.

Thus, in part because of liability insurance, tort law-in-action constitutes a sliding scale system of deterrence at least partially attuned to the defendant's ability to pay. The greater the wealth of the defendant, the more tort law-in-action serves a deterrence function. The less the wealth of the defendant, the more deterrence gives way to compensation. I am reserving my normative judgment about that for a better understanding of the world than that provided by current tort and insurance theory.

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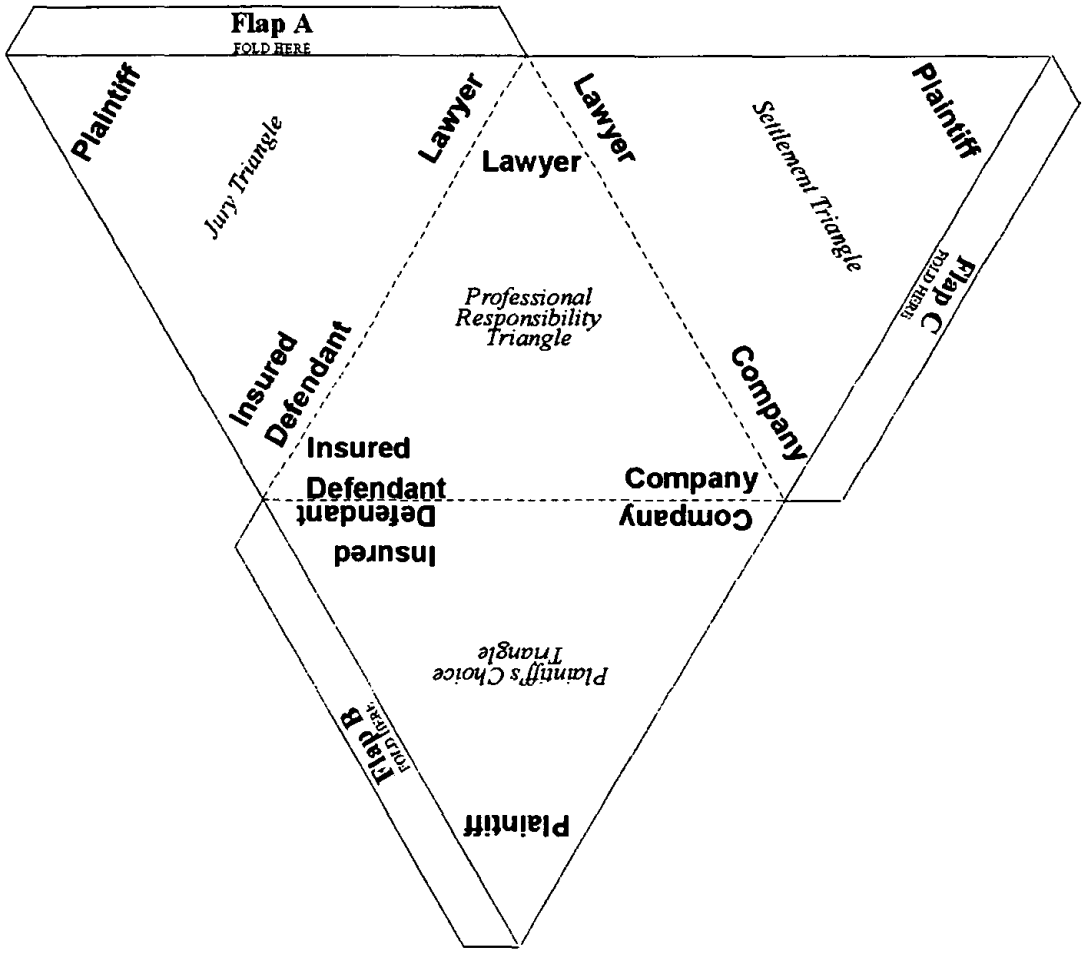
APPENDIX
CONSTRUCTING THE INSURANCE LIABILITY TETRAHEDRON

1. Copy and enlarge the insurance liability tetrahedron below.
2. Fold dotted lines and Flaps A, B & C down.
3. Tape Flap A under the *Settlement Triangle.*
4. Tape Flap B under the *Jury Triangle.*
5. Tape Flap C under *Plaintiff's Choice Triangle.*



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CONSENT, CONTRACT, AND THE RESPONSIBILITIES OF INSURANCE DEFENSE COUNSEL

*Robert H. Jerry, II**

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INTRODUCTION

When one of my young children and I build something with blocks or Legos™[1] (the current favorite), we succeed because the shapes with which we work are unambiguous. Their contours are clearly defined. Most of the pieces are rigid, but even those that are flexible have constant characteristics and predictable applications. When employed for a particular purpose, the pieces do not disappoint. Legal principles are not much like blocks or Legos™, even

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1. "Lego™" refers to a brick-shaped plastic building block (as well as many other shapes) with studs on top and tubes underneath. The interface of these bricks, etc., results in a snugness that allows large assemblies to hold together without becoming fused; the bricks pull apart almost as easily as they snap together. For more information, visit the Lego™ website at www.lego.com.

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if we often wish they were. True, we sometimes refer to rules of law as "building blocks"[2] and we use these rules and corollary ideas to build elaborate structures (or "models" or "paradigms"). Beckoned, perhaps, by recollection of a time when the problems with which we dealt seemed simpler, we sometimes invoke the geometry of childhood play to explain legal relationships. Thus, many writers have explored the terrain of the triangle—the relationship of insurer, insured, and defense counsel.[3] Professor Tom Baker is correct to urge that the triangle's geometry is too simple to illustrate adequately all of the complexity inherent in insurers' defense of policyholders under liability insurance contracts, and he offers the tetrahedron as the appropriate geometric explanation.[4] Because a four-cornered three-dimensional shape figured less prominently in our childhood construction projects, most of us are less comfortable with the tetrahedron, but this is how it should be, for there is plenty to be uncomfortable about in the area of insurance defense.

Geometry works, at least in my reckoning, only when there is certainty with respect to certain assumptions. If some elements of these assumptions or the assumptions themselves are soft or disputed, the larger structure is unstable or even shapeless. As a metaphor for law in action, this will not do; the geometry must be Euclidean, because non-Euclidean geometry, like Chaos Theory and Cosmology, makes most of us very uncomfortable. Yet this is, in fact, the heart of the problem in assessing the ethical responsibilities of defense counsel. Too many fundamental assumptions are contested, and too many are

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2. *See, e.g.*, Scott v. Heckler, 768 F.2d 172, 178 (7th Cir. 1985) ("The obligation of an agency to follow its own regulations is the primary building block of administrative law"), *overruled by* Bauzo v. Bowen, 803 F.2d 917 (7th Cir. 1986); *See also* In re Federal Skywalk Cases, 93 F.R.D. 415, 420 (W.D. Mo. 1982) ("The Court views [Fed. R. Civ. P.] Rule 23 as the key building block in the federal courts' continuing effort to make the civil procedure system more responsive to the needs of contemporary litigation"), *vacated*, 680 F.2d 1175 (8th Cir. 1982); Continental Bankers Life Ins. Co. v. Simmons, 561 S.W.2d 460, 464 (Tenn. Ct. App. 1977) ("Applicable equitable principles will be the building blocks of the Court's decision"); State v. Collins, 409 S.E.2d 181, 200 (W. Va. 1990) (Workman, J., dissenting) ("One must admire the skillful manner in which the majority makes subtle mischaracterizations and then uses them as tiny little building blocks with which to construct major new principles of law.")

3. *See, e.g.*, Douglas R. Richmond, *Lost in the Eternal Triangle of Insurance Defense Ethics*, 9 GEO. J. LEGAL ETHICS 475 (1996); Robert E. O'Malley, *Ethics Principles for the Insurer, the Insured, and Defense Counsel: The Eternal Triangle Reformed*, 66 TUL. L. REV. 511 (1991); Robert B. Gilbreath, *Caught in a Crossfire Preventing and Handling Conflicts of Interest: Guidelines for Texas Insurance Defense Counsel*, 27 TEX. TECH L. REV. 139, 142 (1996) (describing the "triangular model").

4. Tom Baker, *Liability Insurance Conflicts of Interest and Defense Lawyers: From Triangles to Tetrahedrons*, 4 CONN. INS. L.J. 101 (1997).

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murky. Fortunately, much recent work in this area sheds important light on these issues, and a real possibility exists that a more stable geometric metaphor is imminent. Professor Baker, for example, deserves praise for taking us closer to that objective.

This paper examines some of the assumptions on which many contemporary assessments of defense counsel's relationship with the insurer and the policyholder rest, contends that some of the current turmoil in this area is traceable to shaky assumptions, and argues that the drafting of clearer liability insurance contracts would add stability to the relationships. Part I briefly describes the current uncertainty confronting policyholders and defense counsel. Part II explores what the most widely-used liability insurance contracts say about the responsibilities of insurance defense counsel, examining both the context in which these policies are sold and the texts themselves. It contends that current liability policies do not support a dual-client model when conflicts between insurer and policyholder arise. Part III discusses the ramifications of the conclusion reached in Part II. In brief, those who have concluded that counsel owes his or her allegiance to the policyholder in such circumstances have reached the right conclusion. Clearer liability insurance contracts would be helpful, however, in affirming this answer—or providing a different one if the insurance industry believes the current weight of opinion has reached the wrong result.

I. THE UNCERTAIN IMPLICATIONS OF UNCERTAIN RULES

Although in some states the rules appear clear[5] even if some commentators think the rules are clearly wrong,[6] the range of answers to the simple question "whom does defense counsel represent" is surprisingly broad. In many cases, it is said that defense counsel's only client is the insured, and that the insurer is not a client.[7] In other cases, courts have said that both insurer and insured

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5. *See, e.g.*, In re Youngblood, 895 S.W.2d 322 (Tenn. 1995); MGM, Inc. v. Liberty Mut. Ins. Co., 855 P.2d 77 (Kan. 1993); White Mountain Constr. Co. v. Transamerica Ins. Co., 631 A.2d 907 (N.H. 1993).

6. For a spirited critique of precedents in Texas, Tennessee, and California, see Charles Silver & Michael S. Quinn, *Wrong Turns on the Three Way Street: Dispelling Nonsense About Insurance Defense Lawyers*, 5 COVERAGE 1 (Nov./Dec. 1995).

7. *See, e.g.*, Gibbs v. Lappies, 828 F. Supp. 6, 7 (D.N.H. 1993) ("When an attorney is retained by an insurance company to provide a defense under a liability policy, the attorney's client is the insured, not the insurer."); Booth v. Continental Ins. Co., 634 N.Y.S.2d 650 (N.Y. Sup. Ct. 1995); In re Youngblood, 895 S.W.2d 322 (Tenn. 1995); L&S Roofing Supply Co., Inc. v. St. Paul Fire & Marine Ins. Co., 521 So. 2d 1298 (Ala. 1987); Atlanta Int'l Ins. Co. v. Bell, 475 N.W.2d 294 (Mich. 1991); Bradt v. West, 892 S.W.2d 56, 77 (Tex. App. 1994) (citing Employers Cas. Co. v. Tilley, 496 S.W.2d 552, 558 (Tex. 1973) ("There is no attorney-

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are clients of the defense counsel; the representation is, or at least can be, joint, at least until a conflict between the interests of insurer and insured arise.[8] The Model Rules of Professional Conduct provide no answer.[9] This kind of contradiction is precisely the circumstance where academics are inclined to come to the rescue and provide the clarity so lacking in the cases. Indeed, many recent works in addition to the other papers in this symposium shed important light on the question. But one who desires the comfort of a consensus will not find relief in these works.[10]

For an attorney, few things are as fundamental as understanding whom he or she represents and the precise scope of that representation. The ramifications for lawyers who misunderstand the nature of these responsibilities can be enormous. Such was the situation facing defense counsel in one recent case[11] who found himself a witness in the insured's suit against the insurer for bad faith refusal to settle. When asked at trial about his role as defense counsel, he said, "I was employed by them [the insurer]."[12] Initially, he explained that this employment entailed some duties he owed to the insurer, but that his "first duty"—presumably meaning his primary responsibility—was owed to the insured.[13] He later qualified this answer by stating that his "only duty" ran to the insured, necessarily suggesting that no

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client relationship between an insurer and an attorney hired by the insurer just to provide a defense to one of the insurer's insureds")).

8. *See, e.g.*, Home Indem. Co. v. Lane, Powell, Moss & Miller, 43 F.3d 1322 (9th Cir. 1995) (applying Alaska law); Rogers v. Robson, 392 N.E.2d 1365 (Ill. App. Ct. 1979); Moritz v. Medical Protective Co., 428 F. Supp. 865 (W.D. Wis. 1977); Moeller v. Am. Guar. & Liab. Ins. Co., 1996 WL 532387 (Miss. Sept. 19, 1996). *See also* N.C. STATE BAR REVISED RULES OF PROFESSIONAL CONDUCT Rule 91 (1991) ("Whenever defense counsel is employed by an insurance company to defend an insured against a claim, he or she represents both insurer and insured.").

9. *See* ABA Comm. on Ethics and Professional Responsibility, Formal Op. 46-403 at 2 (1996) [hereinafter Formal Op. 96-403] ("The Model Rules of Professional Conduct offer virtually no guidance as to whether a lawyer retained and paid by an insurer to defend its insured represents the insured, the insurer, or both.").

10. *See, e.g.*, Charles Silver & Kent Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 DUKE L.J. 255 (1995) (supporting dual client model); Charles Silver & Michael S. Quinn, *Are Liability Carriers Second-Class Clients? No, But They May Be Soon—A Call to Arms Against the Restatement (Third) of the Law Governing Lawyers*, 6 COVERAGE 21 (Mar./Apr. 1996) (supporting dual client model); Thomas D. Morgan & Charles W. Wolfram, *Lawyers Retained by Liability Carriers to Represent Insureds in the Restatement of the Law Governing Lawyers*, 6 COVERAGE 44 (Mar./Apr. 1996) (favoring view that insurer is third-party fee payer, and attorney's sole client is insured).

11. *See* Carrier Express, Inc. v. Home Indem. Co., 860 F. Supp. 1465 (N.D. Ala. 1994).

12. *Id.* at 1482 (quoting trial transcript at 2217).

13. *See id.* (quoting trial transcript at 2230: "my first duty would be to the insured that I am representing").

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duty was owed the insurer.[14] Having answered the same question two different ways but at least being consistent on the point that he owed duties to the insured, he was then asked how he justified failing to communicate to the insurer the insured's demand that the insurer settle the case within policy limits. He responded, and one can imagine his distress as the difficulties of his predicament became more apparent, "No, my client was [the insurer], who I was being paid, but my client was [the insured] and I—that is not my job. I made my recommendation and that is all I did."[15] When asked whether the insurer was his client in the underlying action, he said, "Obviously, I represented, I was paid by [the insurer]. But I represented—my first duty was to [the insured] . . . . ."[16] The court concluded that the attorney's "confusion about his role was apparent from his testimony in the case at bar."[17] The jury awarded the insured $2.46 million in compensatory damages and $4.81 million in punitive damages, awards which were not altered by the judge when ruling on post-trial motions.[18] If Alabama's law (the applicable law in the foregoing case) regarding defense counsel's responsibilities were clear, perhaps the attorney should have been grateful that the court described him only as "confused."[19] But the wide range of opinion on the correct answers in this area caution against being too critical of any defense attorney who finds himself or herself caught in the mire. This, of course, provides little comfort to the attorney who is actually stuck in it.

If lawyers encounter difficulty in sorting through the relevant rules, it is plainly inapt to expect lay policyholders to have much sense about the nature of the insurer's obligations under a standard liability insurance contract. More will be said on this subject in Part II,[20] but the essence of the issue is captured by an advertisement which ran on national television networks in 1996 on behalf of a large insurance company. The advertisement was noteworthy in its focus on the insurer's duty to defend, as distinguished from the insurer's duty

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14. *See id.* (quoting trial transcript at 2266-67).

15. *Id.* (quoting trial transcript at 2267-68).

16. *Id.* (quoting trial transcript at 2267-68).

17. *Id.*

18. *See id.* at 1486, 1487.

19. In L&S Roofing Supply Co., Inc. v. St. Paul Fire and Marine Ins. Co., 521 So. 2d 1298 (Ala. 1987), the Alabama Supreme Court held that when the insurer defends the insured under a reservation of rights, "RPC [Rules of Professional Conduct] 5.4(c) demand that counsel understand that he or she represents only the insured, not the company." *Id.* at 1303. The defense counsel in the *Carrier Express* litigation "testified that he was unaware of the reservation of rights until his deposition was taken in the case at bar even though a copy of the reservation of rights letter was in his case file." 860 F. Supp. at 1469.

20. *See infra* text accompanying notes 43-65.

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to indemnify.[21] The opening image is of a middle-aged man standing on what appears to be a multi-lane divided highway, with vehicular wreckage all around him. The figure is dressed in a business suit, but his tie is loose around the neck of his white business shirt, and he is obviously fretful and concerned. The scene implies that he alone is responsible or at least allegedly responsible for all of the damage around him. The narrator begins with bad news: "You are about to be sued by thirty-two people." As this message is conveyed, two more collisions are heard in the background, implying that the number of lawsuits needs to be recalculated. The good news follows: "[Insurer] defends over fifty thousand [or some large number] lawsuits against its customers every year," the implication being that the fretful figure, if he is a policyholder, can take comfort in the security provided by the insurer.[22]

In all likelihood,[23] the foregoing is about all the typical insured will understand about the insurer's obligations under the defense insurance policy. There is much that the insured will not understand, and there is much that the advertisement does not say. The advertisement does not communicate that if the first two of the thirty-four anticipated claims result in a good faith settlement or judgment that exhausts the policy limits, the insurer's duty to

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21. The author and others with whom he has spoken cannot recollect another insurance company television advertisement for the general public's consumption which focuses on the insurer's defense obligation. There may, however, have been some others in times past. Also, the author has been unable to secure a copy of the advertisement (either videotape or text), thus his summary of the advertisement may be erroneous in some respects.

22. Professor Ellen Smith Pryor aptly suggests that the use of a middle-aged, implicitly middle-income professional is intended to encourage this kind of mainstream customer to reexamine his or her policy to ascertain whether sufficiently high limits have been purchased. Clearly, the advertisement is directed at litigation-averse individuals who, because of their knowledge of what litigation entails and what it can cost, may be predisposed to purchase additional coverage. This more subtle subplot has a substantial free-rider dimension, in that it encourages insureds with other companies to check the adequacy of their policies, which says little or nothing about the wisdom of switching companies. While the advertisement has subtexts, its dominant message is that the insured is (or would be) well protected by this particular insurer's good hands, even in the face of the catastrophe he has encountered.

23. This paper, like many others, infers what policyholders expect without offering solid empirical support. This is a weakness in many analyses of insurance coverage issues. Although the assertion in the text is probably a good description of what most policyholders understand, it is appropriate to be skeptical of such assertions. For my part, I did walk into the office of an agent for the insurer that provides my personal insurance. After explaining my purpose to "Wanda," I asked, "If I get into an auto accident and the insurer decides to defend an eventual lawsuit filed against me, whom will the attorney appointed by the insurer represent—me alone, or the insurer and me?" Wanda, perhaps puzzled by my visit as much as anything, answered, "I have no idea. That's a legal question, and we don't get into those." Generalizing about the understanding of this (and other insurers') agents is risky, but I suggest that Wanda's answer is typical of what most agents and brokers would say if presented with the same question. Whatever agents and brokers comprehend about the issue, lay policyholders understand less.

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defend will be at an end.[24] The advertisement does not communicate that the insurer may claim the right to control the lawsuit and to make strategic decisions about the conduct of the defense without obtaining the insured's approval.[25] The advertisement does not communicate that the insurer may act to protect only the insured's economic interests, and that the insurer in conducting the litigation might disregard any of the insured's reputational or other non-economic interests.[26] Although the policy is clear about the insurer's retained discretion to settle claims against the insured without the insured's consent, the advertisement does not communicate this important limitation on the insurer's obligations to the insured. If the advertisement tells little about the insurer's obligations to the insured, it tells even less about the role that the attorney will play in carrying out the insurer's obligations.

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24. *See, e.g.*, Texas Farmers Ins. Co. v. Soriano, 881 S.W.2d 312 (Tex. 1994); Pareti v. Sentry Indem. Co., 536 So. 2d 417 (La. 1988); Gibson v. Preferred Risk Mut. Ins. Co., 456 S.E.2d 248 (Ga. Ct. App. 1995); Levier v. Koppenheffer, 879 P.2d 40 (Kan. Ct. App. 1994). The upshot of these cases is that the insurer can make good faith settlements of some claims even if this exhausts the policy limits and leaves the insured personally responsible for the remaining claims. If, however, the insurer enters into settlements for the purpose of exhausting the policy limits so that the insurer can avoid defending and indemnifying the insured on other claims, the insurer is not acting in good faith and may be held liable for damages caused the insured.

25. *See* Silver & Syverud, *supra* note 10, at 265 ("For the last century, these common [liability] insurance arrangements have permitted the company . . . to supervise counsel's litigation and settlement strategy, and to settle claims within policy limits at the company's discretion").

26. *See, e.g.*, Western Polymer Tech., Inc. v. Reliance Ins. Co., 38 Cal. Rptr. 2d 78 (Cal. Ct. App. 1995); Arana v. Koerner, 735 S.W.2d 729, 735 (Mo. Ct. App. 1987). These cases are to be distinguished from those holding that the insurer has no duty to defend because an alleged reputational harm is not an injury within the coverage of the policy and there is no separate allegation of bodily injury or property damage. *See, e.g.*, Waller v. Truck Ins. Exch., Inc., 900 P.2d 619 (Cal. 1995); Reams v. State Farm Fire & Cas. Ins., 683 A.2d 179, 187 (Md. Ct. Spec. App. 1996). Even if the insurer can disregard reputational interests in formulating defense and settlement strategy, this rule must have some limits. The logic of the general principle—that an insurer can enter into a good-faith settlement within policy limits without the insured's consent, even against the insured's contention that settling rather than defending hurts the insured's reputation—is that the settlement reduces the insured's exposure to covered financial risks (whereas damage to reputational interests are not covered), even as it promotes the insurer's interest (which is shared by all insureds) in minimizing total claims expenses, including defense costs. Suppose, however, that plaintiff and insurer agree to settle a claim against the insured for $X, but the plaintiff offers thereafter to accept a sum less than $X if the insurer will agree to a non-confidential settlement document that contains language "testifying" to the insured's negligence in ways that disparage the insured's reputation. The cheaper settlement would further the insurer's claims-cost minimization objectives, but surely such an arrangement would run afoul of the insurer's duty of good faith and fair dealing. Once one enters this territory, the insurer's ability to ignore the reputational interests of its insureds becomes less than absolute.

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It would be highly unrealistic, of course, to expect an advertisement to convey much, if any, information about the coverage of a liability insurance contract or to explore any of the knotty details of an insurer's obligations to policyholders. The point is that information such as that provided in the advertisement, or a similar communication, often is both the beginning and the end of the consumer's understanding of his or her coverage. The bounds of this understanding do not, of course, define the bounds of the insurer's obligations of defense and indemnity, but what the insurer knows or has reason to know about the shape of the insured's expectations pours meaning into the language of the insurance contract. This, in turn, pours meaning into what policyholders are likely to expect of an attorney appointed by the insurer to protect the insured's interests when a claim within coverage is filed against him or her. This is given more attention in Part II.

II. INSURANCE POLICY TEXT AND ITS RAMIFICATIONS

A. Some First Things About "Consent"

"Consent" is a word of no small moment in the Anglo-American legal tradition.[27] In the law of promissory relationships, "consent" is the anchor for many of the principles that define and regulate those relationships. In this important usage, "consent" refers to the voluntary acquiescence, assent, compliance, approval, or agreement with what someone else proposes to do.[28]

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27. Democratic theory utilizes "consent" to anchor the principle under which people organize a society and grant to a government the authority to regulate the behavior of individuals within that society. This finds its early expression in the writings of John Locke, the U.S. Declaration of Independence, and the Federalist Papers, to name a few prominent examples. Consistently with the basic premise, many of the principles which order that society and define the bounds between acceptable and intolerable conduct depend on the existence of "consent" for their application. *See, e.g.*, Pan Eastern Exploration Co. v. Hufo Oils, 855 F.2d 1106, 1121 (5th Cir. 1988) (conversion is defined as "taking without consent"); Rawls v. Conde Nast Publications, Inc., 446 F.2d 313, 315 (5th Cir. 1971) (with regard to defense of consent in tort, "one may not complain of acts to which he had consented," quoting HARPER & JAMES, THE LAW OF TORTS, § 1.11, at 38 (1956)); Shedd v. Lamb, 553 N.W.2d 241 (S.D. 1996) (consent of parties is necessary for formation of contract). In these usages and many others, consent is the essential first step to the creation of authority to act. This is the proper order of things in a society that readily concedes the importance of cooperative enterprises, but gives priority in a great many situations to a person's desire to remain a unilateral actor unless he or she "consents" to some joint or cooperative relationship.

28. These terms conflate the various ideas in various dictionaries. *See, e.g.*, WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 482 (1993); THE OXFORD ENGLISH DICTIONARY 760-61 (2d ed. 1989); BLACK'S LAW DICTIONARY 305 (6th ed. 1990). Much more can, of course, be said about the meaning of "consent" in this context. Consent presupposes that one has the capacity to give it. *See* Reavis v. Slominski, 551 N.W.2d 528, 533 (Neb. 1996) ("[C]onsent

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Consent is also the anchor for the creation of attorney-client relationships, and in this context consent has a meaning that is essentially identical to that which it enjoys in the law of promissory relationships.

How does defense counsel acquire a client? The general rule is that a lawyer-client relationship arises when "a person manifests to a lawyer the person's intent that the lawyer provide legal services for the person" and "the lawyer manifests to the person consent to do so."[29] In the absence of the lawyer's manifestation of consent, the lawyer-client relationship is established "if the lawyer knows or reasonably should know that the person reasonably relies on the lawyer to provide the services."[30] The insurer that appoints defense counsel does not automatically become a client of the attorney appointed to defend the insured; indeed, it may be that the insurer will prefer to carry out its obligations to the insured under the liability insurance contract by assuming the posture of a third-party payor of the expenses of an attorney retained for the purpose of representing only the insured.[31] Sometimes, then, the insurer and attorney will explicitly agree that the insurer is or is not the attorney's client. In the absence of an agreement, the possibility looms that the

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is ineffective if the person lacks capacity to consent to the conduct."); Wythe v. Blair, 885 P.2d 791, 794 (Utah 1994); ([C]onsenting parties must show ... capacity to give consent."). *See* Shedd v. Lamb, 553 N.W.2d 241, 244 (S.D. 1996) (with regard to contract formation, "Consent is not real or free if obtained through fraud, undue influence, or mistake."); Hazel v. State, 157 A.2d 922, 925 (Md. 1960) ([S]ubmission to a compelling force, or as a result of being put in fear, is not consent."). All of this points toward a conscious, knowing understanding of what one is doing when one consents. *See e.g.*, Stewart v. Pantry, Inc. 715 F. Supp. 1361, 1368 (W.D. Ky. 1988) ([N]o facts exist from which it can be inferred that the plaintiffs did not voluntarily and knowingly consent to [polygraph tests]."). Consent can be implied, however, from circumstances. *See, e.g.,* Rawls v. Conde Nast Publications, Inc., 446 F.2d 313, 315 (5th Cir. 1971) ("Consent may be implied from custon, local or general, from usage or from the conduct ot the parties, or some relationship between them." (quoting HARPER & JAMES, *supra* note 28, § 1.11, at 38); Lawyers Title Ins. Corp. v. Dearborn Title Corp., 904 F. Supp. 818, 821 n.2 (N.D. Ill. 1995) ("[C]onsent may be implied by silence where a reasonable person would speak if objecting.").

29. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 26 (Proposed Final Draft No. 1, Mar. 29, 1996) [hereinafter RESTATEMENT]. Section 26 also provides that the relationship can be formed without the lawyer's manifested consent if "a tribunal with power to do so appoints the lawyer to provide the services."

30. *Id.*

31. This is precisely what the "Proposed Movants'-Reporters' Text on Liability-Insurance Issues," states in proposed comment f to section 215 of the Restatement. *See also* RESTATEMENT, *supra* note 29, §26, cmt. i ("Duties may be owed to a liability insurance company that designates a lawyer to represent the insured even if the insurer is not a client of the lawyer . . . ."). Florida State Bar Assoc. Comm. on Professional Ethics, Formal Op. 81-5 (1981) ("The insurer may choose to proceed by employment of counsel for the insured alone, and separate counsel for the insurer, or by employment of counsel jointly for the insurer and insured").

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insurer is relying on the attorney to provide representation for the insurer, and because the attorney should reasonably (or may actually) know this, the attorney will have the insurer as a client.[32]

As Professors Silver and Syverud observe in their important 1995 article in the *Duke Law Journal*[33] where they sought to clarify the state of things for insurance defense counsel, how the insured comes to be the attorney's client is not so simple.[34] In the usual case, the insured upon receipt of service of process will forward the service, the complaint, and other suit papers to the insurer and ask the insurer to undertake the defense, a request which can reasonably be construed as including a request that the insurer appoint a lawyer to represent the insured.[35] But as Silver and Syverud state, again correctly, the fact of the insured's consent to representation by defense counsel at the time the defense is requested "is too weak to show that the insured consents to *joint* representation by demanding a defense."[36]

The importance of the question of consent to *joint* representation is apparent when one isolates the role that consent plays in the broader thesis advanced by Professors Silver and Syverud. They conclude that with respect to within-limits claims where coverage is not disputed,[37] defense counsel (if the insurer so chooses) has an attorney-client relationship with both the insurer and the insured,[38] and that the liability insurance contract, the terms of which "bleed" into the retainer agreement between insurer and defense counsel,[39] can severely constrain defense counsel's obligations to the insured.[40] The second part of the Silver–Syverud thesis depends on the validity of the first. If the

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32. This raises some interesting possibilities in jurisdictions where the governing rules insist that the attorney represent only the insured. Is it reasonable to presume that the insurer knows of such rules? Should such knowledge be imputed to the insurer? If those questions are answered in the negative, does the attorney who fails at the time of appointment to explain the situation to the insurer find himself or herself in an attorney-client relationship with the insurer in violation of the jurisdiction's applicable law? The case discussed in the introduction, Carrier Express, Inc. v. Home Indem. Co., 860 F. Supp. 1465 (N.D. Ala. 1994), gives one possible answer: "counsel beware."

33. *See* Silver & Syverud, *supra* note 10, at 255.

34. *See id.* at 280.

35. *See id.* at 280-82.

36. *Id.* at 284.

37. *See id. at* 263. These are important limiting assumptions, and will receive more attention later in this piece. See *infra* note 117.

38. *See id.* at 273.

39. *See id.* at 271-73.

40. This conclusion (and the word "severely" is their own) appears at the end of the Silver & Syverud article. However, the bulk of the article is devoted to articulating the argument in favor of this conclusion, as well as illustrating the operation of the framework in a variety situations.

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first part of the argument is incorrect, i.e., if defense counsel's only client is the insured, the default rules of agency law and professional responsibility law govern counsel's obligations to the insured. It would be highly inapt to suggest that the liability insurance policy, which exists as a bilateral contract between insurer and insured, is irrelevant; after all, the policy creates the insurer's defense obligation and outlines what the insurer must do to fulfill that obligation. But the policy, to which counsel is not a contracting party, does not by virtue of its mere existence "bleed" into the retainer agreement between insurer and counsel and does not, whether through "bleeding" or otherwise, limit the obligations that counsel owes the insured.[41] Instead, the entirety of the argument that defense counsel's obligations to the insured are constrained hinges on the existence of the insured's consent to joint representation.

Silver and Syverud purport to find the insured's consent to joint representation in the liability insurance contract and, more specifically, in the insurer's widely-recognized right to control the defense:

> The company is entitled to control the defense. The company expects to take the helm and can defend the liability suit effectively only if it is a co-client. In contrast, the insured has no right of control, and, in a full coverage case, has no reasonable expectation of asserting control (and perhaps no actual expectation as well). In these circumstances, it is proper to conclude that the insured, by demanding a defense, impliedly agrees to allow the company to become a co-client.[42]

Here, then, is an indispensable and fundamental premise upon which the structure of the joint representation paradigm is erected: the insurer has a right

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41. It may be that the insurer will appoint the attorney to provide a narrower range of services to the insured, and that this limited engagement will reflect the insurer's view that the liability insurance contract obligates the insurer to provide a narrower range of services. The policyholder will consent to and accept the appointment if the policyholder is satisfied that the proposed representation fulfills the insurer's obligations. If the policyholder believes otherwise, the policyholder may decline the appointment. However, this is not an issue for defense counsel. Rather, the issue is for insured and insurer to determine, i.e., what must be done by the insurer to discharge the insurer's contract obligations owed to the insured.

42. *See* Silver & Syverud, *supra* note 10, at 284-85. ("It is our judgment that *an insured who demands a defense thereby consents* both to representation by company-selected counsel and to joint representation because of the context in which the demand is presented.") (emphasis added). *Id.* at 284. *See also id.* at 288 ("Thus far, we have shown that . . . relationships with both clients arise *at the time the company retains counsel* for the insured.") (emphasis added).

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to control the defense, and the insured does not; the insured has no reasonable or actual expectation of a right of control, and the insurer does; therefore, the insured *consents* to joint representation. Much is missing from this argument. As discussed shortly, the so-called "right of control" is more murky than commonly supposed. The insured's expectations, if he or she has any, are more complex than the Silver–Syverud argument credits; and in the absence of actual expectations, what expectations the insured might *reasonably* have is another matter altogether. Unlike Silver and Syverud and contrary to the recent writings of William Barker,[43] I believe there are reasons that insureds, at the time of contracting, do *not* expect the insurer to enjoy the status of a co-client if it becomes necessary for the insurer to appoint defense counsel to represent the insured.

B. Interpreting Insurance Contracts

Before turning to the texts of the widely-used liability insurance forms, it is useful to consider the context in which liability insurance contracts are marketed to and purchased by insurance consumers. But before examining either text or context, the standards which guide this assessment must be sketched.

Generalizing about insurance contract interpretation in a brief space is difficult, and other sources provide a fuller description of the intricacies of the interpretive process.[44] Insurance policies are contracts,[45] and the core principle is that the words of a contract are to be given the meaning that the parties intended. There is little disagreement about this basic point,[46] even if the

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43. *See* William T. Barker, *The Tripartite Relationship and Protection of the Insured: Beyond Professional Responsibility*, 18 INS. LIT. RPTR. 528 (Oct. 1996) ("As an original proposition, it would seem strange to think that the insurer would *not* be a client.") (emphasis in original).

44. For more discussion, *see generally* JEFFREY W. STEMPEL, INTERPRETATION OF INSURANCE CONTRACTS (1994); 2 ERIC M. HOLMES & MARK S. RHODES, HOLMES' APPLEMAN ON INSURANCE, 2D §§ 5.1-9.8 (1996); ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW § 25A (2d ed. 1996); Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531 (1996); Peter Swisher, *Judicial Interpretations of Insurance Contract Disputes: Toward a Realistic Middle Ground Approach*, 57 OHIO ST. L.J. 543 (1996); James M. Fischer, *Why Are Insurance Contracts Subject to Special Rules of Interpretation?*, 24 ARIZ. ST. L.J 995 (1992).

45. *See* STEMPEL, *supra* note 45, at 296 ("[T]he insurance policy remains a species of contract. Contract law, as modified over the years in the insurance context, is the starting point for analysis of coverage issues by both claims departments and courts . . . [T]he current hybrid of basic contract law infused with a number of largely pro-policyholder modifications continues to dominate policy coverage questions").

46. Professor Arthur Corbin offered the classic explanation of interpretation: "[I]t is certain that the purpose of the court is in all cases the ascertainment of the 'intention of the

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apparent simplicity of the observation disguises some rather subtle, and important, difficulties.[47] Although some courts, Professor Williston, and others have encouraged the notion that language has an objective or "plain" meaning apart from the parties' intention,[48] resort to a "plain meaning" approach to interpretation normally produces results in accord with the parties' intentions at the time of contracting, given that most people during contract-formation communications use words consistently with their customary or usual meaning. If a contracting party uses a word that has a customary meaning shared by

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parties' if they had one in common." 1 ARTHUR L. CORBIN, CONTRACTS § 106 (1963). Professor Williston's premise is virtually identical: "In the case of contracts, the avowed purpose and primary function of the court is the ascertainment of the intention of the parties."; 4 SAMUEL J. WILLISTON, WILLISTON ON CONTRACTS § 601, at 303-04 (3d ed. 1961). *See also* HOLMES & RHODES, *supra* note 44, § 5.1 at 4 ("Under the classical method, a court's function is to determine the parties' law through the judicial process of interpretation of the 'meaning' the parties intended.").

47. Because what a party subjectively intends is often impossible to know and because parties rely on what others externally manifest, a party's mental assent is not necessary to form a contract, but parties will be bound to the objectively reasonable meanings of their external manifestations. *See* G. ALLAN FARNSWORTH, CONTRACTS 118-20 (2d ed. 1990). The objective view of assent compromises classical notions of consent, in that assent is based not on actual consent, but on objective manifestations of it. If "assent" to a contract need not be actual, it is a relatively short step to the observation that the content of contractual obligations should depend less on assent and more on the relational aspects of the exchange. *See also* IAN R. MACNEIL, THE NEW SOCIAL CONTRACT, 47-50, 71-117 (1980); Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law,* 72 NW. U. L. REV. 854, 884 (1978) (using insurance contracts to illustrate limitations of "neoclassical" objective theory). A rich literature developing relational contract theory has emerged in the late twentieth century, but the idea that insurance is a "relation" rather than a contract finds its expression in much earlier works. *See* ROSCOE POUND, THE SPIRIT OF THE COMMON LAW 15 (1921) ("[W]e have taken the law of insurance practically out of the category of contract, and we have established that the duties of public service companies are not contractual, as the nineteenth-century sought to make them, but are instead relational; they do not flow from agreements which the public servant may make as he chooses, they flow from the calling in which he has engaged and in his consequent relation to the public").

The extent to which relational theory should be used to adjust reciprocal rights and duties of policyholders and insurers is an intriguing question, the exploration of which must await another day. Insurance law, at least for now, is dominated by the traditional (i.e., classical or neoclassical) model. As Professor Stempel has explained, "the current hybrid of basic contract law infused with a number of largely pro-policyholder modifications continues to dominate policy coverage questions. Insurance law may be different but it remains contract law, at least in theory, rhetoric, and (for the most part) application." STEMPEL, *supra* note 45, at 296. *See also* HOLMES & RHODES, *supra* note 44, § 5.1 at 8 ("More often, however, policies of insurance are traditionally treated much the same as other contracts; they are matters of agreement by the parties. The task for the courts is to determine what the parties intended in that agreement and enforce it accordingly"); Fischer, *supra* note 44, at 1002 ("The special rules governing insurance contract interpretation build on the general rules applicable to all contracts.").

48. *See* FARNSWORTH, *supra* note 47, at 503-04, 522-28.

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most in the community, that party should understand that the recipients of the communication will take the speaker's meaning to be in accord with that customary, or "plain," meaning; if the speaker intends a different meaning, it is the responsibility of the speaker to make that intention known.

The obvious difficulty is that parties to a contract have a proclivity to use words without conferring about what the words mean. This is not to be lamented, for expecting more from parties would cause a great many desirable relationships never to come into existence; conferring over the meaning of terms is very often economically counterproductive. This reality increases the likelihood that parties will attach different meanings to their words, or that one or both of the parties will not pay any particular attention to the words and may have no particular understanding about the meaning of words at the time of contracting. When a party is disappointed with the performance of a contract, it may become convenient for that party to attach a different meaning to a pivotal term or phrase than he or she possessed at the time of contracting, or to articulate for the first time a meaning of the term which, even if articulated in good faith, happens to coincide with benefits to be gained by that party if the contract is interpreted in accordance with this "recently discovered" meaning. A "plain language" approach to interpretation reduces the risk of strategic or opportunistic re-interpretations of contract language that enable contracting parties to reduce the losses that accompany what were, with the benefit of hindsight, unwise exchanges. Thus, champions of this approach should be understood (or interpreted) to mean not that words have an intrinsic meaning apart from the parties' intention when they invoke words, but that "plain meaning" normally accords with mutually intended meanings (or an objectively reasonable intended meaning if the parties appeared to have no actual intentions) held at the time of contracting.[49]

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49. Even Professor Williston, the most important of all classical contract scholars, can be read as concurring with the referenced proposition:

> Thus, it has been said that many of the highest courts in this country have decided that, when the meaning of words is not ambiguous, proof of usage will not be received in the interpretation of contracts.
>
> The accuracy of such statements *cannot be admitted*, but the cases where they are made may generally be readily supported on the ground that even if the proffered evidence were considered, the meaning of the contract clearly still remained the meaning apparent from the normal meaning of the words when unexplained by extrinsic evidence.

WILLISTON, *supra* note 46, § 609, at 412 (emphasis added). Other portions of his treatise, however, point the other direction. *See, e.g., id.* §95 at 359 ("The court will give that language [in a contract] its natural and appropriate meaning; and, if the words are unambiguous, will not even admit evidence of what the parties may have thought the meaning to be").

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Just as scientists studying nuclear particles must be concerned about whether their acts of observation are altering the substance of what they are observing, judges must be concerned that their interpretive efforts will favor a meaning that the parties did not intend. These efforts are complicated by the mere fact that the judicial process is invoked simply because and only when the parties give different meanings to contract language. This requires a court to choose among the meanings offered by the parties or, in rare circumstances, some other objective meaning if no party offers a reasonable one. The core principle—determining what the parties intended at the time of contracting—does not change, even if each party hopes to convince the court that its proffered meaning best explains what the parties must have understood at the time the contract was formed and even if the chasm between these proffered meanings is large. It is in this context that appeals to a "plain" or "objective" meaning of disputed language may occur; but the subtext of any such appeal is that the only conclusion to be reasonably drawn in the circumstances is that the parties' common understanding at the time of contracting was in accordance with the language's "plain meaning."

In urging a court to prefer one meaning of disputed language to the exclusion of another, one party (or both) may argue that the other contracting party knew or had reason to know the meaning (whether or not a "plain" one) attached by the first party, whereas the first party did not know or have reason to know the meaning attached by the other party. In such circumstances, the first party argues that its meaning controls, given that the other party understood at the time of contracting the meaning attached to the disputed language by the first party.[50] An appeal to "plain meaning" simplifies the argument, but not the essential issue: the first party argues that the other party knew or had reason to know the meaning attached to the term by the first party simply because this meaning is a "plain" one; ergo, the other party knew or should have known about the first party's "meaning," and the other party's superior knowledge requires that the meaning favored by the first party controls.[51]

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50. This framework is set forth in RESTATEMENT (SECOND) OF CONTRACTS § 201 (1981). Analogous rules apply to contract formation; if A knows that B means "cow #1" when A and B contract for the sale of "B's cow," but B does not know or have reason to know that A intends the contract to be for "cow #2," the contract is for the sale of "cow #1." *See id.* § 201.

51. Extending from the prior footnote: If A and B contract for the sale of a "horse" but A and B both know that "horse" means A's cow in this instance, the plain meaning approach would require the delivery of the horse. This seems odd, but if in fact both parties agree that "horse" means "A's cow," A will deliver his cow and nothing more will be heard from the parties, particularly in the presence of a judge. If, however, B seeks delivery of the cow under the foregoing contract and A opposes this, the plain meaning approach, as interpreted above, is not so much an endorsement of the intrinsic meaning of the word "horse" as it is a statement

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The foregoing principles assume the presence of the give-and-take associated with contracts formed through bargain and negotiation. The widespread use of standardized form contracts in the twentieth century has put pressure on many principles of classical contract law, including interpretation. Standardization can become a cover for the imposition of unfair terms by parties with disproportionate economic power, and a significant portion of the policing jurisprudence in late twentieth-century contract law is aimed at precisely that problem.[52] It is common to refer to standardized contracts as "adhesive," and on that account to give the benefit of all doubts to the "adhered party," the recipient of the form, to the detriment of the party that drafted the form.

"Standardization" thus becomes a proxy for a vision of the contracting process that involves the imposition of terms by a stronger party upon the weaker. Such a vision provides a nearly-automatic answer when disputes over meaning arise in connection with a standardized form: naturally, the weaker party, who has had the terms thrust upon him or her and is the functional equivalent of the "shorn lamb driven to" slaughter,[53] is the party that needs protection; therefore, the drafter must lose. The flaw in this vision is that standardization, in and of itself, does not prove that monopoly or oligopoly power is being asserted against weaker parties. Suppliers in many highly competitive markets use standardized forms to reduce costs, and insurance is often used to illustrate the point.[54]

The more serious problem presented by standardization is the information imbalance between a standardized form's provider (i.e., drafter) and the form's recipient. The drafter of the standardized form is a repeat player with the

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that allowing B to succeed in forcing the sale of the cow is, in all likelihood, trampling on the parties' mutual understanding at the time of contracting—which was to sell A's horse because the parties said "horse." The plain meaning approach endorses the simple, and reasonable, point that most parties do not say "horse" when they mean "cow." Few cases are this simple, however, and a broader assessment of the context in which the parties spoke their words is in most situations more likely to get closer to the parties' intended meaning at the time of contracting.

52. *See, e.g.*, Williams v. Walker-Thomas Furniture Co., 350 F.2d 445, 448-49 (D.C. Cir. 1965); Henningsen v. Bloomfield Motors, Inc., 161 A.2d 69, 94-95 (N.J. 1960); Jones v. Star Credit Corp., 298 N.Y.S.2d 264 (N.Y. Sup. Ct. 1969); Parton v. Mark Pirtle Oldsmobile-Cadillac-Isuzu, Inc., 730 S.W.2d 634, 637-38 (Tenn. Ct. App. 1987).

53. The metaphor, interestingly enough, is Professor Williston's. *See* 7 WILLISTON, *supra* note 47, § 900, at 19-20.

54. *See* MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 119 (1993); Fischer, *supra* note 45, at 1013 ("Insofar as the scope of coverage is concerned, the issue is not so much disparity in bargaining power, as lack of information available to the insured, which disables him from fully assessing his insurance needs"); Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1205 (1983).

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expertise that comes from familiarity with the transaction; the recipient of the form, a one-shot or few-shot player, is at the other end of the spectrum. The drafter typically benefits from expert legal advice, which may not be available to the form's recipient.[55] The recipient of the form is not expected and may not even have the opportunity to read the form, let alone scrutinize it; and the recipient may lack even the basic skills needed to understand the form's content, even if the recipient were encouraged to read it. Indeed, in most situations the recipient of the standardized writing has no particular desire "to understand or even read the standard terms."[56] These circumstances render classical contract rules pertaining to contract formation and interpretation less meaningful,[57] but courts have for the most part held onto the classical framework while acknowledging the need for and implementing more aggressive policing of exchanges under standardized forms.[58]

Under the classical framework, one who signs a contract without reading it—even if the contract is a standardized form—may well be held bound to its terms. There is, however, considerable authority recoiling from that position.[59] If reading and understanding a proposed form would be irrelevant due to the absence of an opportunity to bargain over terms,[60] it is counter-intuitive to penalize non-readers of forms; encouraging more reading and greater awareness of the content of the forms would, in the best of circumstances, change nothing. Even if one takes a classical view and gives great weight to whether a contracting party has read and understood the terms to which he or she is assenting, the fact that the insured lacks an actual expectation about the meaning of words in a standardized form—even if this understanding is accompanied by failing to read and to attempt to understand the form—does not allow the words to mean whatever the insurer wishes.

In one sense, the flexibility displayed by some courts in excusing parties from the full measure of standardized contracts they signed or adopted but never read or attempted to understand is a logical extension of classical contract doctrine. Drafters of standardized forms know or have reason to know that the recipients of the forms will have considerably less understanding of the

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55. The imbalance in expertise was noted by Professor Williston. *See* WILLISTON, *supra* note 46.

56. RESTATEMENT (SECOND) OF CONTRACTS § 211 cmt. b (1981).

57. *See* TREBILCOCK, *supra* note 54, at 119 ("to hold parties bound to standard form contracts which they had entered into but which they had not read or understood does not rest comfortably with a theory of contractual obligation premised on individual autonomy and consent. Clearly, in many, perhaps most cases, meaningful consent is absent").

58. For a more detailed discussion, *see* STEMPEL, *supra* note 45, §§ 3.5, 10.1-10.4, at 97-107, 283-96.

59. *See* JERRY, *supra* note 44, § 32(b), at 182-84.

60. *See* Rakoff, *supra* note 54, at 1180-83.

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terms of the contract (and the recipient will not know, or have reason to know, the meanings attached by the drafter to particular terms or provisions); this implies that specialized meanings favored by drafters will not trump objectively reasonable understandings held by the recipients of the form, and instead *may be trumped by* the inferred reasonable understanding that the insured would have if he or she had considered the matter at all—which, of course, probably never occurred. The foregoing observation leads one to the brink of embracing the doctrine of reasonable expectations[61] or the pro-consumer standard in *Restatement (Second) of Contracts* § 211.[62] But one need not go that far. Whether one chooses to embrace doctrines that rewrite contract language or discard terms that cause unfair surprise, one basic point cannot be escaped (unless one is prepared to jettison the idea that consent, or at least the objective manifestations of consent, is needed to form a contract): modern contract law requires, quite simply, that anyone who presents a standardized form to a less knowledgeable recipient must make the language of the contract reasonably understandable.[63] This is a hurdle over which the

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61. As approved by many courts, the doctrine of reasonable expectations holds that the insured's objectively reasonable expectations will be upheld even though a painstaking analysis of the policy's provisions would have resulted in a denial of coverage. For more discussion of the doctrine of reasonable expectations, *see generally* Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades,* 51 OHIO ST. L. J. 823 (1990); JERRY, *supra* note 44, § 25D, at 141-47.

62. The Restatement (Second) of Contracts cuts a significant path through the plain-meaning forest by suggesting that courts sometimes disregard even clear terms in a standardized writing. Section 211(3) provides:

> Where the other party has reason to believe that the party manifesting such assent would not do so if he knew that the writing contained a particular term, the term is not part of the agreement.

RESTATEMENT (SECOND) OF CONTRACTS § 211(3) (1981).

Comment (f) to the section elaborates:

> Although customers typically adhere to standardized agreements and are bound by them without even appearing to know the standard terms in detail, they are not bound to unknown terms which are beyond the range of reasonable expectation .... [A] party who adheres to the other party's standard terms does not assent to a term if the other party has reason to believe that the adhering party would not have accepted the agreement if he had known that the agreement contained the particular term.

Id. at cmt. f.

Few courts have explicitly approved the formulation suggested in Section 211; for a notable case to the contrary, *see* Rawlings v. Apadoca, 726 P.2d 565 (Ariz. 1986) (en banc).

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drafter must jump; there is some uncertainty about the height at which the hurdle will be set in any particular situation, but failing to exceed it will produce outcomes that favor the recipient and go against the drafter.[64]

All of this may appear to place a difficult burden on the drafter of a standardized form who wishes to limit the insurer's responsibilities, but the drafter's position is hardly hopeless. In this framework, if the insurer cares deeply about a particular term, the principles contemplate that the insurer clearly manifest its expectation about the term to the insured so that the insured is not later subjected to unfair surprise. Clear drafting of contract language can go a long way down this road, but even clear drafting does not guarantee that the insurer can make its term binding. If a term is so disadvantageous to the insured that it might be found to be "beyond the range of reasonable expectation," the insurer must bring the term and the insurer's understanding of it to the insured's attention in a manner sufficient to cause the insured to expect the term, even if the insured acquires no actual knowledge of the term because he or she is not paying attention to what the insurer is attempting to communicate.

C. The Context of Liability Insurance Contracting

Contextual factors of considerable force place any contract term pursuant to which defense counsel's loyalties are divided between insured and insurer outside the range of the insured's expectations.[65] Initially, it must be conceded that the actual expectations of insureds with respect to the obligations of insurers lack specificity and detail. Insureds rarely read their policies until they have a reason to do so, and even then are unlikely to understand much of what they read. I submit that relatively few insureds realize, for example, that their homeowners insurance provides general liability protection; most insureds believe a homeowners policy provides coverage for the structure of the insured residence and its contents. These insureds are far from understanding the general parameters, let alone the nuances, of the insurer's defense obligations. Insureds probably understand that their automobile policies have a liability

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63. E. ALLAN FARNSWORTH & WILLIAM F. YOUNG, CONTRACTS: CASES AND MATERIALS 413-14 (5th ed. 1995) ("Presenting a standard form contract to a consumer for assent entails a certain obligation to make it intelligible. This general proposition, though not yet fully defined, is exemplified by widespread decisions, statutes, and regulations, quite various in detail.").

64. In his 1996 article on interpretation of insurance contracts, Professor Abraham articulates and describes the various standards courts have approved in their application of the doctrine of *contra proferentum*; some of the standards are stricter than others, and by necessity produce different outcomes in similar cases. *See generally* Abraham, *supra* note 44, at 537-56.

65. I concede that it would be interesting to test this proposition empirically, but I believe that the results of such a test would confirm these assumptions.

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coverage component; in most states, liability insurance is compulsory, insureds are reminded of this when they seek to obtain license plates or a drivers license, and most people are probably attuned to the risk of automobile transportation and the attendant liability exposures. Yet even here, most insureds probably view the liability exposure as the risk of a bankrupting civil judgment, and thus think of the insurance protection largely in terms of indemnity.[66] The exposures associated with the expenses of defending against claims for such judgments are probably secondary in most insureds' range of expectation, if they have any expectation at all about the process through which such judgments are obtained.

It is fair to suggest that insureds in recent years have become more aware of the importance of the defense obligation in liability insurance policies. Some of this has resulted from widely-publicized contentions that civil litigation is both excessive and too expensive, a belief that has been encouraged by some insurers. Yet even if insureds when purchasing liability insurance desire to obtain protection against two distinct risks of loss, namely, the risk of having to pay money to a plaintiff who succeeds in securing a judgment against the insured, and the risk of incurring expenses in defending against that claim, the typical insured probably views the expense of defending the plaintiff's claim primarily in terms of the cost of retaining and paying for a lawyer. This suggests that the insured understands the solution provided by the insurer to be this: "To save you the expense of retaining a lawyer, we will take care of that problem by retaining the lawyer for you and paying the lawyer's fee." Thus, from the insured's perspective, the insurer is simply the "Uncle Joe" who

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66. Professor Widiss may disagree with this assessment of insureds' comprehension of the content of their policies. In a 1990 article, he wrote:

> The practice of undertaking the defense when a claim is made or a suit is filed against an insured is undoubtedly widely known to the public. Consequently, purchasers have come to expect that liability insurers provide insureds with defenses to tort suits, as well as with indemnification (up to the limits of the liability) for any judgment or settlement.

Alan I. Widiss, *Abrogating the Right and Duty of Liability Insurers to Defend their Insureds: The Case for Separating the Obligation to Indemnify from the Defense of Insureds*, 51 OHIO ST. L.J. 917, 918 (1990). Anyone who has been sued once, or has a friend who has been sued once, for alleged tortious conduct probably understands the essential aspects of the indemnity-defense distinction. Perhaps this group is now large enough that Professor Widiss is correct. My sense is that most second- or third-year law students at the beginning of the basic insurance law course do not understand the distinction or even the basics of the coverage (although they are quick to grasp it once encountering it), and this leads me to think that the general public probably understands very little about it either. As the subsequent text explains, however, whether Professor Widiss' or my assessment is more accurate does not matter much.

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comes to the rescue when the unlucky and relatively resourceless nephew finds himself in need of legal help but without either the expertise or financial means to take care of this matter directly. From this perspective, the insurer is the benefactor who takes care of the insured's problem with the same detachment that the insurer pays the proceeds to substitute for the damage to the insured's house when it is damaged by a falling tree. The first-party insurer has an economic stake in minimizing the proceeds to be paid and otherwise reducing claims-processing expenses, but if the loss is covered, the insurer protects those interests through a substitute for the entirety of a within-limits loss. The expectations of the insured in the third-party setting are unlikely to be much different; the insured probably expects that his or her interests will be fully protected, assuming both that the interests are within the coverage and that the insured complies with relevant conditions of the policy relevant to claims processing. In effect, the insured, lacking a reliable or sufficiently wealthy "Uncle Joe," views his or her premium as purchasing the equivalent of a benevolent uncle whose relationship to the insured is for all practical purposes the third-party payor of the insured's defense expenses.

This assumption, just like the contrary one made by Silver and Syverud in their article, is likely to be controversial,[67] and it is important to understand that the assumption has limits. Plainly, it is not reasonable for an insured to assume that the insurer is obligated to do for the insured whatever the insured wants. Indeed, as generous as uncles can be, they are not servants. But an expectation that defense counsel has undivided loyalty to the insured is not one that the insured is likely to form entirely on his or her own; rather, the insurer or its agents are likely to play some role in creating this expectation. It is, of course, dangerous to generalize about the quality and quantity of information brokers or agents provide to applicants at the point where insurance policies are marketed and sold, but it is safe to assert that the quality and quantity of information shared is uneven. In my own experience, the agent or broker selling liability insurance affirms that if the insured is sued, the insurer "will take care of it" for the insured; the message to the insured is that the insured, who is likely to have had little, if any, contact with the legal system and may not even be acquainted with an attorney, will not have to search for and select his or her own attorney. For one unacquainted with lawyers generally and with the specifics of how one goes about finding a lawyer well-suited for the task at hand, the insurer's promise to do this for the insured (i.e., "we will get you an attorney") is a promise of a valuable service. The important point is that the

67. My invocation of Silver and Syverud's language is deliberate, for this is the crux of the debate. *See* Silver & Syverud, *supra* note 10, at 273 ("This [assumption that "the agreement under which defense counsel is retained creates two attorney-client relationships"] is a controversial assumption").

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insured can leave his or her conversation with the broker or agent reasonably expecting that the insurer's promise to defend any future claim is a promise to secure for the insured an attorney whose relationship to the insured will be the same as if the insured had retained the attorney directly. Many courts have conceptualized the content of the liability insurance contract in exactly this way.[68]

D. The Substance of the Liability Insurance Contract

Under the interpretive approaches followed by some courts, clear contract language does not necessarily defeat reasonable expectations.[69] But the analysis cannot end here, because for some courts unambiguous contract language trumps—or, more accurately, prevents inquiry into—whatever expectations the insured has about the insurer's promises.[70] Thus, it is necessary to inquire into the language of the liability insurance contract, looking for text that, if read and understood, would dispel the expectation that the preceding section suggested most insureds bring to the liability insurance contract.

Among Silver and Syverud's working hypotheses is a concise articulation of the content of typical liability insurance contracts:

> [T]he vast majority of policies give the insurance company the right to defend the case, and require the cooperation of the insured in the company's defense of any suits. For the last century, these common insurance arrangements have permitted the company to select counsel to defend an action, to supervise counsel's litigation and settlement strategy, and to settle claims within policy limits at the company's discretion.[71]

The quoted passage states the commonly-expressed wisdom on insurers' rights and privileges as well as insureds' obligations. In footnote 26 to the quoted passage, Silver and Syverud articulate a summary of the foregoing paragraph

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68. *See, e.g.*, Mirchum v. Hudgens, 533 So. 2d 194, 199 (Ala. 1988); Palermo v. Fireman's Fund Ins. Co., 676 N.E.2d 1158, 1164 (Mass. App. Ct. 1997); Illinois Masonic Med. Ctr. v. Turegum Ins. Co., 522 N.E.2d 611, 613 (Ill. App. Ct. 1988).

69. *See* Henderson, *supra* note 61, at 827-28 (observing that at least 16 jurisdictions have approved the application of the doctrine of reasonable expectations without regard to the presence of ambiguous language in the insurance contract).

70. *See, e.g.*, Alf v. State Farm Fire and Cas. Co., 850 P.2d 1272 (Utah 1993); American Family Mut. Ins. Co. v. Elliot, 523 N.W.2d 100 (S.D. 1994); Robbins Auto Parts, Inc. v. Granite State Ins. Co., 435 A.2d 507, 509 (N.H. 1981); JERRY, *supra* note 44, § 25D, at 144.

71. Silver & Syverud, *supra* note 10, at 264-65.

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that appears to have near-universal acceptance as well: that the forms in common use today "entitle the company to control the defense."[72] Moreover, Silver and Syverud's observation accurately reflects the assessment of most courts that have decided to say something about the insurer's rights.[73] Silver and Syverud, like most who assert the foregoing conclusion, cite to but do not parse the text of these forms, probably assuming (as many do) that the matter is settled. But because the dual client argument ultimately depends on the existence of the insurer's right to control the defense, it is worth revisiting this fundamental question, and asking whether the texts of these forms unequivocally communicate this meaning to the reasonable reader. I conclude that it is far from clear that the language of the standard forms conveys to the reasonable reader that the insurer reserves unto itself a right to control the defense.

That the standard language defining the insurer's defense obligations under most liability policies is indefinite in many respects is not a new observation. Professor Abraham stated in his important 1986 book[74] that

> Liability insurance policies often create obligations that are insufficiently detailed to govern insurer conduct completely. They appear to grant the insurer the privilege to settle claims but impose no obligation to do so, and they create a duty to defend the insured without specifying its breadth or limits.[75]

He made the same point with respect to whether the duty to defend is triggered at all in situations where the insurer's coverage responsibility is in doubt, observing that "[t]he language of the standard liability policy provides almost no guidance."[76] Professor Morris argued in an early article on the subject that

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72. Silver & Syverud, *supra* note 10, at 265 n.26.

73. *See, e.g.*, Merchants Indem. Corp. v. Eggleston, 179 A.2d 505 (N.J. 1962); American Cas. Co. v. Timmons, 352 F.2d 563 (6th Cir. 1965); Duke v. Hoch, 468 F.2d 973 (5th Cir. 1972), *motion denied,* Duke v. Hoch, 475 F.2d 761 (5th Cir. 1972); Vandivort Constr. Co. v. Seattle Tennis Club, 522 P.2d 198 (Wash. 1974); Traders & General Ins. Co. v. Rudco Oil & Gas. Co., 129 F.2d 621 (10th Cir. 1942); McCrary v. U.S., 235 F. Supp. 33 (D. Tenn. 1964); Ash v. Farwell, 37 F.R.D. 553 (D. Kan. 1965); McChristian v. State Farm, 304 F. Supp. 748 (D. Ark. 1969); Allstate Ins. Co. v. Wilson, 193 S.E.2d 527 (S.C. 1972).

74. KENNETH S. ABRAHAM, DISTRIBUTING RISK: INSURANCE, LEGAL THEORY AND PUBLIC POLICY (1986).

75. *Id.* at 178.

76. *Id.* at 196. In a footnote appended to the bottom of that page, he observed that "[t]hree distinct kinds of doubts about when the duty of defense attaches arise because of this incompleteness of policy language." These were situations where the insurer questioned its responsibility under the policy, based on what he labeled as a policy defense (an issue about the policy's applicability to the loss in question), an enforceability defense (a defense based on

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the typical liability insurance policy's language does not explicitly support the dual representation model and that the "right to defend" verbiage in the typical policy "does not limit the control [of the defense] that insureds otherwise might have."[77] His conclusion that the policy language mandates that defense counsel represent only the insured[78] goes too far in the other direction, but this early article is important for recognizing that the language of the usual liability policy allows a mismatch between what the insurer may intend and what the policyholder may reasonably expect with respect to the insurer's defense obligation. A closer look at the policy language bears out the observations of Abraham and Morris about the absence of clarity in the standard language on the duty to defend.

Consider first the standard Personal Auto Policy. Given the frequency with which this policy form (or others like it) is invoked in our country, this is an appropriate place to start. The relevant language on the insurer's duty to defend in Part A, Paragraph A provides:

> INSURING AGREEMENT
>
> A. . . . . We will settle or defend, as we consider appropriate, any claim or suit asking for these damages. In addition to our limit of liability, we will pay all defense costs we incur. Our duty to settle or defend ends when our limit of liability for this coverage has been exhausted. We have no duty to defend any suit or settle any claim for "bodily injury" or "property damage" not covered under this policy.[79]

The phrase "We will settle or defend, as we consider appropriate" can plausibly be read to mean "We will settle, as we consider appropriate, or we will defend, as we consider appropriate." Under such a reading, the insurer has control of the defense. This reading, however, requires repeating a phrase which the drafters only used once in the text. As the text stands, it can reasonably, and more plausibly, be read as giving the insurer the discretion to

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the insured's post-loss conduct) or a coverage defense (based on someone claiming to be an unnamed but additional insured under the policy). *Id.* at 196 n.*.

77. John K. Morris, *Conflicts of Interest in Defending Under Liability Insurance Policies: A Proposed Solution*, 1981 UTAH L. REV. 457, 464.

78. *See id.* at 465 ("Only a standard of undivided loyalty is consistent with the provisions of insurance policies . . . ."); *see also id.* at 493 ("That standard, undivided loyalty to the insured, is . . . contractually required by the insurance policy.").

79. Personal Auto Policies (PP 00 01 12 89), reprinted in SUSAN J. MILLER & PHILIP LEFEBVRE, 1 MILLER'S STANDARD INSURANCE POLICIES ANNOTATED 2 (4th ed. 1997) (hereinafter "MILLER'S POLICIES ANNOT.").

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settle *or* to defend, electing whichever of those two courses it "consider[s] appropriate." This language, then, is designed, arguably, to inform the insured that the insurer may not provide an attorney to defend the suit if in its discretion the insurer thinks a settlement is more appropriate. The words "We will . . . defend" do not, in and of themselves, indicate that the insurer reserves unto itself the right to make all of the key decisions in managing the defense. Although reading "we will . . . defend" as "*we* are going to do this, *not* you; you will not be involved, even if you want to be"—is not implausible, this phrase "we . . . will defend" can also reasonably be read as a simple way of manifesting the insurer's intent to "take care of" the insured. The second sentence manifests only that the insurer will pay the bills, without regard to the limits of liability found elsewhere in the policy. This sentence is qualified by the third, but the third relates to circumstances under which the duty terminates, not to the insurer's right of control. The last sentence speaks to when the duty is triggered, not to the insurer's right of control. In short, nothing in this paragraph communicates unequivocally or in a way likely to bring home to the insured that the insured gives up control of the defense to the insurer.

Other sections of the Personal Auto Policy form impose obligations on the insured to cooperate with the insurer. These provisions are found in Part E, Paragraphs A-D,[80] but the strongest language in this Part indicates only that "A person seeking any coverage must: 1. Cooperate with us in the investigation, settlement or defense of any claim or suit." "Cooperation" reasonably implies to the reader that the insured (or other person seeking coverage) must strive to "get along" with the insurer; indeed, cooperating normally connotes "working *together with*" someone, not relinquishing, giving up, or taking a position of subservience to another.[81] Whatever else the cooperation clause may mean,[82] it is a stretch from this language to conclude that the policy "entitles the company to control the defense of liability suits."[83]

Although not invoked as often as the automobile forms, the liability coverage in the standard homeowners form is perhaps the next most pervasive liability coverage in force today. The standard language provides:

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80. These provisions are reprinted in full in the Appendix to this article.

81. *See* WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY, *supra* note 28, at 501 (defining "cooperate" as "to act or work with another or others to a common end"; "to act together").

82. *See* JERRY, *supra* note 44, at 717-27.

83. Silver & Syverud, *supra* note 10, at 265 n.26.

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> Section II-Liability Coverages
>
> If a claim is made or a suit is brought against an "insured" for damages because of "bodily injury" or "property damage" caused by an "occurrence" to which this coverage applies, we will:
>
> * * *
>
> 2. Provide a defense at our expense by counsel of our choice, even if the suit is groundless, false, or fraudulent. We may investigate and settle any claim or suit that we decide is appropriate. Our duty to settle or defend ends when the amount we pay for damages resulting from the "occurrence" equals our limit of liability.[84]

The language "we will . . . provide a defense at our expense by counsel of our choice" is the strongest phrase favoring insurer control in the paragraph. That the insurer can choose counsel is unambiguous, and, as with the Personal Auto Policy form, it is plausible to read the phrase "we will . . . provide a defense" as indicating that the insurer will control the defense. It is, however, no less plausible to read the paragraph as manifesting that the insurer will protect the insured against the risk of having to underwrite the defense directly. This reading is strengthened if one places emphasis on the phrase "at our expense." The second sentence of paragraph 2 articulates in clear language the insurer's option to settle any claim or suit if it thinks it appropriate to do so. Noticeably absent from that sentence, which more clearly articulates the privileges the insurer is reserving than the preceding one, is the insurer's articulation of its prerogative to control the defense of the suit. The last sentence of the paragraph refers to when the insurer's duty to defend ends, not how the insurer is to perform that duty. In short, this paragraph falls short of communicating in unequivocal terms to the insured that it "entitles the company to control the defense."[85]

The homeowners form imposes a number of duties on insureds after loss which can fairly be summarized as an obligation to "cooperate" even if the

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84. Homeowner's Policy Form (HO 00 03 04 9) in 1 MILLER'S POLICIES ANNOT., *supra* note 79, at 199.

85. Silver & Syverud, *supra* note 10, at 265 n.26.

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policy does not use that precise term.[86] The language is mandatory—"You will help us by seeing that these duties are performed"—and the duties are set forth with a fair amount of specificity. For example, in Paragraph 3(c), the insured is required to "help us: . . . (3) With the conduct of suits and attend hearings and trials," but nothing in that language or elsewhere in the paragraph explicitly states that the insured's assistance when the insurer is providing the defense is tantamount to surrendering control of the defense to the insurer.

Before proceeding to the Commercial General Liability policy ("CGL"), the principal commercial form, it is worth pausing to note that if these policies fail to communicate clearly to the insured that the insurer has reserved to itself the privilege to control the defense, how can it be said that these policies express the insurers' intent to establish a joint-client relationship with the insured when the insured is sued on a claim within coverage? On the contrary, these policies cannot reasonably be read as unequivocally expressing this intent. But under hornbook contract law principles, that is not even the correct question to ask. The correct question is, what would a reasonable person standing in the shoes of the insured reasonably understand these words to mean? The absence of any reference to a co-client relationship, or even an explicit reference to the insurer's privilege to control the defense, makes it difficult to contend that a reasonable person in the insured's position would comprehend from the texts that the insurer intends dual representation, if indeed that is what the insurer does in fact intend from the quoted texts. This, too, can be reasonably doubted given the fact that an attorney-client relationship between insurer and defense counsel is not necessary to implement the terms of the contract.

Although one might assume that commercial insureds are more savvy on insurance matters than policyholders in the personal lines, this is a risky assumption, even if there are many commercial entities with a considerable amount of corporate understanding of insurance coverages. Many businesses are sole proprietorships, or so-called "mom and pop" enterprises, and these businesses are functional equivalents of individual consumers in the personal lines. Commercial status does not guarantee that an insured has an enhanced understanding of what the insurer promises by way of a defense to covered claims. Fairly read, however, the Insuring Agreement in the Commercial General Liability policy ("CGL") is more explicit than the Personal Automobile and Homeowners policies: in the CGL, the insurer reserves unto

86. Homeowners Form, §II, ¶3, (HO 00 03 04 91) in MILLER'S POLICIES ANNOT., Vol. 1, *supra* note 79, at 199.

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itself a "right . . . to defend" any suit within coverage; this text does not appear in the other forms.[87]

The relevant language of the CGL reads in full as follows:

> COVERAGE A. BODILY INJURY AND PROPERTY DAMAGE LIABILITY
>
> 1. Insuring Agreement.
>
> a. We will pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies. We will have the right and duty to defend any "suit" seeking those damages. We may at our discretion investigate any "occurrence" and settle any claim or "suit" that may result. But:
>
> ***
>
> (2) Our right and duty to defend end when we have used up the applicable limit of insurance in the payment of judgments or settlements under Coverages A or B or medical expenses under Coverage C.[88]

The second and third sentences of subparagraph (a) are the key ones. Read together, the sentences make clear that the insurer can defend the suit if it desires rather than pay the claim, or may settle the suit if it desires, rather than defend the claim or pay it in full. The insurer, not the insured, is privileged to make this call. This was the reading of the CGL urged by Professor Morris in his 1981 article:

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87. If this enhanced clarity makes a difference (and I suggest shortly that it does not), it may follow that the conclusions urged by Silver & Syverud in their Duke article must be limited to defenses provided under CGL policies and may not apply to defenses provided in the personal lines. In their footnote 27, Silver & Syverud state that "[t]he working hypotheses advanced in this Part and the views on professional responsibility advanced later in this Article are tailed to the Commercial General Liability Coverage Form . . . . When insurance is governed by a policy other than the CGL Policy, the working hypotheses and the views on professional responsibility advocated here may not apply." Silver & Syverud, *supra* note 10, at 265 n.27.

88. Commercial General Liability Form, (CG 00 01 10 93), MILLER'S POLICIES ANNOT., *supra* note 79, at 409.

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> [T]he phrase "right . . . to defend" does not limit the control that insureds otherwise might have. Instead, the phrase means only that insurers have a right to insist that a case against their insureds be competently defended, rather than decided by default. The phrase speaks only of the right to provide a defense, not the right to control a defense once provided.[89]

I disagree with Professor Morris that this is the *only possible* reading of the CGL, but Professor Morris's reading is certainly *one possible* reading of the CGL, and is one that a reasonable insured could reasonably give to it. Whatever might be said about the drafters' intention, the language by its terms falls short of clearly expressing the insurer's intention to reserve control of the defense to itself.

As with the other policies, the CGL contains provisions explicitly requiring the insured to cooperate with the insurer in the investigation, defense, and settlement of the claims,[90] but these provisions do not by their own terms explicitly surrender control of all aspects of these functions to the insurer. The CGL contains a provision proscribing the insured from incurring expenses without the insurer's consent, except at the insured's own cost,[91] but this language can fairly be read as requiring the insurer's participation in the decision to incur costs, not the insurer's exclusive right to control how these expenditures are made.

These are not the only liability forms in use today, but a survey of the others[92] shows that there are no material variations in the remaining forms which would change, one way or the other, one's assessment of whether insurers have succeeded in manifesting to their insureds their desire to reserve unto themselves the right to control the defense. When the right to control falters, the co-client paradigm falters along with it.

E. Prevailing Constructions of the Contract

My conclusion—that the language of the policy forms does not clearly manifest the insurer's intention to control the defense—is definitely at odds with the conclusion asserted by most courts that have had anything to say on

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89. Morris, *supra* note 77, at 464.

90. *See* Commercial General Liability Form, § IV, ¶ 2, (CG 00 01 10 93) in MILLER'S POLICIES ANNOT., *supra* note 79, at 409.

91. "No insureds will, except at their own cost, voluntarily make a payment, assume any obligation, or incur any expense, other than for first aid, without our consent." Commercial General Liability Form, § IV, ¶ 2 (d), (CG 00 01 10 93), in MILLER'S POLICIES ANNOT., Vol 1, p. 409 at 416.

92. *See* forms in Appendix.

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the matter.[93] Some of these decisions cite, and may be explainable by virtue of the influence through the decades of, the Appleman multivolume treatise *Insurance Law and Practice.*[94] In section 4681 of the first edition, the treatise opines that the insurer's right to control the defense is very nearly absolute:

> To insure an orderly and proper disbursement of these funds [i.e., funds established with premiums] and minimize unwarranted claims, the insurer has exclusive control over litigation against the insured, and the latter is required to surrender all control over the conduct of the defense. . . . The right is a valuable one in that it reserves to the insurer the right to protect itself against unwarranted liability claims and is essential in protecting its financial interest in the outcome of litigation.[95]

These sweeping observations are unaccompanied by any analysis of the language of policy forms in customary use. Yet for many courts, the words of a distinguished, authoritative treatise writer are the beginning and the end of the answer to a question of law, and the words quoted above have received such application in many opinions.[96]

Other portions of section 4681, however, indicate that the quoted passage is subject to some important limitations. The paragraph in section 4681 which follows the quoted passage is one sentence long:

> A policy provision giving the insurer the right to control the defense has been held in early Massachusetts cases to be inserted primarily for the benefit of the insurer, in the sense that where there is a conflict of interests, the insurer may exercise the right to defend for its own advantage, even

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93. *See* cases cited *infra* notes 104-09.

94. JOHN A. APPLEMAN, INSURANCE LAW AND PRACTICE (Walter F. Berdal ed., 1979) [hereinafter APPLEMAN]. For another secondary source in accord with Appleman's treatise, see William T. Barker, *The Right and Duty to Defend: Conflicts of Interest and Insurer Control of the Defense, in* LITIGATING THE COVERAGE CLAIM: DENIAL OF COVERAGE AND DUTY TO DEFEND 195 (Tort and Insurance Practice Section, American Bar Association, 1992).

95. 7C APPLEMAN, *supra* note 94, § 4681, at 2, 3.

96. *See, e.g.*, Aberle v. Karn, 316 N.W.2d 779 (N.D. 1982); Moritz v. Med. Protective Co., 428 F. Supp. 865 (W.D. Wis. 1977); Merchants Indem. Corp. v. Eggleston, 179 A.2d 505 (N.J. 1962); American Cas. Co. v. Timmons, 352 F.2d 563 (6th Cir. 1965); Duke v. Hoch, 468 F.2d 973 (5th Cir. 1972), *motion denied,* 475 F.2d 761 (5th Cir. 1972); Nandorf, Inc. v. CNA Ins. Co., 479 N.E.2d 988 (Ill. App. Ct. 1985).

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> though a different course would have been preferable from the standpoint of the insured.[97]

The stated principle—that when the interests of insurer and insured diverge, the insurer is free to promote its own interests without regard to the interests of the insured—is one that few seriously urge today. The footnote to the quoted passage says as much, but the footnote is interesting for what it adds:

> Such is no longer the rule, of course, as will be seen subsequently under cases dealing with the duty owing to the insured. The insurer has the right to come into court *solely as the professional champion of the insured;* and where a conflict arises as to their respective interests, those of the insured must be served first.[98]

Because this last statement appears in the same section often cited approvingly by courts for allowing the insurer exclusive control of the defense, the clear implication of the Appleman treatise is that exclusive control rests with the insurer only when the interests of the insured and insurer coincide.[99] Of course, when the interests of the insured and insurer are identical, the fact that the insurer has exclusive control makes no difference to the insured. Moreover, a sentence in the 1996-97 pocket part to the treatise[100] underscores that the insurer's right to control the defense can be subject to significant constraints: "An insurer's desire to control the defense must yield to its obligations to defend the insured."[101] With all of the considerable respect that

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97. APPLEMAN, *supra* note 94, § 4681, at 2,3.

98. *Id.* at 4 n.8.

99. In their discussion of impeachment of the insured, Silver & Syverud quoted the first paragraph from the Appleman text, *see* Silver & Syverud, *supra* note 10, at 317, but did not mention the footnote in Appleman which essentially retracts the statement in the treatise's text, indicating that it is no longer the law. Silver & Syverud, however, described the retracted text as "the prevailing doctrine," *id.* at 317, and reasoned from this passage that "insurance law does permit the company to request impeachment of the insured." *Id.* This is not a fair reading of Appleman and, by extension, the applicable insurance law rules regarding impeachment.

100. *See* JOHN A. APPLEMAN, INSURANCE LAW AND PRACTICE § 4681 (Stephen L. Liebo, ed. Supp. 1997).

101. *Id.* at 1. One case is cited for this proposition, and this case comes from New York, a jurisdiction where the attorney owes undivided loyalty to the insured in the event of a conflict, Public Service Mut. Ins, Co. v. Goldfarb, 425 N.E.2d 810, 815 (N.Y. 1981), Allstate Ins. Co. v. Riggio, 509 N.Y.S.2d 594, 595 (N.Y. App. Div. 1986), and where there is some authority that the attorney's allegiance is owed solely to the insured. *See* Booth v. Continental Ins. Co., 634 N.Y.S.2d 650, 654 (Sup. Ct. 1995) (quoting 6 NY JUR. 2d *Attorneys at Law* § 70: "When counsel, paid by an insurance company, undertakes to represent the policyholder, he owes to

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is due the Appleman treatise, it is not possible to argue from that platform that "[t]he law is clear that, absent certain conflicts of interest, the company possesses exclusive and plenary control of the defense"[102] under the text of the liability insurance forms in current usage.

A closer look at the cases approving the insurer's right to control the defense yields additional insights of interest. In several of these cases, the court's approval of the insurer's right to control is pure dictum, given that in those cases the insurer had refused to defend the insured and the issue was whether this refusal was wrongful.[103] In other cases, the question was whether an excess insurer had the right to control the defense, which did not implicate the insured's rights vis-a-vis the insurer,[104] or whether the policy provided coverage or a right to recovery at all.[105] In short, in many of the cases espousing the general rule, no issue was presented involving a contest between insurer and insured as to who should control the defense.[106] In other decisions where the insurer's right to control was recognized, the court made clear that the right to control ended when a conflict arose between insurer and insured.[107] In other cases, the court made clear that the insurer's right is not absolute when the claim against the insured exceeds the policy limits.[108] As it turns

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his client, the insured, an undeviating and single allegiance."; note, however, that other passages assume that counsel can represent both insurer and insured); N.Y. Cty. Lawyer's Ass'n Comm. on Prof. Ethics, Eth. Op. 669 (89-2) (May 17, 1989) ("Despite the payment of legal fees by the insurance company and the fact that the lawyer may have a long-standing relationship with the insurance company, the lawyer's client in the matter is the insured.").

102. Silver & Syverud, *supra* note 10, at 272 n.37.

103. *See, e.g.*, Stevens v. Gulf Oil Corp., 274 A.2d 163 (R.I. 1971); Waste Management v. International Surplus Lines Ins. Co., 579 N.E.2d 322 (Ill. 1991); White Mountain Constr. Co v. Transamerica Ins. Co., 631 A.2d 907 (N.H. 1993); Hartford Accident & Indem. Co. v. Sherwood Brands, Inc., 680 A.2d 554 (Md. Ct. Spec. App. 1996), *cert. granted,* Mutual Life Ins. Co. v. Ins. Comm'r Md, 685 A.2d 450 (Md. 1996); Hodges v. State Farm Mut. Auto. Ins. Co., 488 F. Supp. 1057 (D.S.C. 1980).

104. *See* Diamond Heights Homeowners Ass'n v. National Am. Ins. Co., 277 Cal. Rptr. 906 (Cal. Ct. App. 1991).

105. *See, e.g.*, Clark v. Bellefonte Ins. Co., 169 Cal. Rptr. 832 (Cal. Ct. App. 1980); International Ass'n of Chiefs of Police, Inc., v. St. Paul Fire and Marine Ins. Co., 686 F. Supp. 115 (D. Md. 1988).

106. *See* American Cas. Co. v. Timmons, 253 F.2d 563 (6th Cir. 1965) (holding that insurer could not assert that contractor could not sue on policy based on lack of final determination of contractor's obligation to pay for damaged electrical duct).

107. *See, e.g.*, Nandorf, Inc. v. CNA Ins. Cos., 479 N.E.2d 988 (Ill. App. Ct. 1985); Parker v. Agric. Ins. Co., 440 N.Y.S.2d 964 (N.Y. Sup. Ct. 1981). One case standing apart from these others is Duke v. Hoch, 468 F.2d 973 (5th Cir. 1972), where the court discussed the issue at some length and observed that the insurer's "duty to control the defense and the insured's correlative duty to cooperate in the defense derive from the policy itself." *Id.* at 978 n.1.

108. *See, e.g.*, Traders & Gen. Ins. Co. v. Rudco Oil & Gas Co., 129 F.2d 621, 627 (10th Cir. 1942).

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out, these cases are consistent with the weight of authority holding that when the interests of insurer and policyholder diverge, the insurer's right to control the defense must yield and the insured's interests must be protected.[109]

The essential point is that who possessed the right to control the defense made little difference in most of the cases pronouncing that the right belongs to the insurer. It is therefore uncertain whether these cases tell us anything particularly significant about the number of clients defense counsel represents. If the interests of insurer and insured are coterminous, as they are in most full-coverage cases where the plaintiff's claim is within the policy limits, putting the defense in the insurer's control is of no consequence to the insured. It is problematic, therefore, to extend from a proposition articulated and approved in a situation where the answer makes no difference to a situation where the proposition, if applied, will allow the insurer to favor its own interests to the

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109. *Id.* ("the rights of the insurer [where the claim exceeds the policy limits] are not absolute"); Collier v. Union Indem., 31 P.2d 697, 700 (N.M. 1934) ("where the liability of the insurer is limited and that of assured is open . . .[t]he responsibility primarily assumed is to defend the assured against the charge and total amount sued for; [the insurer's] own defense is incidental . . . The courts could not permit counsel to appear nominally for the assured, but actually in the interest of another."); Point Pleasant Canoe Rental, Inc. v. Tinicum Township, 110 F.R.D. 166, 170 (E.D. Pa. 1986) ("When conflicts-of-interest arise between an insurance carrier and its insured, the lawyer representing the insured must act exclusively on behalf of, and in the best interests of the insured."); CHI of Alaska, Inc. v. Employers Reinsurance Corp., 844 P.2d 1113, 1117 (Alaska 1993) ("most courts hold that in conflict situations the insured has the right to independent counsel to conduct its defense and the insurance company has the obligation to pay the reasonable value of the defense conducted by independent counsel"); Hartford Acc. & Indem. Co. v. Foster, 528 So. 2d 255, 270 (Miss. 1988) ("When there is a question of coverage . . . and the insurance company notifies the insured that it will fulfill its obligation to defend the suit, while at the same time reserving a right to deny coverage of the insured's conduct, . . .[t]he lawyer may be required to withdraw from the case altogether, or be restricted his continuing representation with the insurance company furnishing at its expense an independent counsel chosen by the insured to represent his own interests."); Booth v. Continental Ins. Co., 634 N.Y.S.2d 650, 654 (N.Y. Sup. Ct. 1995) ("where an insurer disclaims coverage or reserves the right to do so, it is generally improper for an attorney to represent both the insured and insurer in the same action"); Illinois Advisory Op. 92-02 (1992) ("the attorney represents both the insured, as well as the insurance company, in furthering the interests of each. In the usual case, those interests are compatible, or at least not antagonistic . . . Where the interests of the insurance company and its insured are in direct conflict, . . . the insurer will not be permitted to control, or even to participate in, the defense. In such a case, the insured is entitled to representation by counsel of his own choosing, and the insurer's duty to defend is satisfied by reimbursement of the insured for the costs of the defense"); Michigan Ethics Op. RI-89 (1991) (Syllabus: "If a lawyer represents the insured and the insurer in a matter, and one client later wishes the lawyer to assert a factually sustainable theory that serves that client's interest but is adverse to the other, the lawyer must withdraw from representation of both clients."). *See also* Vigilant Ins. Co. v. Behrenhausen, 889 F. Supp. 1130, 1135 (W.D. Mo. 1995) (conflict of interest disappears because "this attorney [appointed by insurer] has a duty to defend the interests of only its client, [the insured]").

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detriment of the insured. This is particularly problematic in circumstances where much of what is said in the cases is consistent with defense counsel owing undivided loyalty to the insured when the interests of policyholder and insurer diverge.

III. RAMIFICATIONS

A. Disclosure, Consent, and Defense Counsel's Responsibilities

Professors Silver and Syverud are correct that depending on the agreement between insurer and insured, defense counsel might represent the insured only, or might represent the insurer and insured together.[110] Thus, I agree that a co-client relationship between insurer and insured is possible; furthermore, I agree that joint representation is desirable in many situations for reasons of efficiency, cost, and effectiveness of the defense.[111] I disagree, however, with their contention that consent to joint representation is given at the time the insured requests the insurer to provide a defense. As discussed in Part II, neither the language of standard liability policies nor the context in which they are marketed and sold supports the conclusion.[112] An important ramification of Silver and Syverud's argument that consent devolves from the liability policy and the context in which the request for a defense is made is that defense counsel need not provide any disclosures or obtain any further consent at the time defense counsel undertakes to provide a defense. This is incorrect; because the current forms and the context in which they are marketed are insufficient to establish the insured's consent, defense counsel cannot assume the presence of consent. As a recent ABA Formal Opinion warned, "[w]e cannot assume that the insured understands or remembers, if he ever read, the insurance policy, or that the insured understands that his lawyer will be acting

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110. *See* Silver & Syverud, *supra* note 10, at 274-76. *See also* Formal Op. 96-403, *supra* note 9, at 2 (1996) ("The insurer, the insured, and the lawyer may agree on the identity of the client or clients the lawyer is to represent at the outset.").

111. This is also the position of Professor Baker. *See* Tom Baker, *supra* note 4, at 105.

112. Note that the gap between the Silver–Syverud position and my own may be narrower than the text supposes. The Silver–Syverud article's analysis was explicitly predicated on the language of the CGL, which, as discussed in Part II, comes the closest of any of the kinds of widely-used forms to articulating the insurer's right of control. In a footnote, Silver and Syverud stated that their conclusions may not apply under the language of forms other than the CGL. *See* Silver & Syverud, *supra* note 10, at 265 n.27 ("When insurance coverage is governed by a policy other than the CGL Policy, the working hypotheses and the views on professional responsibility advocated here may not apply.") This allows the possibility that they might agree with my own position at least when personal liability policies are involved.

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on his behalf, but at the direction of the insurer without further consultation with the insured."[113]

Of course, consent to joint representation (and the concomitant constraints on defense counsel's obligations to the insured) need not occur as early as the time of contracting between insurer and insured, or as early as the time the insured requests a defense or the insurer retains an attorney. If, however, consent is not given at any of these times, it must be given (and the constraint created) at the outset of the representation. To this point in the analysis, Professor Pepper agrees.[114] After this point, Professor Pepper, relying on a close reading of Model Rule of Professional Conduct 1.7(b), contends that the potential for conflict in every liability defense representation requires a robust disclosure to the insured of all foreseeable, possible future conflicts (and there are many, even if none of them is likely to materialize in most situations), followed by the insured's consent to the joint representation. I read the prescriptions of Rule 1.7(b) more flexibly; although conceding that Pepper's more literal reading of the Rule can be justified by its text, I urge the appropriateness of a more flexible reading when the rule is applied to insurance defense counsel.

Before examining the subtleties of Rule 1.7(b), it is useful to return briefly to the question of the insured's expectations, because what the reasonable insured typically expects and wants from the insurer is relevant to what the insured expects defense counsel to provide in counsel's capacity as the agent designated to discharge the insurer's duties.[115] In some situations, although it is impossible to know how many, the insured is probably asked to and does in fact give an informal, but informed consent to joint representation; in many other situations, including those where some kind of consent is sought and given but the quality of the consent falls short of being fully informed, the insured would willingly give an informed consent if asked to do so. Why should this be? Although future conflicts are always possible, the chance that a conflict will materialize is small. If the claim is covered and within the policy limits, the insured has no financial stake in the outcome. If the insured has no reputational interests at stake, and usually none will be, the insured will not perceive significant benefits from insisting upon the appointment of counsel with an undivided loyalty, and the insured will have no reason to incur

113. Formal Op. 96-403, *supra* note 9, at 4.

114. *See* Stephen L. Pepper, *Applying the Fundamentals of Lawyers' Ethics to the Insurance Defense Practice*, 4 CONN. INS. L.J. 25, 37 (1997) ("there is nothing in the contract stating or implying that the defense must be provided by a lawyer who has the company as a client as well").

115. The justification for taking the insured's expectations into account is the same one set forth *supra*, in the text accompanying notes 45-65.

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the additional inconvenience of insisting upon and possibly locating and appointing his or her own counsel. In short, when defense counsel first communicates with the insured and explains what the nature of the relationship will be, the insured is likely to say, "please proceed and take care of this problem for me; let me know what I must do to help, but bother me as little as possible."[116]

To be able to give this answer consensually, the insured must first be informed about what the answer entails, and this brings us back to the question of what disclosures defense counsel must make at the outset of the representation. What Model Rule 1.7(b)[117] requires by way of disclosure to the insured as a prerequisite to joint representation is important, but my view is that Rule 1.7(b) is not sufficiently nuanced to speak clearly about defense counsel's responsibilities. The phrase "*may* be materially limited" can be read in a way that requires each and every insurance defense to be accompanied by a disclosure of an extensive list of each and every kind of conflict that *might* arise in the course of the representation.[118] Such a formal, literal reading is inappropriate in insurance defense. A more contextual, functional reading of the Rule suggests that the attorney is expected to exercise judgment about the

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116. Professor Pepper disagrees, believing that an insured is "highly unlikely" to consent to joint representation "if that consultation is competently performed." *See* Pepper, *supra* note 114, at 35. We may disagree on the amount of disclosure required; a blunderbuss disclosure in the type of case where no conflict is apparent or likely to arise may create sufficient insecurity to scare the insured into seeking, at his expense, legal advice about how to respond, but good advice would recommend that consent be given. My view is that the insurer's promise to take over the suit from beginning to end, including the process of selecting defense counsel, is very valuable to the insured, and the insured is likely to welcome it in within-limits cases where coverage is not, and probably will not be, contested.

117. Model Rules of Professional Conduct Rule 1.7(b) states:

> A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless
>
> (1) the lawyer reasonably believes the representation will not be adversely affected, and
>
> (2) the client consents after consultation. When a representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.

MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7(b) [hereinafter MODEL RULES].

118. I do not read Professor Pepper as going this far, but he takes a strong view of Model Rule 1.7(b), and considers it triggered in every insurance defense representation. *See* Pepper, *supra* note 114, at 31-33. A more contextual reading of the Rule might concede that it is always triggered, but that "triggering" is a relative concept, with "soft triggering" requiring less disclosure than a "hard trigger."

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amount of disclosure necessary as a prerequisite to the insured's consent based on a reasoned assessment of the "likelihood that a conflict will eventuate" and "if it does, whether it will materially interfere with the lawyer's independent professional judgment."[119] This suggests that a more modest explanation of the risks of dual representation (along the lines of the explanation suggested by William Barker,[120] along with a brief explanation that if a conflict arises in the future counsel may have to withdraw[121]) is appropriate at the outset of the representation,[122] but unfolding circumstances may create more serious

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119. MODEL RULES, *supra* note 117, Rule 1.7(b) cmt. In context, these phrases describe considerations relevant to whether "[a] possible conflict" precludes representations, not the amount of disclosure that counsel must give. A contextual reading of Model Rule 1.7(b) would argue that these issues cannot be neatly separated.

120. *See* William T. Barker, *Insurance Defense Ethics and the Liability Insurance Bargain*, 4 CONN. INS. L.J. 75, 89 (1997).

121. In his discussion of the "defeasible client" model, which appears to be the same as the law in most jurisdictions, see *infra* note 123 and accompany text, except that it allows an attorney to cease representing the insurer without notifying it (a position with which I disagree, see *infra* note 123), Professor Pepper explains that the possibility of this event needs to be disclosed at the outset of the joint representation in order to meet the requirements of Rule 1.7(b). *See* Pepper, *supra* note 114, at 70-71.

122. This appears to be the import of Formal Op. 96-403, which concluded: "After *appropriate* disclosure to the insured as to the limited nature of the representation being offered under the insurance contract, a lawyer may proceed with the representation of an insured at the direction of the insurer in accordance with the terms of the insurance contract." Formal Op. 96-403, *supra* note 9, at 6-7. Interestingly, the Opinion did not discuss Model Rule 1.7(b). However, it addressed what Model Rule 1.2(a), which pertains to limitations on the objectives of a representation, requires by way of "consultation," the same word that appears in Model Rule 1.7(b). Thus, the Opinion was concerned with the extent of disclosures needed at the commencement of representation where the policy "authorizes the insurer to control the defense and settlement of the claim in its sole discretion without consultation with the insured." *Id.* at 1. The Committee "presume[d] that in the vast majority of cases the insured will have no objection to proceeding in accordance with the terms of the insurance contract. Nonetheless, communication between the lawyer and the insured is required [by Model Rule 1.2]." *Id.* at 4. The Opinion then stated that "[a] short letter clearly stating that the lawyer intends to proceed at the direction of the insurer in accordance with the terms of the insurance contract and what this means to the insured" is sufficient, and that "extended discussion" is not required. All that is needed is that the insured be "clearly apprised" of the limitations in the representation and that the lawyer will follow the directions of the insurer; if this is done, "the insured has sufficient information to decide whether to accept the defense offered by the insurer or to assume responsibility for his own defense at his own expense." *Id.* at 4. One might argue that the disclosures needed to satisfy the conflict rule in Model Rule 1.7(b) must necessarily be more detailed than the disclosures needed to meet the "scope" rule of Model Rule 1.2(a). *See* Nancy J. Moore, *The Ethical Duties of Insurance Defense Lawyers: Are Special Solutions Required?*, 4 CONN. INS. L.J. 259, 272 (1997). If it is true, however, that in the "vast majority" of cases the insured has no objection to proceeding with a defense pursuant to a joint representation, and there is no particular reason to suspect that conflict will arise, the logic of the Opinion would seem equally appropriate for determining the extent of disclosure needed

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concerns and a concomitant obligation to make further disclosures (and perhaps even to withdraw from the representation).[123]

Indeed, in some situations, more than additional disclosures and the insured's reaffirmation of consent to joint representation will be required. If the insured's consent to joint representation is given at a time when no conflict is apparent or foreseen, and thereafter an actual conflict arises for a reason unforeseen when the representation began, defense counsel will need to consider whether the conflict is one to which consent can be given at all and whether the representation can continue without materially impairing the rights of one client or the other. In some situations, the answer will be "no" to one or both questions, and the attorney will need to withdraw, even if this encourages the insurer to investigate the circumstances of the coverage and the defense of the claim more closely.[124]

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under Model Rule 1.7(b). Indeed, because the circumstances presented to the Committee involved a conflict between insurer and insured over the insurer's right to settle a suit against the insured without the insured's consent, a conflict which was at least "potential" if unlikely at the outset of the representation, a fair reading of the Opinion is that the Committee thought more robust disclosures at the outset of the representation were unnecessary, even under Model Rule 1.7(b).

Professor Pepper may not disagree. In his discussion of the primary client model, he states: "If in fact [defense counsel] will serve the interest only of the insured in the event a conflict arises, it is also arguable that the type of informed consent required under Rule 1.7(b) and discussed in Part I above might not be required, or at least might be much less elaborate." *See* Pepper, *supra* note 115, at 69. My position is that the point Pepper says is "arguable" is more than arguable; indeed, it is exactly right.

123. Consent to joint representation must always be "fully informed," but the amount of information needed to *fully* inform the insured can vary based on the likelihood and severity of any perceived future conflict. Model Rule 1.4(b) is entirely consistent: "A lawyer shall explain a matter *to the extent reasonably necessary* to permit the client to make informed decisions regarding the representation." MODEL RULES, *supra* note 117, Rule 1.4(b) (emphasis added). What is "reasonably necessary" must vary from situation to situation. This appears to be consistent with Professor Silver's views on the matter; *see* Lexis Counsel Connect conversation referenced in Pepper, *supra* note 114 at 33 n.14. This analysis is equally pertinent to Model Rule 1.8(f), which proscribes a lawyer from accepting compensation from a third party for representing a client "unless . . . the client consents after consultation." MODEL RULES, *supra* note 117, Rule 1.8(f). Professor Pepper concludes, however, that the disclosures necessary to satisfy Rule 1.8(f) are much less than what is needed to meet Model Rule 1.7(b). *See* Pepper, *supra* note 114, at 33 n.14. Mr. Barker, like me, reads Model Rule 1.7(b) more contextually. *See* Barker, *supra* note 120, at 87 ("the key issue [in satisfying Rule 1.7(b)] is whether there will be adequate opportunity to address any such conflict before it adversely affects either client").

124. I agree with Professor Moore that withdrawal of counsel is not an answer that needs to be avoided at all costs. *See* Moore, *supra* note 122, at 281-83. *See also* Moeller v. American Guar. & Liab. Ins. Co., 1996 WL 532387 at *8 (Miss. Sept. 19, 1996) ("such counsel must be careful at the time he is asked to represent the insurance carrier and the insured, and if there is any reason indicating a possible conflict of interest at the time of his employment, he should

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It is argued by Professor Pepper and others that dual representation, even if ethically possible, is "very risky" because of potential conflicts of interest inherent in any joint representation provided by defense counsel pursuant to the provisions of a liability insurance policy.[125] That conflicts might arise in virtually any dual representation involving insured and insurer is well understood by all.[126] The question, however, is whether a prophylactic rule prohibiting *all* dual representation in the liability defense setting is necessary when it is known that in the vast number of situations where coverage is not disputed and the claim is within the policy limits no conflict will surface.[127]

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under no circumstances undertake to represent them both. Furthermore, any attorney representing two clients must remain on alert and ever watchful for any possible conflict of interest arising between the two, because the moment that happens, counsel should not attempt to represent them both."); California Ethics Op. 1995-139 (1995) ("In coverage question situations where there has not been a Civil Code section 2860 disclosure and consent to the representation, or where subsequent to disclosure and consent, new information has come to light which affects the question of coverage, the attorney may be required to withdraw.").

125. *See* Pepper, *supra* note 114, at 72.

126. *See, e.g.*, Silver & Syverud, *supra* note 10, at 266-67; JERRY, *supra* note 45, at 779 ("Conflicts between the interests of insurers and insureds are inevitable in insurance."); ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW 809 (student ed. 1988) ("There is a very substantial prospect that actual or potentially conflicting interests betwen an insurer and insured will exist in regard to almost any tort claim that may be covered by liability insurance.").

127. Although it is often said that conflicts are inevitable and arise frequently, it is easy to lose sight of the fact that in the vast majority of insurance defense relationships, conflicts do *not* arise. *See* KEETON & WIDISS, *supra* note 126, at 808 ("In most situations, there is an accord, reached either explicitly or implicitly, between the insurer and the insured as to an appropriate course of action to be pursued in response to the tort claim."); MALLEN & SMITH, LEGAL MALPRACTICE § 28.14, at 553 (4th ed. 1996) ("Dual representation by defense counsel usually is harmonious and equally beneficial to both the insurer and insured since they share the same goals during the pendency of the litigation."); Barker, *supra* note 120, at 91-92.

Professor Pepper argues that if coverage is not at issue and the claim is within limits, the insurer should be willing to waive its right to later contest coverage, which would make it easier for the insured to give consent. *See* Pepper, *supra* note 114, at 35. The argument's two-way-street appeal discounts the economic realities of insurance contracting, where combating policyholder fraud is a very important consideration. When an insurer issues a policy, it does not surrender indefinitely the right to contest coverage at some future time (except in some lines of personal insurance where the interests of third-parties in not having to defend against insurers' contests many years in the future trumps the insurers' interest in paying invalid or fraudulent claims). The process of application and evaluation enables the insurer to elicit material information without the expense of original investigation; the insurer is entitled to rely on this information; if the information turns out to be false, the insurer is entitled (assuming materiality, reliance, etc.) to rescind the coverage. Indefinite incontestability would increase the incidence of policyholders defrauding the insurer, a cost which must be built into the rate base and paid by all policyholders. In insurance defense, the insurer's waiver is tantamount to creating indefinite incontestability, and the effect is to provide a vehicle for insureds to escape the consequences of what should be a disqualification of coverage. Stated otherwise, the claims of policyholders bent on fraud are not strong ones. In the absence of compelling countervailing

Professor Pepper's careful analysis recognizes that it is far from clear that such a rule is necessary.[128] Indeed, in the absence of a genuine conflict, there is nothing to be gained by forcing the parties to act as if there is such a conflict.

The reality is that there are many joint representations which work well, and there are joint representations which do not play out so neatly. It should be presumed that the insured will decline to give consent to joint representation if the interests of insurer and insured have already diverged, or are thought to be likely to diverge at some point in the future. In that circumstance, the insurer must evaluate whether the grounds for the insured's refusal to accept a joint representation are sound. The insurer has a duty to defend, but the insured has an essentially reciprocal duty to cooperate,[129] and the insured's refusal to cooperate with defense counsel selected by the insurer where no conflict exists or is reasonably foreseeable should be construed as a breach of the insured's duty[130] (unless the insured exercises his or her prerogative to decline the benefits of the contract, i.e., decline the defense, and undertake personally the risk and the cost of the defense[131]). If the insured's breach is a material one,[132] as would be the case where the insured unqualifiedly refuses to assist in the defense, the insurer may suspend the performance of its duty to defend and, once it is clear that cooperation will not be forthcoming, treat its own duty as discharged.[133]

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considerations (such as protecting accident victims through compulsory auto insurance, where insurers lose some defenses, *see* JERRY, *supra* note 45, at 861-63, 865), legal rules should not be designed and implemented in ways that make fraud easier to commit.

128. *See* Pepper, *supra* note 114, at 69.

129. *See* Jerry, *supra* note 44, at 719-24.

130. If one concludes that the insurer has no right to control the defense because of inadequacies in the language of current policy forms, *see* discussion accompanying notes 93-109 *supra*, an insured's rejection of the insurer's non-existent right of control could not constitute a breach of the insured's duty to cooperate. This is one reason clearer policy forms would be helpful; by describing the insurer's rights more clearly, the policy would better explain the insured's reciprocal cooperation duties. *See infra* note 137 and accompanying text.

131. *See* Formal Op. 96-403, *supra* note 9, at 5 ("the insured retains the power to reject the defense offered by the insurer under the policy and to assume the risk and expense of his own defense").

132. *See* JERRY, *supra* note 44, at 724-25. This is simply an application of basic contract law principles, which require that a party's breach of a contractual duty be material (i.e., that the party's performance of the duty fall short of substantial performance) before the other party is entitled to suspend performance in response to the breach. *See* RESTATEMENT (SECOND) OF CONTRACTS § 237 (1981).

133. This simply refers to the fact that when parties exchange duties, each side's duty is a constructive condition to the other side's duty, and that the two legal effects of nonsatisfaction of a condition, including constructive conditions, is suspension followed by discharge. *See* RESTATEMENT (SECOND) OF CONTRACTS § 225(1).

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The insurer is not required, of course, to respond to the insured's breach by suspending performance. Indeed, there is some risk in doing so because the insurer's erroneous judgment that the insured breached first will cause the insurer's suspension to be the first material breach. Under the same analysis, if the insured contends that a conflict of interest exists necessitating the appointment of independent counsel for the insured and if the insurer erroneously refuses to proceed on this basis, it is the insurer that will have committed the first material breach. Instead of suspending performance in response to the insured's breach (or perceived breach), the insurer may elect to provide a defense with counsel whose loyalty runs exclusively to the insured. In contract law terms, this is a straightforward application of the principle that whenever a condition, whether express or constructive, to a duty is not satisfied, the party whose duty is conditioned can elect to waive the nonsatisfaction of the condition.[134] As for the indemnity obligation, the insurer that chooses not to withhold a defense should be expected to reserve rights to contest coverage at a later time. In doubtful or close cases, the insurer will usually choose to provide the defense under reservation simply because the consequences to the insurer of being wrong are severe.

The relationship between insurer and defense counsel is a different side of the triangle, but the analysis complements what happens on the insured-defense counsel side. Defense counsel can undertake a joint representation of insurer and insured as long as the interests are not divergent. If, however, a conflict should arise that requires the attorney's withdrawal,[135] the insurer might appoint new defense counsel to represent only the interests of the insured. If the insurer believes, based either on the fact of defense counsel's withdrawal or its own investigation, that the insured is not entitled to coverage, another alternative is for the insurer to provide no counsel and to refuse to defend. The logic of such a response is that either the insurer owes no contract duties to the insured or the insurer is entitled to suspend its own contract performance because of the insured's first material breach of the contract through non-cooperation or otherwise. Unless the insurer is prepared to take the position that the insured has no rights under the contract and that no defense is owing, the insurer's duty to defend remains an undischarged duty, and it must be fulfilled through the appointment of counsel.

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134. *See id.* § 237.

135. Model Rules of Professional Conduct Rule 2.2(c) states that a lawyer acting as an "intermediary" must withdraw from the joint representation and cannot thereafter represent either client if the conditions allowing the joint representation, as set forth in Model Rule 2.2(a), cease to exist. Comments to the Rule indicate that it applies "when the lawyer represents two or more parties with potentially conflicting interests." *See* MODEL RULES, *supra* note 117, Rule 2.2(c), cmt. (a).

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Thus, at the end of the analysis, one reaches a best answer, even if it is not a perfect one: if defense counsel cannot serve the interests of both clients without compromising the interests of either, counsel appointed by the insurer must give undivided loyalty to one client, and this client is the insured. This, in fact, is what the substantial weight of authority holds.[136]

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136. In the absence of a conflict, the representation can be joint. *See, e.g.*, Home Indem. Co. v. Lane, 43 F.3d 1322, 1330 (9th Cir. 1995) (applying Alaska law; "In a typical insurer-insured relationship, where there is no reservation of rights, there is no actual conflict of interest that would preclude an attorney from representing both the insurer and the insured"); Moeller v. American Guar. & Liab. Ins. Co., 1996 WL 532387 at *8 (Miss. Sept. 19, 1996) (defense counsel "represent[s] two separate and distinct clients"); Rogers v. Robson, 392 N.E.2d 1365, 1369 (1979) ("an attorney represents both the insured as well as the insurance company in furthering the interests of each . . . The fact that the attorney also represents the insurer in no way alters his obligations or responsibilities to the insured."); North Carolina Ethics Op. RPC 91, Jan. 17, 1991 ("Whenever defense counsel is employed by an insurance company to defend an insured against a claim, he or she represents both the insurer and the insured."); Michigan Ethics Op. RI-89 (1991) ("When an insurer retains a lawyer to defend an insured, the insured is the lawyer's client . . . dual representation is ethically permitted only if the interests of the insurer and the insured do not conflict."). *See also* Moritz v. Med. Protective Co., 428 F. Supp. 865, 872 (W.D. Wis. 1977) (defense counsel was "common attorney of two clients . . and . . . the two sets of attorney-client relationships had come into being simultaneously"). This draws support from ABA Comm. on Professional Ethics and Grievances, Formal Op. No. 282 (May 27, 1950), which stated that "a community of interest exists between the company and the insured growing out of the contract of insurance with respect to any action brought by a third person against the insured within the policy limits." In conflict situations, the insured has a right to counsel whose loyalty runs only to the insured. *See* cases cited *supra* note 124.

Both of the foregoing ideas were reflected in California Ethics Op. 1995-139 (1995), which stated: "Clearly, insurer is denominated a "client' by case law' . . . But while insurer is indeed a client in some respects . . . it is a client whose rights under case law are clearly limited. . . . Although insurance defense counsel's representation of divergent interests can be attempted "provided there is full disclosure and consent,' this dual role cannot diminish counsel's responsibility to the insured." The same idea is reflected in those formulations which recognize the appropriateness of dual representation but consider the insured to be the primary client. *See, e.g.*, North Carolina Ethics Op. RPC 92 (1991) ("The representation of insured and insurer is a dual one, but the attorney's primary allegiance is to the insured, whose best interest must be served at all times"); Oregon Ethics Op. 1991-121 (1991) ("As a general proposition, an attorney who represents an insured in an insurance defense case has two clients: the insurer and the insured. . . .both the ethical rules and insurance law require that an attorney hired by the insurer to defend an insured must treat the insured as 'the primary client' whose protection must be the attorney's 'dominant' concern," citing ABA Standing Comm. on Ethics and Professional Responsibility, Informal Op. No. 1476 (1981)).

The foregoing rule needs tempering when a claim exceeding the policy limits is involved. The language of the standard policy gives control of settlement decisions to the insurer; it may be that the agreement between defense counsel and insured will explicitly remove advice and counsel with regard to settlement issues from the scope of the representation. *See* North Carolina Ethics Op. RPC 91 (Jan. 17, 1991); JERRY, *supra* note 44, at 807-08.

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B. The Liability Insurance Contract

As discussed in Part II, current liability insurance forms do not contain language that can be reasonably read as expressing the insurer's intent to appoint counsel who will represent the insurer and the insured jointly. Insurers could draft clearer contracts with respect to the conduct of the defense; an obvious starting point would be to have the policy state that the defense will commence as a joint representation of insured and insurer. If insurers did so, would it matter? There are reasons to think that clearer contract language would be helpful.

First, and most obviously, clearer contract language would help define the relative rights and obligations of insurer and insured, resulting in more predictable outcomes when disputes arise over the scope of these rights and obligations. Past experience with the insurer's privilege to settle illustrates the point. With regard to whether the insured has a right to consent to settlement in professional liability insurance policies, insurers have drafted clear contract language, and courts treat this language as dispositive on the insured's and insurer's relative rights.[137] That settlement decisions are generally controlled by the insurer has been resolved with clear contract language.[138] With a similar effort, the policy forms could be written to indicate unambiguously that the insurer is entitled to co-client status with the insured pursuant to the representation of the attorney selected by the insurer.[139] If co-client status at the outset of representation is the default rule, any claim of entitlement to sole-client representation must be sharply focused, clearly articulated, and based on a specific set of alleged circumstances that justify trumping the default rule.

Second, clearer contract language would elucidate the insured's duty to cooperate and the ramifications of the insured's breach of that duty. If the

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137. *See, e.g.*, Lieberman v. Employers Ins. of Wausau, 419 A.2d 417 (N.J. 1980) (insurer's settlement of claim in face of insured's revocation of consent to settle breached consent provision of medical malpractice policy); Arana v. Koerner, 735 S.W.2d 729 (Mo. Ct. App. 1987) (insured should be allowed to try to prove that defense counsel committed tort when, in violation of medical malpractice policy, settled suit without insured's consent).

138. *See* JERRY, *supra* note 44, at 763 ("the typical language reserves to the insurer a privilege to settle, or not to settle, as the insurer in the exercise of its discretion sees fit"), and cases cited *supra* note 2.

139. That insurers have not done so already, particularly in the face of a large number of precedents requiring that defense counsel give undivided loyalty to the insured, implies that insurers do not perceive this as a major issue or problem. *See* Silver & Syverud, *supra* note 10, at 338 n.196 ("When presenting drafts of this report, we have been repeatedly struck by the extent to which defense lawyers, general counsel for insurance companies, and claims personnel have internalized PCR [the rule that defense counsel owes primary loyalty to the client, the insured]").

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insurer's right to control the defense in no-conflict situations is non-existent, it follows that the insured does not fail to cooperate by denying the insurer's right of control. Stated otherwise, an insured's rejection of an insurer's non-existent right cannot constitute a breach of the insured's duty to cooperate. More clearly articulating the insurer's right to control the defense would give the insurer a more reliable basis for suspending its own performance in the face of an insured's refusal to cooperate with the defense offered by the insurer.

Third, clearer contract language would reduce the risk of the insured's surprise when the insurer explains that the designated attorney will serve as counsel for both insurer and insured. Surprise can evolve into disillusionment, controversy, and conflict, particularly if the insured is predisposed to distrust the insurer. Although clear contract language cannot, in and of itself, provide the consent necessary to establish a joint representation, it can support and re-enforce the disclosures made by counsel at the outset of the representation when securing the insured's consent. In this sense, clearer contract language provides "grease for the wheels," easing the process through which the joint representation is created. If after an occurrence an insured reads his or her policy for the first time and discovers a description of the steps that will unfold should the insured submit a claim to the insurer for defense, the odds that he or she will be surprised by counsel's subsequent request for consent to dual representation are greatly reduced. Moreover, clear language describing the insurer's right to control the defense would re-enforce a message that the insurer would deliver to the insured: the insured is free to reject the joint defense, but absent legitimate grounds for doing so (i.e., conflicting interests between insured and insurer), the insurer will not provide insured with a sole-client defense because, as the policy would state, this is not one of the insurer's obligations.[140] Some may consider this coercive and therefore conclude that consent to joint representation can never exist, but if these are the terms on which insurers are willing to provide liability insurance, the fact that the insured must make hard choices is not a justification for creating coverage or a defense obligation where none exists.[141]

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140. This is consistent with Mr. Barker's analysis: "[the liability insurance contract] can structure the options presented when consent is sought." Barker, *supra* note 120, at 76. Mr. Barker explains that the insurer's message—because it cannot be counsel's—can be delivered by counsel, but that the insured must be told that counsel cannot advise the insured about the message, and that any disputes must be resolved between insurer and insured. *See id.* at 88.

141. It is well settled that insureds under policies of property insurance whose property has been destroyed by fire and who are suspects in criminal arson investigations cannot decline to provide information to and otherwise cooperate with insurers and still recover under the policies. *See* JERRY, *supra* note 44, at 557.

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Reducing the risk of surprise also re-enforces the value of consumer protection; clearer forms are, if anything, fairer to the insured. Banks, for example, must explain how much interest they are really going to charge the consumer for a loan, even if consumers do not take the time to read or understand the disclosure. Indeed, it is probably easier for an insured to relate to the concept of having one lawyer to himself or herself versus sharing a lawyer with someone else than it is to understand plain language forms explaining how interest is calculated. Fairness is enhanced if insureds are given an explanation, even if they are not listening, of what they are purchasing when they pay their premiums.

Of course, some insureds will dislike the clearer policies and the articulated limitations on what the insurer will provide by way of defense (although the number of insureds who will not read their policies or know of the change will be much larger). For example, any insured who perceives liability insurance as the insurer's commitment to provide independent counsel would dislike the content of clearer policies articulating the insured's obligation to share counsel with the insurer, but there are many limitations in insurance contracts that insureds do not like. Nor is it necessary that the insured comprehend each and every limitation in an insurance policy for the limitation to be effective; if there is no unfair surprise to the insured's reasonable expectations, the fact that the insured wants a defense on different terms is not enough to expand the insurer's obligations.

One last question raised by the prospect of clearer policy language deserves our attention: is it possible that clearer contracts would *eliminate* the need for defense counsel to obtain the insured's separate consent to joint representation? In other words, would the Silver-Syverud contention that consent to dual representation occurs at the time the request for the defense is made be correct if the language of the insurance contracts were clearer? Obviously, if these questions could be answered in the affirmative, the case for modifying the existing relevant language would be overwhelming. The extent to which clear language in a standardized form is binding on the recipient who manifests assent to it is a complex question.[142] However one answers it, a more pragmatic concern is whether the party who drafts the form can count on courts enforcing it in accordance with its clear terms. The answer to this last question varies from jurisdiction to jurisdiction and from case to case, but the lessons of nearly a half-century of litigation over standardized forms gives little security to a person who has drafted what he or she thinks is a clear form. If this did not provide enough caution, the fact remains that counsel is not a party

142. For the general parameters relevant to the question, see *supra* notes 45-65 and accompanying text.

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to the contract between insurer and insured. Thus, whatever the insured might manifest to the insurer, this assent does not fulfill the attorney's independent professional responsibilities,[143] which require counsel to make an independent judgment about the situation and to obtain the client's consent after consultation—which necessarily cannot occur until after the time of contracting, a request for defense by the insured, and the appointment of defense counsel. Prudence would suggest, therefore, that even with clear contract language, defense counsel should seek and obtain the insured's informed expression of assent to the dual representation.

143. *See* Barker, *supra* note 120, at 76 ("an adhesion contract cannot itself constitute informed consent").

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APPENDIX

DEFENSE AND SETTLEMENT LANGUAGE IN MODERN LIABILITY INSURANCE FORMS: EXCERPTS FROM POLICY FORMS IN *MILLER'S STANDARD INSURANCE POLICIES ANNOTATED*

The insurance policies from which the following excerpts are taken are Insurance Service Office, Inc. ("ISO") forms reprinted with the permission of the ISO in Susan J. Miller & Philip Lefebvre, *Miller's Standard Insurance Policies Annotated.*[144]

1. Personal Auto Policy, PP 00 01 12 89 (1988)[145]

INSURING AGREEMENT

A. . . . . We will settle or defend, as we consider appropriate, any claim or suit asking for these damages. In addition to our limit of liability, we will pay all defense costs we incur. Our duty to settle or defend ends when our limit of liability for this coverage has been exhausted. We have no duty to defend any suit or settle any claim for "bodily injury" or "property damage" not covered under this policy.

2. Homeowners Composite Form, HO 00 03 04 91 (1990)[146]

Section II-Liability Coverages

If a claim is made or a suit is brought against an "insured" for damages because of "bodily injury" or "property damage" caused by an "occurrence" to which this coverage applies, we will:

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144. I MILLER'S POLICIES ANNOT., *supra* note 79. According to Miller and Lefebvre, the forms in Volume I are "the most widely used and litigated forms." *Id.* at User's Guide at 1.

145. *Id.* at 1.

146. *Id.* at 199. The Homeowners Composite Form is "a composite of six homeowners forms which differ somewhat in the property coverage they provide." *Id.*

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1. Pay up to our limit of liability for the damages for which the "insured" is legally liable. Damages include prejudgment interest awarded against the "insured"; and [coverage for punitive damages awarded against an insured.]

. . . .

2. Provide a defense at our expense by counsel of our choice, even if the suit is groundless, false, or fraudulent. We may investigate and settle any claim or suit that we decide is appropriate. Our duty to settle or defend ends when the amount we pay for damages resulting from the "occurrence" equals our limit of liability.

3. Commercial General Liability (Occurrence) Form, CG 00 01 10 93 (1992)[147]

COVERAGE A. BODILY INJURY AND PROPERTY DAMAGE LIABILITY

1. Insuring Agreement.

a. We will pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies. We will have the right and duty to defend any "suit" seeking those damages. We may at our discretion investigate any "occurrence" and settle any claim or "suit" that may result. But:

. . .

(2) Our right and duty to defend end when we have used up the applicable limit of insurance in the payment of judgments or settlements under Coverages A or B or medical expenses under Coverage C.

---

147. *Id.* at 409. Identical language to that presented here is found in the claims-made version of the form. *See* Commercial General Liability Form-Claims Made Coverage, CG 00 02 10 93 (1992), *id.* at 421. Also, identical language is found, with some differences in language describing the scope of the coverage, in the following forms: Owners and Contractors Protective Liability Coverage Form—Coverage for Operations of Designated Contractor, CG 00 09 10 93 (1992), *id.* at 429; Liquor Liability Coverage (Occurrence) Policy, CG 00 33 10 93 (1992), *id.* at 435; Liquor Liability Coverage (Claims-Made) Policy, CG 00 33 10 93 (1992), *id.* at 440.0; Railroad Protective Liability Coverage Form, CG 00 35 10 93 (1992), *id.* at 440.4; Products/Completed Operations Liability Coverage (Occurrence) Form, CG 00 37 10 93 (1992), *id.* at 441.0; Products/Completed Operations Liability Coverage (Claims-Made) Form, CG 00 38 10 93 (1992), at 441.8; Pollution Liability Coverage Form Designated Sites, CG 00 39 10 93 (1992), *id.* at 442.3.

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4. Massachusetts Automobile Insurance Policy, 6th ed., 222-0806 (1993)[148]

2. Our Duty to Defend You and Our Right to Settle. We have the right to defend any lawsuit brought against anyone covered under this policy for damages which might be payable under this policy. We also have a duty to defend any lawsuit, but our duty to defend ends when we offer, tender, or pay to any claimant the maximum limits of coverage under this policy. We may end our duty to defend at any time during the course of the lawsuit, by offering, tendering, or paying the maximum limits of coverage under the policy, without the need for a judgment or settlement of the lawsuit or a release by the claimant.

We have the right to settle any claim or lawsuit as we see fit. If any person covered under this policy settles a claim without our consent, we will not be bound by that settlement.

5. Farmers Comprehensive Personal Liability Policy, HO-73 (Ed. 4-80)[149]

Section II-Liability Coverage

If a claim is made or a suit is brought against any **insured** for damages because of **bodily injury** or **property damage** to which this coverage applies, we will:

a. pay up to our limit of liability for the damages for which the **insured** is legally liable; and

b. provide a defense at our expense by counsel of our choice. We may make any investigation and settle any claim or suit that we decide is appropriate. Our obligation to defend any claim or suit ends when the amount we pay for damages resulting from the occurrence equals our limit of liability.

148. *Id.* at 13.
149. *Id.* at 247.

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6. Business Auto Coverage Form, CA 00 01 12 90 (1990)[150]

Section II-Liability Coverage
A. Coverage
. . .
We have the right and duty to defend any "suit" asking for such damages or a "covered pollution cost or expense." However, we have no duty to defend "suits" for "bodily injury" or "property damage" or a "covered pollution cost or expense" not covered by this Coverage Form. We may investigate and settle any claim or "suit" as we consider appropriate. Our duty to defend or settle ends when the Liability Coverage Limit of Insurance has been exhausted by payment of judgments or settlements.

7. Garage Coverage Form, CA 00 05 12 90 (1990)[151]

We have the right and duty to defend any "suit" asking for these damages. However we have no duty to defend "suits" for "bodily injury" or "property damage" or a "covered pollution cost or expense" not covered by this Coverage Form. We may investigate and settle any claim or "suit" as we consider appropriate. Our duty to defend or settle ends when the applicable Liability Coverage Limit of Insurance-"Garage Operations" - Other Than Covered "Autos" has been exhausted by payment of judgments or settlements.

8. Physicians, Surgeons and Dentists Professional Liability Insurance, GL 00 11 01 73 (1973)[152]

I. COVERAGE AGREEMENTS
The company will pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages because of . . . .
and the company shall have the right and duty to defend any suit against the insured seeking such damages, even if any of the allegations of the suit are groundless, false or fraudulent, and may make such investigation and, with the written consent of the insured, such settlement of any claim or suit as it deems expedient, but the company shall not be obligated to pay any claim or judgment

150. *Id.* at 259.
151. *Id.* at 264. Except for language referring to the content of the policy, identical text is found in the Truckers Coverage Form, CA 00 12 12 90 (1990). *See id.* at 270.
152. *Id.* at 453.1.

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or to defend any suit after the applicable limit of the company's liability has been exhausted by payment of judgments or settlements.

9. Physicians, Surgeons and Dentists Professional Liability Insurance, GL 00 12 03 81 (1981)[153]

I. COVERAGE AGREEMENTS

The company will pay on behalf of the insured [all sums . . .]

The company shall have the right and duty to defend any suit against the insured seeking damages because of such injury even if any of the allegations of the suit are groundless, false or fraudulent. The company may make such investigation and settlement of any claim or suit as it deems expedient. The company shall not be obligated to pay any claim or judgment or to defend any suit after the applicable limit of the company's liability has been exhausted by payment of judgments or settlements.

10. Lawyers Professional Liability Insurance, GL 00 23 03 81 (1981)[154]

1. COVERAGE—LAWYERS PROFESSIONAL LIABILITY

. . . .

The company shall have the right and duty to defend any suit against the insured seeking damages for claims to which this insurance applies even if any of the allegations of the suit are groundless, false or fraudulent. The company may make such investigation and settlement of any claim or suit as it deems expedient. The company shall not be obligated to pay any claim or judgment or to defend or continue to defend any suit after the applicable limit of the company's liability has been exhausted by payment of judgment, settlements or claims expenses.

153. *Id.* at 453.2.

154. *Id.* at 453.8. The claims-made version of this form has identical language to the paragraph quoted above. *See* Lawyers Professional Liability Insurance (Claims Made), GL 00 24 03 81 (1981), *id.* at 454.0.

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FLAT FEES AND STAFF ATTORNEYS: UNNECESSARY CASUALTIES IN THE CONTINUING BATTLE OVER THE LAW GOVERNING INSURANCE DEFENSE LAWYERS

*Charles Silver**

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INTRODUCTION

Nineteen-ninety-six was a pivotal year in the development of the law governing the professional responsibilities of insurance defense lawyers. The two most high-profile events involved the American Law Institute and

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* Cecil D. Redford Professor of Law, University of Texas at Austin. I have received valuable comments from Ellen Smith Pryor, Janet Bachman, Jim McCormack, Sally Field, Susan Lawshe, Bill Barker, Sean Fitzpatrick, and Jeffrey Lennard. Drafts of this article were presented at meetings of the Association of American Law Schools, the American Corporate Counsel Association, Farmers Insurance Company, and the University of Connecticut Insurance Law Center. I also received valuable assistance from John Geer, Randall Hove, Jeffrey Jackson, and a host of other lawyers who commented on presentations of this essay.

I have received flat fees on many occasions when providing legal services. Most recently, I agreed to accept one when performing a professional responsibility review for a major liability insurance company with a large staff counsel operation in Texas. Although I learned a great deal from that experience that bears on subjects discussed in this article, I received no compensation or support from any insurance company or industry group for writing this article, and the views expressed here are mine alone.

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the American Bar Association. The American Law Institute narrowly escaped a floor fight over § 215 of The Restatement (Third) of the Law Governing Lawyers when the Reporters and their critics hammered out a compromise provision just prior to the annual meeting in May. Although § 215 was sent back to the Reporters for redrafting, it seems likely that a proposed final version based on the compromise will be presented to the membership and adopted next time around.[1] Then, in August, the American Bar Association issued a landmark advisory opinion on the responsibilities of defense lawyers whose clients disagree over the settlement of claims. This subject has deserved serious and thoughtful attention for years, and that is precisely what it received. Formal Opinion 96-403 is a wonderful example of the contribution careful lawyers can make to the standards of conduct that govern the legal profession.

The amendment to Restatement § 215 and Formal Opinion 96-403 are tangible products of a renewed debate among academics, lawyers, and insurance company representatives over the professional responsibilities of defense lawyers. This debate will likely prove to be the most important development of the past three years, years in which the subject received the most sustained scholarly attention than in the preceding three decades combined.[2] After Professor (now Judge) Robert E. Keeton wrote his classic articles in the 1940s, 1950s, and 1960s, the subject dropped off the radar screen insofar as most academics were concerned. Lawyers continued to see its importance and write about it, and some, especially

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1. Professor Charles W. Wolfram, the Lead Reporter, released Proposed Final Draft No. 2 of § 215 on March 6, 1998.

2. Works by law professors published in the recent past include, James M. Fischer, *Should Advice of Counsel Constitute a Defense For Insurer Bad Faith?*, 72 TEX. L. REV. 1447 (1994); Michael Sean Quinn, *The Advice-of-Counsel Defense: A Response to Fischer*, 72 TEX. L. REV. 1487 (1994); Charles Silver, *Does Insurance Defense Counsel Represent the Company or the Insured?*, 72 TEXAS LAW REVIEW 1583 (1994); Charles Silver, *Introduction: Thoughts on Procedural Issues in Insurance Litigation*, VII INSURANCE LAW ANTHOLOGY (1995); Charles Silver & Kent Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 DUKE L.J. 255 (1995); Charles Silver & Michael Sean Quinn, *Wrong Turns on the Three-Way Street: Dispelling Nonsense About Insurance Defense Lawyers*, 5 COVERAGE 1 (Nov./Dec. 1995); Charles Silver & Michael Sean Quinn, *Are Liability Carriers Second-Class Clients? No, But They May Be Soon—A Call to Arms Against the Restatement (Third) of the Law Governing Lawyers*, 6 COVERAGE 21 (Mar./Apr. 1996); Thomas Morgan & Charles Wolfram, *Insurance Defense Lawyers and the Restatement: A Reply to Professors Silver and Quinn*, 6 COVERAGE 8 (Jan./Feb. 1996); Charles Silver & Michael Sean Quinn, *All Clients are Equal, but Some are More Equal than Others: A Reply to Morgan and Wolfram* 6 COVERAGE 47 (May/June 1996); ROBERT JERRY, UNDERSTANDING INSURANCE LAW § 114 (2d ed. 1996).

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William T. Barker and Ronald E. Mallen, made important contributions.[3] But few academics did, even though lawyers paid by insurers appeared in a high percentage of civil matters throughout the period and questions about their responsibilities frequently arose. Now, owing to the controversy over the Restatement and the prominence of insurance issues on the nation's political agenda, law professors again find the subject worth pondering. This symposium, the first ever to focus on the professional responsibilities of insurance lawyers, carries the debate forward into 1998. With so large and diverse a group of talented academics addressing the subject, there is reason to hope that a respectable body of scholarship on insurance lawyers' professional responsibilities will develop. With luck, some important practical problems will be solved.

If 1996 was a good year in the law of lawyering as it relates to insurance lawyers—and I think it was—it was also a year with one serious flaw. In March, the Supreme Court of Kentucky handed down its decision in *American Insurance Association v. Kentucky State Bar*.[4] The decision is my candidate for the title of Worst Opinion On A Professional Responsibility Topic In 1996.[5] It is certainly the worst opinion about the

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3. *See* William T. Barker et al., *Is an Insurer a Fiduciary to Its Insureds?*, 25 TORT & INS. L.J. 1 (1989); William T. Barker, *"The Right and Duty to Defend": Conflicts of Interest and Insurer Control of the Defense, in* LITIGATING THE COVERAGE CLAIM: DENIAL OF COVERAGE AND DUTY TO DEFEND (1992); William T. Barker, *Settling Without the Insurer's Consent, in* LITIGATING THE COVERAGE CLAIM: DENIAL OF COVERAGE AND DUTY TO DEFEND (1992); William T. Barker & Lance C. Martin, *A Defense Perspective: The Not-So-Peculiar Fate of Excess Insurers in the Law of Bad Faith*, 7 BAD FAITH L. REP 162 (1991); William T. Barker, *Defense Counsel and Policy Limits Settlement Offers: Another View*, 6 BAD FAITH L. REP. 141 (1990); William T. Barker, *Fiduciary Duty, R.I.P.*, 6 BAD FAITH L. REP. 107 (1990); William T. Barker, *Reservation of Rights and Conflict of Interest: When Does the Insurer Lose the Right to Control the Defense?*, 58 DEF. COUNS. J. 469 (1991); William T. Barker, *Control of the Defense and Control of Settlement: Need They Go Together*, 8 BAD FAITH L. REP. 59 (1992); William T. Barker, *Coverage Disputes and Control of Settlement*, 8 BAD FAITH L. REP. 77 (1992); William T. Barker, *Insurer Liability for Defense Counsel's Blunders*, 9 BAD FAITH L. REP. 73 (1993); RONALD E. MALLEN & JEFFREY M. SMITH, LEGAL MALPRACTICE § 28 (4th ed. 1996) [hereinafter MALLEN & SMITH].

4. 917 S.W.2d 568 (Ky. 1996) (hereinafter *AIA*).

5. It would be interesting, and even worthwhile, to convene an annual symposium on the best and worst professional responsibility opinions. If such a symposium had been held this year, I am sure that many scholars would nominate for the "worst" prize Barcelo v. Elliot, 923 S.W.2d 575 (Tex. 1996), in which the Supreme Court of Texas refused to allow disappointed beneficiaries of a misdrafted will to sue the negligent attorney, thereby leaving Texas among the small minority of states that refuses to raise the privity bar in this context. I am not convinced that *Barcelo* was wrongly decided, *see* Charles Silver, *The Legal*

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professional responsibilities of insurance defense lawyers, a corner of the field I know quite well.

The issue before the court in *AIA* was whether a lawyer could properly contract with a liability insurer to handle all of the insurer's defense work for a fixed fee per matter that was to cover both the lawyer's time and litigation costs. The issue came to the court's attention when State Farm, the American Insurance Association, and the National Association of Independent Insurers jointly appealed Advisory Opinion E-368, issued by the Ethics Committee for the Kentucky State Bar, which prohibited the proposed arrangement.[6] In turn, the Ethics Committee received the opportunity to compose the advisory opinion after State Farm asked a defense lawyer in a small Kentucky town to consider the flat fee arrangement.[7] The lawyer disliked the proposal and asked the Committee for an opinion condemning it.

That Opinion E-368 issued in response to a request from a disgruntled defense lawyer is worth considering.[8] Most requests for advisory opinions come from lawyers who want to do something of questionable legality and seek the protection of an opinion before doing it. Here, the lawyer did *not* want to work for a fixed fee. This makes his request curious. The lawyer could therefore have rejected State Farm's offer and been completely safe. His decision to request an advisory opinion must therefore have been motivated by a desire to prevent State Farm from paying *other* lawyers fixed fees. The decision may have reflected the lawyer's belief that the

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Establishment Meets the Republican Revolution, 37 S. TEX. L. REV. 1247 (1996), but the weight of academic opinion is surely against me. *See, e.g.*, Geoffrey C. Hazard, Jr., *The Privity Requirement Reconsidered*, 37 S. TEX. L. REV. 967 (1996); John H. Bauman, *A Sense of Duty: Regulation of Lawyer Responsibility to Third Parties by the Tort System*, 37 S. TEX. L. REV. 995 (1996) (taking opposing positions on the liability of lawyers to third parties, but agreeing that liability is appropriate in the negligent will-drafting context).

6. Advisory Ethics Opinion KBA E-368, 58 KY. BENCH & BAR 4 (Fall 1994) (hereafter KBA E-368). SCR 3.530 gave the Kentucky Supreme Court authority to review the Order of the Board of Governors of the Kentucky Bar Association adopting Opinion E-368.

7. *See* Letter from Janet Bachman to Charles Silver (Feb. 18, 1998) (on file with author).

8. This was not the first time the Ethics Committee received a complaint from a disgruntled insurance defense lawyer. *See* Advisory Ethics Opinion KBA E-331, 52 KY. BENCH & BAR (Fall 1988) [hereinafter KBA E-331] ("several insurance defense counsel have sought guidance from the Committee because of the imposition of extraordinary [fee- and expense-related] limitations that certain liability insurers have sought to impose upon them"). The Committee also came to the lawyers' rescue in E-331, stating that severe budgetary restrictions can prevent a lawyer from providing competent, conflict-free representation to the insured, and interfere with a lawyer's independent professional judgment. *See id.*

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professionalism of Kentucky's insurance defense bar was in jeopardy, but it may also have reflected a fear of competition. If other lawyers were to accept State Farm's offer, the complaining lawyer would find it difficult to hold out for better terms. Lawyers often invoke ethics rules for self-interested reasons, and bar associations have been criticized for promulgating rules that benefit lawyers by making legal services more expensive.[9] The Kentucky Bar's Ethics Committee might have kept in mind the possibility that its authority had been invoked for a low purpose rather than a lofty one when pondering the lawyer's request.[10]

As it was, the Ethics Committee eagerly launched itself into the fray.[11] It prohibited the proposed arrangement absolutely and outright. On review, the Supreme Court of Kentucky affirmed Opinion E-368 without qualification. It also reaffirmed another opinion, U-36, issued fifteen years earlier. The Ethics Committee had cited U-36, which forbids insurance carriers from using staff attorneys to defend liability suits against insureds, in support of its reasoning in E-368.[12] In both respects, the court's decision is appalling. On the staff counsel issue, *AIA* puts Kentucky into a

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9. Jonathan R. Macey & Geoffrey P. Miller, *An Economic Analysis of Conflict of Interest Regulation*, 82 IOWA L. REV. 965 (1997) (forthcoming 1998) (stating that when making professional responsibility law, "the organized bar . . . can enhance its profits . . . by reducing the supply of legal services available in the marketplace").

10. The Ethics Committee might also have considered Kentucky Supreme Court Rule 3.530 which provides for requests by attorneys who are "in doubt as to the propriety of a. any professional act contemplated by that attorney or b. any course of conduct or act of any person or entity which may constitute the unauthorized practice of law"). KY. SUP. CT. R. 3.530 (1993). If the defense attorney who submitted the request had already rejected the offer of a flat fee, then the request did not obviously fall within the scope of a.

11. This was to be expected. The Ethics Committee frequently has been hostile to insurers and their efforts to control litigation costs. *See, e.g.*, KBA E-331, *supra* note 8 (holding that a liability insurance carrier's instruction to defense counsel to conduct or limit a defense so as to minimize the carrier's costs can cause an ethical conflict for defense counsel, as the insured is counsel's client and is entitled to competent and zealous representation; where counsel cannot provide such representation because of the insurer's limitations, withdrawal may be justified or required); Advisory Ethics Opinion KBA E-378, 59 KY. BENCH & BAR 3 (Summer 1995) (preventing insurance carrier from using a single lawyer to defend itself and its insured in a lawsuit where a separate claim was asserted against the insurer); Advisory Ethics Opinion KBA E-340 (July 1990) (advising defense lawyer to resist insurer's demands to have its claims representatives sit in on interviews with the insured unless the insured gives informed consent).

12. *See* Kentucky Bar Association Unauthorized Practice Op. U-36 (Nov. 1981). In this advisory opinion, the ethics committee also held that a lawyer could not be retained by an insurer on terms that required the attorney to bear litigation expenses, e.g., expert witness fees, court reporter fees, etc., with no right to reimbursement from the insurer.

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tiny minority of jurisdictions; on the flat fee issue Kentucky is also a minority state;[13] and on both issues the *AIA* opinion makes wholly inappropriate use of professional responsibility law.

I. THE ECONOMICS AND LEGAL ETHICS OF FLAT FEE ARRANGEMENTS

Q: What's the difference between a lawyer and a boxing referee?
A: A boxing referee doesn't get paid extra for a longer fight.

Q: What's the difference between baseball and law?
A: In baseball, if you're caught stealing, you're out.

Q: How many lawyers does it take to change a light bulb?
A: How many can you afford?

Lawyers and computers have both been proliferating since 1970. Unfortunately, lawyers, unlike computers, have not gotten twice as smart and half as expensive every 18 months.

Between grand theft and a legal fee,
There only stands a law degree.[14]

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13. *C.f.* N.H. Bar Ass'n, Formal Op. 1990-91/5 (1991) (approving flat fees for insurance defense cases); Ore. State Bar Ass'n, Formal Op. 1991-98 (1991) (same); Iowa Ethics Advisory Comm., Formal Op. 86-13 (1987) (same); Ohio Sup. Ct. Bd. of Comm'rs., Op. 97-7 (Dec. 5, 1997) (allowing defense lawyers to accept fixed fees from insurance companies).

14. The source of these jokes is Nolo's Favorite Lawyer Jokes at Cartalk.com, http://www.cartalk.msn.com/About/Lawyers/#jokes.

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A. The Need for Alternatives to the Hourly Rate

Abuses involving fees are arguably the single greatest source of embarrassment for the legal profession. A large fraction of all grievance actions and malpractice complaints are at root disputes over fees,[15] and stories of fee-related abuses abound.[16] Mark Kirby bills clients an average of almost 1,200 hours per month in 1990 and 1991, with a low of 851 hours and a high of 1,547 hours; remarkable accomplishments given that there are only 744 hours in a 31-day month.[17] Forriss Elliott one-ups Kirby by billing 82 hours in a single day, a rate that would yield 1640 hours in a month with only 20 working days.[18] James Spiotto bills 6,022 hours in a single year, an average of 16.5 hours a day 7 days a week for 52 weeks.[19] When questioned about Spiotto, lawyers at his firm, Chicago's prestigious Chapman & Cutler, suggest lamely that "[his] clients might have agreed to be charged multiple hours for each hour he put in—as a sort of premium for high-level work."[20] Maureen Fairchild, also of Chapman & Cutler, takes five friends by limousine to a party at the Four Seasons Hotel, where they treat themselves to "massages, manicures, make-up sessions, lunch, and instruction from a personal trainer," all at the expense of a client, the Harris Bank. Her billing statement describes the frolic "as business development with a representative from the State of Illinois and four minority business owners."[21] Rodney King's lawyers request compensation for attending his birthday party when applying for a fee

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15. For a discussion of the frequency of fee-related complaints, see Alan Scott Rau, *Resolving Disputes Over Attorneys' Fees: The Role of ADR*, 46 SMU L. REV. 2005, 2005-08 (1993).

16. For a collection of billing horror-stories, see Lisa G. Lerman, *Lying to Clients*, 138 U. PA. L. REV. 659 (1990).

17. *See* Emily Barker, *Now That's Alternative Billing*, AM. LAW., Apr. 1994, at 23.

18. *See* Emily Barker, *Think You Bill Long Hours?*, AM. LAW., Mar. 1995, at 19.

19. *See* Amy Stevens & Milo Geyelin, *Chapman & Cutler's Client Billing Is Said to Be Investigated by U.S.*, WALL ST. J., Nov. 18, 1994, at B6; Victoria Slind-Flor, *Chapman & Cutler: Better Economy Led to Layoffs*, NAT'L L.J., Apr. 3, 1995, at A4.

20. Amy Stevens, *Lawyers and Clients: Top Chapman & Cutler Partner Chalked Up Astronomical Hours*, WALL ST. J., May 27, 1994, at B1.

21. Stephanie B. Goldberg, *Billing Fraud Alleged*, A.B.A. J., Feb. 1997, at 39. Ms. Fairchild has since pled guilty to fraud and truned in her law license. Thus does fate twist itself in curious ways. Fairchild was the lawyer at Chapman & Cutler who blew the whistle on Spiotto, alleging that he took credit for time she worked on a matter and billed it at his hourly rate, which was higher than hers. *See* Randall Samborn, *Complaint Puts Fraud at $500K*, NAT'L L.J., Sept. 19, 1994, at A4.

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award.[22] F. Lee Bailey seeks reimbursement from the U.S. government for $655 meals, $550-a-night hotel stays, and 200 roses sent to a prison inmate.[23] Timothy Flato purchases airplane tickets, cancels them, and submits the receipts to clients for payment, augmenting his salary by over $100,000 per year.[24] Shearman & Sterling overbills Citibank by an estimated $57 million over 3 years.[25] H. Lee Godfrey charges the City of Austin, Texas $970 per hour in a non-contingent representation.[26] Ronald Reagan's lawyers charge him even more.[27] A law firm bills a client $250 per hour for work performed by a contract attorney and, when the client inquires, refuses to reveal the rate the attorney was actually paid.[28] All these stories, and many more, were featured prominently in the press.[29]

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22. *See News of the Weird*, AUSTIN-AMERICAN STATESMAN, Jan. 24, 1995, at B8.

23. *See F. Lee Bailey Wants Reimbursement; U.S. Wants Answers Government Questions Travel Expenses, $655 Meals, Roses for Inmate*, ST. LOUIS POST DISPATCH, Aug. 13, 1996, at 4A; *Bailey Defends his Billings for Sushi, Filet Mignon, Roses*, SEATTLE TIMES, Aug. 13, 1996, at A9.

24. *See* Chris Rauber, *Quiet Law Firm Making Noise Latham & Watkins Expands S.F. Presence*, SAN FRAN. BUS. TIMES, Aug. 9, 1996, at 4.

25. *See* Roger Parloff, *Overbilled by $57 Million?!*, AM. LAW., May 1994, at 65.

26. *See No More Good Deals*, AUSTIN AMERICAN-STATESMAN, July 13, 1996, at A10. Godfrey's bill was the subject of considerable controversy and was lampooned in a local humor column. *See* John Kelso, *$970-an-Hour Nuke Lawyer is No Bargain*, AUSTIN AMERICAN-STATESMAN, July 12, 1996, at B1.

27. *See Reagan Wins Fees for Iran-Contra*, AUSTIN AMERICAN-STATESMAN, Sept. 4, 1996, at A5 (stating, in connection with a request for reimbursement of fees incurred in the Iran-Contra investigation, that the court "balked at paying more than $1,000 an hour for five high-priced lawyers who held seven joint meetings to plan strategy"); *Reagan Wins Fees Reimbursement*, FT. WORTH STAR-TELEGRAM, Sept. 4, 1996, at 3.

28. *Charging $250/Hour For Contract Attorney Not 'Unconscionable'*, LAWYERS WEEKLY USA, May 8, 1995, at 8; *see also* Shaffer v. Superior Court 39 Cal. Rptr. 2d 506 (Cal. Ct. App. 1995) (refusing to require law firm to reveal the amount the contract attorney was paid).

29. After I drafted this paragraph, the National Law Journal ran the following front page headline: *"Excessive Fees Are Attacked Across the Board." See* Gail Diane Cox, *Fie on Fees: Excessive Fees Are Attacked Across the Board*, NAT'L L.J., Nov. 4, 1996, at A1. The article described a number of instances in which lawyers were disciplined or chastised for charging unreasonable fees. It also stated that "an unprecedented number of legal fee measures were introduced in nearly a dozen state legislatures" in 1996, although few were adopted. *Id.* at A22. The latter development bears out an assertion Michael Sean Quinn and I recently made. Failure to control costs is a major threat to lawyers' professional independence. *See* Charles Silver & Michael Sean Quinn, *Wrong Turns on the Three Way Street*, *supra* note 2, at 10-11. This is true even if, as doubtlessly also is true, most of the political pressure for regulation comes from tort reformers who wish to throttle plaintiffs' lawyers.

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The effect on the reputation of the bar in the eyes of the public can only have been deleterious.

I have never been a lawyer-basher, and I do not mean to become one. Lawyers seem to me to be no more avaricious than other professionals and no less honest or trustworthy. The anecdotes prove only that lawyers are no better than anyone else. The bar has its bad apples and its wealth-seeking overachievers, most likely in the same percentages as other professions.

If lawyers differ from others, it is partly by virtue of their particular skills and the subject matter of their work, and it is partly because demand for their services is unusually high. Legal services now constitutes the fourth largest sector of the service economy, and the rate of growth over the past three decades has been spectacular, rivalling that of the health-care sector prior to the advent of managed care.[30] As a profession, lawyers have demonstrated that they are willing and able to provide valuable services to those with the capacity to pay, but they have also shown a tendency to take advantage of clients who fail to incentivize and monitor them properly.

If lawyers differ from others, it may also be because they face temptations more often than other professionals do. In part, this occurs because lawyers are more often compensated at hourly rates.[31] When paid

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30. "[S]ince 1977 total revenues of the legal services industry have risen at an annual growth rate of 12 percent, even more rapidly than health services output and at a substantially higher rate than output for the economy as a whole. Indeed, by 1989, the revenue of the legal services industry exceeded $75 billion, a figure roughly one-fourth the size of total corporate profits in that year, and nearly five times the revenue of the legal industry in 1977. And these data refer only to expenses for *outside* counsel." Robert E. Litan & Steven C. Salop, More Value for the Legal Dollar: A New Look At Attorney-Client Fees and Relationships 2 (ABA 1996) (citing Commerce Department data) (prepared for The Section of Litigation Program, Value Billing and Gaining A Competitive Advantage in the Legal Marketplace, 1992 ABA Annual Meeting, Aug. 9-12, 1992, San Francisco, CA) (emphasis in original) (on file with author) [hereinafter Litan & Salop, More Value]. An adaptation of this article appears as Robert E. Litan & Steven C. Salop, *Reforming the Lawyer-Client Relationship Through Alternative Billing Methods*, 77 JUDICATURE 191 (1994) [hereinafter Litan & Salop, *Alternative Billing Methods*]. *See also* Marianne Larelle, *Lawyers Are Top Earners*, NAT'L L.J., Aug. 28, 1995, at A1. (ranking legal services behind health services, business services, and engineering, accounting, research).

31. Although many have announced the death of the hourly rate, it continues to be the most frequently employed method of compensating lawyers. *See 1997 Attorney Economic Survey: Hourly Rates in Texas Law Firms*, STATE BAR OF TEXAS DEPT. OF RESEARCH & ANALYSIS (State Bar of Texas, Austin, TX), 1997, at 2 (reporting that more than 90% of attorneys responding to survey bill by the hour at least some of the time) [hereinafter *Texas Attorney Economic Survey*]. *See also* Deborah R. Hensler, Talking To Each Other Or Talking Past Each Other? Corporate Legal Officers' and Outside Counsels' Views on

on the basis of the amount of time expended, any service provider must be tempted to maximize time. Many providers, including many lawyers, resist the temptation to over-bill. Owing to strength of character, fear of discovery, a desire to retain a client's business, or some other cause, they suppress the desire to log hours. But, as is completely predictable and understandable, many service providers give in. Unable to resist the lure of wealth, they work slowly or charge for more time than they actually expend. Because hourly rate arrangements have been especially popular means of compensating lawyers, lawyers have had more opportunities to succumb to temptation and have succumbed in larger numbers.

Lawyers may also find the temptation to overbill especially difficult to resist because the impact of the hourly rate is magnified by other incentives. Suppose that only a minority of lawyers initially gives in to the temptation to overbill. Might the minority corrupt other lawyers, until a point is reached at which a far larger percentage of lawyers overbills?[32] Chain reactions are possible because many lawyers work, compete to advance, and share compensation in firms where most lawyers charge by the hour. Consider the position of a young associate whose reputation, year-end bonus, and chances of winning the "promotion-to-partnership tournament"[33] are partly a function of billings.[34] Such an associate might overbill to hide a lazy disposition, to earn more compensation, or to gain a leg up on the competition.[35] However, by inflating his or her own

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Strategies for Controlling Legal Costs 11 (ABA 1992) (prepared for The Section of Litigation Program, Value Billing and Gaining A Competitive Advantage in the Legal Marketplace, 1992 ABA Annual Meeting, Aug. 9-12, 1992, San Francisco, CA) (on file with author) ("On average, corporate legal officers reported that about 86 percent of the outside fees they are currently paying are charged on this [hourly-fee-and-expense] basis.").

32. The argument of this paragraph and the following is offered as a speculation, not an assertion. In forming these thoughts, I benefitted from conversations with Anthony Davis, a risk management consultant for law firms at Fox, Horan & Camerini, and my colleague Henry Hu, who generously shared their knowledge of law firm compensation structures with me.

33. MARC GALANTER & THOMAS PALAY, TOURNAMENT OF LAWYERS 77-120 (1991).

34. *See* Lerman, *supra* note 16, at 710-711, reporting an example of a senior associate who allegedly committed gross excesses after being pressured to increase billable hours by a law firm.

35. *See* GALANTER & PALAY, *supra* note 33, at 100-101. It is unclear whether Galanter and Palay take overbilling into account when describing what associates must do to win the tournament. They recognize that law firms must discourage associates from shirking, *see id.* at 100, but their discussion of how firms do so, *see id.* at 100-102, does not expressly take overbilling into account. It seems straightforward that associates use time records to signal to partners both that they are reliable and that they will generate significant income after being promoted. But signals like these tend to be measured on relative, not absolute, scales.

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contribution, the overbiller makes the contributions of other associates seem smaller by comparison. To protect themselves, other associates may criticize or "rat" on the overbiller (disfavored courses of action in many firms), or they may inflate their own contributions. In the competition for rewards in law firms, the only stable equilibrium may be that all associates overbill.

Partners benefit from this race to the bottom among associates and may tolerate billing abuses for that reason. In many law firms, a partner's compensation is partly a function of associates' billings. When low associate billings can lead to low partner compensation, a partner has an economic interest in seeing that associates' charges are high, and a partner has little reason to care whether high billings reflect time that was actually worked or not. Billings cannot be *too* high, of course. There is a limit, which can only be guessed at, as to how much a client will pay. Associate charges above that level must be written off. The concern is just that billings should not be too low. There need be little fear of that. The "race to the bottom" assures that plenty of hours will be logged.[36]

If hourly-rate arrangements are corrosive, then a turn to alternative incentive structures may make many lawyers more honest, trustworthy, and happy than they are today. Is it just a coincidence that the perceived devolution of the profession, the symptoms of which include billing excesses, crushing workplace demands that leave little time for family or community life, scorched-earth litigation tactics, and widespread career dissatisfaction, occurred while the hourly rate was ascendant? It is possible, and it seems plausible to me, that alternative compensation formulas will change the way lawyers practice law for the better. Innovative fee structures have at least as much potential to encourage professionalism and improve the quality of life for attorneys as lawyers' creeds, disciplinary rules, and exhortations from leaders of the bar.[37]

Because an associate who overbills sends a louder signal than one who does not, all associates will feel pressure to overbill if any associate does.

36. Obviously, this is an incomplete story. It ignores independent incentives partners working under hourly rate arrangements have to overbill their own time. It also ignores market-based pressures on law firms competing for business to reduce costs.

37. Lawyers have already seen important changes in their firms: "The very structure of law firms—the 'normal' procedures and ways of operation—evolve and change once alternate fee arrangements are adopted. The 'pyramid' type structure of firms is likely to evolve into a more 'diamond'-shaped configuration, with more permanency, structure, and competition in the middle levels of the firm; the partner-to-associate ratio will change." Thomas P. Grace & Peter J. Neeson, *Alternatives to Traditional Fee Arrangements*, FOR THE DEF., May 1996 at 31.

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Changes appear to be in the pipeline whether they are good for lawyers or not. Many publications have heralded the demise of the hourly rate, and the consensus among academics is that institutional consumers can significantly improve the cost/quality ratio for legal services by shifting from hourly rates to other compensation schemes.[38] The simple logic that time-based compensation formulas encourage lawyers to maximize time without regard to quality appears to have sunk in. Because new compensation formulas are now evolving, it is premature to predict what their impact on lawyers will be. But one thing seems clear: alternative fee structures will revolutionize the way many lawyers practice, just as managed care regimes have radically altered the practice of medicine over the past ten years. When significant economic actors press for change, change will come, even if the solons of the legal profession do not want it. Creative clients and creative lawyers seeking to win their business will find ways to come to terms.

B. How Flat Fee Arrangements Work

Some of the economically most important purchasers of legal services are liability insurance companies. After watching defense costs escalate at double-digit rates throughout the 1980s, these companies are pressuring lawyers to be more efficient.[39] In seeking cost reductions, they are doing nothing new. For years, insurers have obtained price concessions by offering steady work in exchange for reduced hourly rates.[40] They have

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38. *See, e.g.*, Litan & Salop, *Alternative Billing Methods, supra* note 30.

39. Litan & Salop report that "the property-casualty industry found its legal expenses jumping more than *four-fold* in the decade 1978-88, from $2.8 billion to $11.8 billion, representing a 15 percent rate of annual increase." Litan & Salop, More Value, *supra* note 30, at 2-3 (emphasis in original). They also report that "in 1988, legal costs counted for approximately 9 percent of the $132 billion in losses incurred by the property-casualty insurance industry." *Id.* at 3 n.5. Their figures are based on information provided by the Insurance Services Office, Inc. (ISO). Similar figures are reported in Gary Taylor, *Party's Over In Insurance*, THE NAT'L L. J., Sept. 23, 1991, at 1; James Howland & Michael Pritula, *Legal Costs: Can the Flow Be Slowed?*, BEST'S REV. PROP. & CAS. INS. ED., Feb. 1991, at 14.

In pressuring lawyers to reduce costs, liability insurers are acting like other commercial purchasers of legal services. See Hensler, *supra* note 31, at 10 ("Almost all of the Fortune 1000 corporate legal officers surveyed . . . have adopted some sort of strategy for controlling legal costs, and most have adopted multiple strategies. On average, corporate legal officers say they have reduced their legal expenses by about 18 percent as a result of adopting new practices.")

40. *See* Zoe Baird, *A Client's Experience With Implementing Value Billing*, 77 JUDICATURE 198 (1994) (discussing volume discount arrangements); *Texas Attorney*

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extracted additional savings by requiring lawyers to adhere to litigation budgets and outside counsel guidelines, by subjecting lawyers to supervision by claims personnel, and by conducting file audits.[41] By these well-worn means, insurers have discouraged over-billing and monitored the quality of service lawyers provide.

The new twist in insurers' efforts to reduce legal costs is the turn away from the hourly rate. One new approach to attorney compensation, recommended by Robert Litan and Steven Salop in a research project supported by Aetna Life and Casualty Company, involves bundling a large number of similar matters, assigning the bundle to a single law firm, and paying the firm on a per matter basis without regard to the amount of time or the level of resources any individual matter requires.[42] For example, a law firm might assume responsibility for defending all automobile liability cases in a large city in return for a fee of $3000 per case. The fee would cover both time and other litigation expenses. An insurance carrier would find this arrangement attractive for at least three reasons. First, it caps the carrier's exposure to defense costs at a predetermined level, reducing uncertainty. Second, it frees the carrier from the burden of assessing the reasonableness of the firm's investments of time and resources. Whenever the law firm expends costly resources on a matter, the firm bears the cost. Because the carrier has no direct stake in attorney time or litigation expenses, it can allow the law firm to monitor itself. Third, if payment is made as matters are closed, the carrier has some assurance that the firm will not delay resolving matters, as firms are tempted to do when lawyers are paid at hourly rates.[43]

Economic Survey, supra note 31, at 4, 17 (reporting average rates of $154 and medial hourly rates of $150 for all attorneys; comparable rates of $135 and $125 for insurance lawyers; and comparable rates of $137 and $125 for PI-defense lawyers).

41. *See* Howland & Pritula, *supra* note 39 at 14 (describing means insurers are using to control costs). Many corporate purchasers of legal services use similar methods to control legal costs. *See* Kasey W. Kincaid & Kimberly J. Walker, *Managing Litigation Costs: The Client Cannot Start Too Soon*, 41 Drake L. Rev. 67, 70-73 (1992) (discussing widely-used monitoring methods).

42. *See* Litan & Salop, More Value, *supra* note 30, at 23-26.

43. *See* Zoë Baird, Value Billing: Reforming the Lawyer-Corporate Client Relationship 15-16 (ABA 1996) (prepared for The Section of Litigation Program, Value Billing and Gaining a Competitive Advantage in the Legal Marketplace, 1992 ABA Annural Meeting, Aug. 9-12, 1992, San Francisco, CA) [hereinafter Baird, Value Billing]. Time savings may be the most important advantage of flat fees, which often do not save clients money. *See* Edward P. Liebensperger, *A Proposal for Improving Litigation Team Management: Task Based Billing, in* BEYOND THE BILLABLE HOUR 153, 156 (Richard C. Reed ed., 1989) (reporting that a majority of staff and outside counsel agreed that fixed rates do not save companies money but do encourage lawyers to complete tasks quickly).

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One might think that a law firm would become too stingy with resources under this arrangement. Once assigned a block of cases, a firm could maximize its profit—the difference between the amount it receives from the carrier and the cost it incurs defending cases—by minimizing its use of resources. In other words, a law firm would be inclined to shirk, and if it did shirk, payouts on judgments and settlements would rise.[44] This would harm the insurance company and its policyholders. The carrier would bear most of the cost in the first instance because most claims are resolved within policy limits. Some policyholders would also be directly affected, however, because the frequency and size of excess judgments and settlements would rise. Eventually, all policyholders would share the added burden as higher claim costs translated into higher premiums. This, in turn, would put the carrier at a disadvantage in the marketplace, where it must compete with other, more efficient insurers for business.

The preceding makes clear that an insurance company has an interest in ensuring that a law firm retained on a flat fee basis devotes an appropriate level of resources to the defense of claims. A carrier can protect this interest in a variety of ways. For example, it can demand documentation of litigation investments, including lawyer-time and other resources, and compare them to records obtained from other defense firms. It can also 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'. 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.[45] 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

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44. *See* Howland & Pritula, *supra* note 39, at 14 ("It is easy to cut legal expenses in half, but difficult to achieve this savings without driving up loss results.").

45. *See* Hensler, *supra* note 31, at 12 (stating that although "some clients might . . . be concerned that [a lawyer working at a flat rate] would invest too little in the matter, the lawyer's incentives to maintain and expend her client pool should mitigate any tendencies in this direction").

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larger the bonus to the firm.[46] None of these arrangements will work perfectly, but they will provide some assurance against shirking.

The need for supplemental incentives and monitoring devices shows that the bundled, flat fee approach is imperfect. Like any other incentive arrangement, including compensation formulas based on hourly rates or contingent percentages, it aligns the interests of principal and agent imperfectly because it gives the agent less than the full marginal product of the agent's contribution.[47] It therefore requires costly supplementation. This does not mean that bundled, flat fee arrangements are inferior compensation structures. All principal-agent relationships require costly supplementation because all have flaws. Whether the bundled, flat fee approach is better or worse than other incentive structures depends on many things, including the ease with which shirking can be discovered and discouraged. A carrier's decision to use the bundled approach suggests that, all things considered, it expects its total costs to be lowest under this arrangement.

If a liability insurer might like the bundled, flat fee arrangement, could a law firm find it advantageous as well?[48] One reason a firm might accept the arrangement is that a firm is uniquely able to encourage its lawyers to act efficiently.[49] In other words, the risk of inefficient use of litigation resources is one a firm is best able to bear, and contracting parties usually

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46. One author labels this sort of structure "Incentive Billing." *See* Baird, Value Billing, *supra* note 43, at 17-18.

47. All principal-agent relationships in which the agent receives less than 100% of the return on effort are susceptible to agency failures, i.e., situations in which an agent can advance his or her own interests at a principal's expense. Macey & Miller, *supra* note 8. There is a highly developed and, unfortunately, highly technical economics literature on principal-agent relationships, agency costs, and incentive structures designed to align the interests of agents with those of the principals they represent. For an introduction and bibliography, see Joseph E. Stiglitz, *Principal and Agent, in* THE NEW PALGRAVE: A DICTIONARY OF MONEY AND FINANCE 185 (Peter Newman et al., eds., 1992).

48. I do not mean to deny that many lawyers are fearful of innovative compensation approaches and suspicious of insurers' efforts to reduce legal costs. *See, e.g.,* STEPHEN J. ABARBANEL & SUSAN MURPHY, ETHICAL CONSIDERATIONS AND THE TRI-PARTITE RELATIONSHIP: ATTORNEY/INSURER RELATIONSHIPS IN MANAGING CONFLICTS OF INTEREST 70,72 (Defense Research Institute 1995), (suggesting that "[a] horrifying analogy between casualty insurers engaging in billing arrangements designed solely to reduce litigation expenses and the recent experience of a health maintenance organization could be made if there is a perception that the goals of reducing litigation costs received a greater priority than the quality of the insured's defense").

49. *See* Ted Schneyer, *Professional Discipline for Law Firms?*, 77 CORNELL L. REV. 1 (1991) (discussing the ability of law firms to provide internal monitoring).

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assign risks to those who can bear them at least cost. Another reason is that an insurer will have to promise a level of compensation sufficient to cover a law firm's expected defense costs and to yield an acceptable profit. In other words, the firm will demand a fee large enough to make the undertaking worthwhile. To ensure that the payment is adequate, the firm will have to estimate defense costs for the block as a whole, which in turn requires an estimate of the cost of defending the average case. If the number of cases in the block were small, the law firm could not do this reliably. Actual costs might deviate substantially from predicted costs because the variance associated with the estimate of average case cost would be large.[50] However, when a large number of independent cases with similar loss-bearing characteristics are pooled, the law of large numbers applies and the variance associated with the estimate of the cost of defending the average case declines dramatically. Some cases take less time than expected, others take more. Because in a large case block the gains and losses will be offsetting, a firm can estimate its cost of defending the case bundle with reasonable precision. This enables a law firm to accept a bundle at a stated price per case with considerable assurance of earning an acceptable profit.

The bundled case, flat fee arrangement requires a law firm to mimic an insurer's underwriting department. Insurers pool independent risks with similar loss-bearing characteristics. Then they use the law of large numbers to predict the expected loss for the pool and the premium required from each insured to cover the risk. Under the bundled arrangement, the risk is the amount of lawyer-time and other resources the firm will have to provide when defending a given claim.[51] The premium is the amount offered by the insurer per case. If the premium is large enough, the firm will accept the entire block of cases. Otherwise, it will not.

Variations on the simple bundling approach can readily be devised.[52] For example, time can be compensated on a fee-per-matter basis while litigation expenses are reimbursed as incurred. This arrangement might satisfy an insurer that found attorney time difficult to monitor but not expenses. Flexibility with respect to compensation for hours could also be

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50. Flat fees may still be used in solitary representations, depending on the variance, the risk of shirking, and other factors.

51. I recognize that the fact of assignment to the same firm creates a link between all the risks in the case bundle, to some extent undermining their independence.

52. For a discussion of typical fee arrangements employed by outside defense counsel, including modified fixed fees, *see generally* Grace & Neeson, *supra* note 37.

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preserved. An insurer could pay a flat fee of $3000 per case with a bump to $4500 for any case meeting criteria thought to signal a need for extra work, e.g., evidence of intoxication by an insured-driver, evidence of intoxication by a claimant- driver, unusual injuries to or status of a victim, or the presence of a particular lawyer, doctor, or chiropractor on the claimant's side. A carrier could also agree to pay a fixed amount per stage of litigation, e.g., $2000 for all work through summary judgment, $1000 for work from summary judgment thru trial; $1500 for first appeal, $1500 for second appeal. Modified approaches would reflect claims-handling experience and the belief that alterations could be made without generating perverse incentives or messy problems of administration.

Flat fees are not one-size-fits-all compensation formulas. They 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. The last point shows that the flat fee is a limited alternative to the hourly rate. Not all matters can or should be sold to the lowest fixed-price bidder.[53] Bet-the-company and other high-risk, high-dollar cases may require special handling, including the sort of no-stone-unturned approach to litigation the hourly rate is famous for having created. It is impossible to predict how large a fraction of legal work will one day be done for flat fees, but there is no reason to fear the imminent demise of the hourly rate.

C. Flat Fee Arrangements And Professional Responsibility Law

AIA addressed the permissibility of flat fee arrangements under Kentucky professional responsibility law. As the Supreme Court of Kentucky put it, "[a]t issue in this action is the following question . . . : (1) May a lawyer enter into a contract with a liability insurer in which the lawyer or his firm agrees to do all of the insurer's defense work for a set fee?"[54] The Court answered No for a host of reasons, none of which makes

53. *See, e.g.* Litan & Salop, More Value, *supra* note 30, at 22-24 (offering typology of cases, ranging from bet-the-company work to commodity work, and recognizing that not all legal work is or should be equally price sensitive).

54. *AIA*, 917 S.W.2d at 569.

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sense. There is no sound basis in professional responsibility law for preventing an insurance company and a defense lawyer from agreeing to transact on the suggested terms.

It is helpful to begin by identifying the rules the Kentucky Supreme Court relied upon when reaching its decision, rules 1.7(b) and 1.8(f) of the Kentucky Rules of Professional Conduct.[55] These rules are similar to the corresponding provisions of the Model Rules of Professional Conduct, a fact that may tempt courts in other jurisdictions to follow *AIA*. That is, other courts may be tempted to hold that the Model Rules of Professional Conduct, and not just the Kentucky rules, prohibit flat fee insurance defense arrangements. If they do, insurers will have to abandon a practice they are using with increasing frequency nationwide.[56]

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55. Rule 1.7(b) reads as follows:

> (b) A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:
>
> (1) The lawyer reasonably believes the representation will not be adversely affected; and
>
> (2) The client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.

KENTUCKY RULES OF PROFESSIONAL CONDUCT Rule 1.7(b) (1993) [hereinafter KENTUCKY RULES].

Rule 1.8(f) reads as follows:

> (f) A lawyer shall not accept compensation for representing a client from one other than the client unless:
>
> (1) Such compensation is in accordance with an agreement between the client and the third party or the client consents after consultation;
>
> (2) There is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and
>
> (3) Information relating to representation of a client is protected as required by Rule 1.6.

Id. Rule 1.8 (f).

56. *See, e.g.*, Reynolds Holding, *Lawyers Give Doctors Measure for Measure*, S.F. CHRON., Sept. 15, 1995, at 6/Z1 (describing new policy of a medical malpractice insurer in

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The prediction that other jurisdictions may follow Kentucky's lead is not an idle one. On January 17, 1997, the Board of Commissioners of the Michigan State Bar voted not to publish an advisory opinion that would have recognized the lawfulness of flat fee arrangements between insurance companies and defense lawyers. The Michigan Defense Trial Counsel (MDTC), a group that includes insurance defense lawyers, opposed the opinion. In testimony to the Board, MDTC's President, John P. Jacobs, stated that "the potential risks and conflicts associated with flat fee arrangements are so serious that they have been held to be unethical per se."[57] In support of this statement, Jacobs cited *AIA*.

The Kentucky court's decision to apply Rules 1.7(b) and 1.8(f) can be questioned initially because neither rule directly governs the amounts attorneys can charge or the terms on which attorneys can be paid. These functions are performed by Kentucky Rule 1.5 and its analogue, Model Rule 1.5, both of which permit clients to pay lawyers flat fees.[58] Rules 1.7(b) and 1.8(f)(2) are conflict of interest rules. The former regulates conflicts arising from a lawyer's obligations to persons other than a client and from a lawyer's own interests. The latter regulates third-party fee payments but says nothing about the amount a lawyer can charge a third-party or the terms on which compensation may be paid.

Because the opinion relies on two conflict of interest rules, it is difficult to know whether the court found flat fee arrangements inherently objectionable. Conflict rules apply mainly when a lawyer has more than one client or is compensated by a third-party payor. Consequently, the *AIA* opinion may not prohibit flat fees in single-client first-party payor representations, that is, representations where the person paying the fee is also the person being represented and is the only such person. It is impossible to be sure, however, because one of the arguments featured in *AIA* unquestionably applies to single-client first-party payor situations. The argument is that

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Napa of paying defense lawyers flat fees to defend doctors); Gary Taylor, *Party's Over In Insurance*, THE NAT'L L. J., Sept. 23, 1991, at 1 (observing that insurance defense arrangements involving fixed fees and defense contingencies are becoming more common and hourly-rate arrangements less common).

57. Marcia M. McBrien, *Flat Fee Ethics Opinion Rejected by State Bar*, MICH. LAWS. WKLY., Jan. 27, 1997, at 401.

58. Flat fees were also permitted under the former Model Code of Professional Responsibility. *See, e.g.*, ABA Comm. on Ethics and Professional Responsibility, Informal Op. 1389 (1977) (considering tax-related representation and allowing lawyer to charge an hourly rate, a flat fee, or a fee contingent on the amount of tax saved).

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> [t]he set fee arrangement also clashes with Rule 1.7(b) in that it creates a situation whereby the attorney has an interest in the outcome of the action which conflicts with the duties owed to the client: quite simply, in easy cases, counsel will take a financial windfall; in difficult cases, counsel will take a financial loss.[59]

This conflict exists *whenever* a flat fee arrangement is employed. *AIA* therefore seems to support the proposition that Kentucky Rule 1.7(b) prohibits all flat fee representations. This may surprise the many Kentucky lawyers who charge flat fees in first-party payor situations.[60] They may wonder what happened to prompt a change in the state's law, given the many prior occasions on which Kentucky courts took note of flat fees without criticizing them.[61]

In fairness to the Kentucky court, it must be admitted that flat fees can cause problems in single-client first-party representations. If a client were to agree to pay a fee that was obviously too low to motivate an attorney to do the work required at an acceptable quality level, there would be a risk, perhaps considerable, that the client would be poorly served. Finding other matters more profitable, the attorney would be tempted to shirk

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59. *AIA*, 917 S.W.2d at 235.

60. Flat fees are the compensation formula of choice in criminal defense representations nationwide. *See, e.g.*, Pamela S. Karlan, *Contingent Fees and Criminal Cases*, 93 COLUM. L. REV. 595, 599 (1993) (stating that flat fee arrangements are one of the two compensation methods most often used in criminal defense representations). They are also commonly used in simple estate work, title work, and divorce litigation. *See* ROBERT L. ROSSI, 1 ATTORNEYS' FEES § 1:25, at 63-64 (2d ed. 1995). Newspaper articles indicate that flat fees are available in a variety of kinds of representations in Kentucky. *See, e.g.*, Bill Wolfe, *Cutting the Cost of Divorce: From mediation to do-it-yourself, couples have ways to break up without going broke*, COURIER - J. (Louisville) Oct. 7, 1996 at 1D. (observing that certain lawyer charge flat fees for uncontested divorces); Dan Shingler, *Reminger Flat-Fee Billing Attracts Big-Time Clients*, CRAIN'S CLEVELAND BUS., Oct. 16, 1995, at 2 (stating that Chrysler Corp. hired Reminger, an Ohio law firm, on a flat-fee basis to handle its automotive design liability cases in Ohio, Kentucky and West Virginia); Bob Hill Schuhmann, *Crime Does Pay*, COURIER - J. (Louisville), Oct. 31, 1992, at 13S (discussing career of Frank Haddad, Jr., a famous Louisville criminal defense attorney who charged hourly rates and fixed fees).

61. *See, e.g.*, Garnett v. Walton, 242 S.W.2d 107, 110 (Ky. Ct. App. 1951) (commenting on the variety of compensation approaches used in Kentucky, and specifically mentioning fixed fees).

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responsibility for the client's matter so as to be able to devote more time to other representations.[62]

Contemporary professional responsibility law does not address this problem directly. It entitles a client to a malpractice remedy when promised services are not delivered, but it does not prohibit attorneys from charging too little.[63] In other words, it does not require a lawyer to earn a profit on every single case.[64] The absence of the prohibition is easily explained. Although overcharging is a serious problem for the legal profession, undercharging is not, never has been, and is unlikely ever to be. Lawyers have no incentive to offer their services at sub-market rates. Their interest lies in charging as much as the market will bear. If there is anything we can be confident of, it is that lawyers will turn away clients who are unable or unwilling to pay to going wage.

If there is little reason to expect lawyers knowingly to accept flat fees that are inadequate, there is more reason to think that lawyers will, occasionally and with unknown frequency, underestimate the investments they will have to make. Because any estimate of an unknown variable contains an error factor, a lawyer's estimate of the resources needed to complete a fixed-fee project may turn out to be low. To guard against this problem, a lawyer may be tempted always to bid on the high side, reducing the likelihood of undercompensation. However, this strategy will be disfavored in a competitive market where other lawyers quoting unpadded fees can compete away business without risking an expected loss.

If it is admitted, as I think it must be, that lawyers will sometimes bid out their services at prices that turn out to be too low, it remains to consider whether this risk affords a reason for prohibiting flat fees. That all jurisdictions permit flat fees suggests the answer is no, and this is the right result, for at least two reasons. First, lawyers and clients are aware of

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62. On inter-client competitions for attorneys' time, see Saul Levmore, *Commissions and Conflicts in Agency Arrangements: Lawyers, Real Estate Brokers, Underwriters, and other Agents' Rewards*, 36 J. L. & ECON. 503 (1993).

63. At one time, many bar associations had voluntary minimum fee schedules. These were said to be justified on the paternalistic ground that clients who bargained for lower fees would wind up being disserved, and on the ground that minimum fees were needed to protect the bar's reputation for delivering services of suitable quality. See ABA Comm. on Professional Ethics and Grievances, Formal Op. 190 (1939) (discussing reasons for voluntary minimum fee schedules in the course of holding that a lawyer could not be disciplined for charging a below-minimum fee). The use of minimum fee schedules largely ended when the Supreme Court handed down Goldfarb v. Virginia State Bar, 421 U.S. 773 (1975).

64. *See, e.g.*, McIlvoy v. Russell, 24 S.W. 3 (Ky. 1893).

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this risk when they enter into flat fee arrangements. They use these arrangements precisely because they want to assign the risk to the lawyer. There are only two possibilities: either the client must pay more than the predicted amount, or the lawyer must provide a higher level of service than anticipated without additional compensation. It can be jointly rational to put the burden on the lawyer, who can better predict the time and resources likely to be required and can more readily ensure that time and resources are efficiently employed.

Second, undercompensation can be a problem under many fee arrangements, including the hourly rate. Contingent fee attorneys receive nothing when their clients lose. They also earn low effective hourly rates when recoveries are small, when matters consume more time than expected, and when expenses are greater than expected. Lawyers who work for lodestar fee awards (contingent hourly rates) are routinely underpaid because the U.S. Supreme Court forbids the use of multipliers to offset the risks of nonpayment and underpayment.[65] Hourly rate attorneys incur losses when, owing to increased demand for their services, the opportunity cost of their time exceeds the amounts some of their clients are paying.[66] If the possibility of underpayment justifies a prohibition on flat fees, many other fee arrangements must also be barred. Consistent application of the principle employed by the Kentucky Supreme Court would likely prevent attorneys working in Kentucky from being paid.

In sum, the Kentucky Supreme Court overreacted to the risk of undercompensation. It also did nothing to ameliorate the more widespread and important problem of lawyers benefitting at their clients' expense.[67] If anything, the court took a step backwards in this regard. Hourly rates encourage attorneys to harm clients by overbilling. If markets can be believed, growing numbers of clients find this particular harm more worrisome than the risks posed by flat fee arrangements. This is why clients increasingly employ alternative billing arrangements, including flat fees, that cap their exposure to legal expenses and encourage attorneys to resolve matters quickly. This movement is a broad-based effort, undertaken

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65. *See* City of Burlington v. Dague, 505 U.S. 557 (1992). For a critical discussion of *Dague*, see Charles Silver, *Incoherence and Irrationality in the Law of Attorneys' Fees*, 12 REV. LITIG. 301 (1993).

66. For example, a new client might offer an attorney $300 per hour. If other clients are paying the same attorney $250 per hour, the attorney will suffer a loss by working on their matters instead of the new client's and will have an incentive to shirk.

67. This is especially true if one regards a defending insurance carrier as a client, as I do. For a discussion of this view, see articles by Charles Silver, *supra* note 2.

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with the active support of the American Corporate Counsel Association and the American Bar Association, to control legal costs.[68] Members of these groups would doubtlessly be surprised to learn that Model Rule 1.7(b) prohibits the use of the alternatives they are working hard to create.

They might also disagree, and with good reason. The so-called problem cited by the *AIA* court—that attorneys enjoy windfalls in easy cases and incur losses in hard ones—is not really a problem at all. It is one of the reasons clients *like* flat fees. Clients are happy to offer attorneys the opportunity to earn windfalls in return for fee caps and reduced case-resolution time. It is nonsensical to offer an aspect of flat fees that clients like in support of a rule that prevents them from using these arrangements.

Obviously, it is a mistake to conclude, as the Kentucky Supreme Court apparently did, that Kentucky Rule 1.7(b) permits only fee arrangements that bring lawyers' and clients' interests into perfect alignment. No compensation formula meets this standard. It is more likely that Rule 1.7(b) does not apply to fees at all.[69] The Comment that expands upon Kentucky rule 1.7(b) does not address terms of compensation. It mentions situations in which an impecunious attorney takes on a matter he or she is not competent to handle, an attorney represents a client on a matter in which the lawyer's conduct is at issue, and a lawyer advises a client to deal with a business in which the lawyer holds an undisclosed interest.[70] The concerns these examples raise—financial hardship combined with

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68. *See, e.g.*, BEYOND THE BILLABLE HOUR: AN ANTHOLOGY OF ALTERNATIVE BILLING METHODS (Richard C. Reed ed., 1989), which stemmed from the ABA Section of Litigation, Value Billing and Gaining A Competitive Advantage in the Legal Marketplace, 1992 ABA Annual Meeting, Aug. 9-12, 1992, San Francisco, CA.

69. The chapter of the ABA/BNA Lawyer's Manual on Professional Conduct dealing with Rule 1.7(b), contains no discussion of the terms of compensation, other than the fact of third-party payment. *See* ABA/BNA LAWYER'S MANUAL ON PROFESSIONAL CONDUCT 51:401 (1997).

70.

> The lawyer's own interests should not be permitted to have adverse effect on representation of a client. For example, a lawyer's need for income should not lead the lawyer to undertake matters that cannot be handled competently and at a reasonable fee. See Rules 1.1 and 1.5. If the probity of a lawyer's own conduct in a transaction is in serious question, it may be difficult or impossible for the lawyer to give a client detached advice. A lawyer may not allow related business interests to affect representation, for example, by referring clients to an enterprise in which the lawyer has an undisclosed interest.

KENTUCKY RULES, *supra* note 55, Rule 1.7 cmt. 6.

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incompetence, liability exposure arising from a prior representation, and ownership of a business—have nothing to do with the financial terms on which lawyers are retained. In each case, the interest stems from a lawyer's activities outside the instant representation. This suggests that Kentucky Rule 1.7(b)'s purpose is to discourage lawyers from accepting representations when their external interests conflict with the interests of their clients, regardless of how they are to be paid.

Assuming as a general matter that professional responsibility law permits lawyers to charge flat fees in single-client first-party payor situations, it remains to consider whether there is something about insurance defense representations that renders these arrangements objectionable. The simple fact of third-party payment would not seem to be a source of concern. Lawyers sometimes receive flat fees in fee award cases, in cases referred to them by legal aid offices, and in criminal defense representations, even though in all these cases the payor is or may be someone other than the client. These arrangements are proper, even though fees are often pitifully small.[71] Nor would the combination of flat fees and case bundling seem inherently objectionable. That, at any rate, was the conclusion reached in an advisory opinion issued by the American Bar Association.[72]

By its terms, Kentucky Rule 1.8(f) does not prohibit lawyers from accepting flat fees from third-party payors.[73] It permits third-party payor

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71. On third-party payment of flat fees by legal aid offices, see ABA Comm. on Ethics and Professional Responsibility, Informal Op. 1334 (1975) (allowing a legal aid office to pay a flat fee to an attorney who agreed to take a case by referral). On the nature and size of fee awards, see, e.g., Myrna Oliver, *Hard Work, Low Pay, Death Row: Few Lawyers For Big Task*, L.A. TIMES, Mar. 21, 1988, 1:1 (stating that the State of Alabama pays $600 for the trial and first appeal in death cases, that other states in the South pay comparably low rates, and quoting Steve Bright, of the Southern Prisoners Defense Committee, that such small fees attract only "totally inexperienced lawyers or old broken-down alcoholics," as anyone would have to agree).

72. ABA Comm. on Ethics and Professional Responsibility Informal Op. 1334 (1975) (stating that a legal aid society can permissibly contract with private counsel to handle all of its clients with a legal problem in a particular area of law on a flat-fee per case basis).

73. I assume, without conceding, that Kentucky Rule 1.8(f) applies to insurance defense representations. It seems to me that the rule should not apply to representations in which the person paying the fee is a co-client, which a defending insurance carrier usually is. *See generally* Charles Silver, *Does Insurance Defense Counsel Represent the Company or the Insured?*, 72 TEX. L. REV. 1583 (1994) (arguing for co-client status). The Reporters working on the Restatement (Third) of the Law Governing Lawyers support the application of rule 1.8(f). For a discussion of such application, see Morgan & Wolfram, *supra* note 2, at 30-35.

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arrangements (1) in accordance with an agreement between the client and the third party or when the client consents, as long as (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship, and (3) confidentiality of information is preserved. When these conditions are met, a lawyer can accept compensation from a third-party on any terms the third-party is willing to pay.

Why did the Kentucky Supreme Court conclude that the flat fee proposal violated rule 1.8(f)? The Court could not have relied on condition (1) because flat fees would be paid pursuant to an insurance policy, i.e., "an agreement between the client and the third party," as this condition expressly contemplates. Nor could the court find a violation of condition (3). Any fee formula leaves a defense lawyer equally free to withhold from an insurer information the lawyer must not disclose.[74] That leaves only condition (2), which is in fact the condition cited by the court. The Justices found a violation because, in their judgment,

> a set fee arrangement enables the insurer to constrain counsel for the insured by, in effect, limiting the defense budget—a practice that [the Kentucky Bar Association] cautioned, [in a prior advisory opinion], could create ethical problems similar to those herein. We agree with [the Kentucky Bar Association] that the pressures exerted by the insurer through the set fee interferes with the exercise of the attorney's independent professional judgment, in contravention of Rule 1.8(f)(2).[75]

This is an extraordinary interpretation of Rule 1.8(f). On this reading, a third-party payor must promise a lawyer an unlimited fee. Otherwise, a lawyer's ability to pursue a client's interests will be restricted and counsel's professional judgment will be constrained. Obviously, this remarkable requirement could never be met in the real world, where all potential third-party payors possess limited resources. If the court is correct, then, it follows that third-party payments are always prohibited. Thus does the court's logic transform rule 1.8(f) from a rule requiring

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74. The duty of confidentiality in the insurance defense context is discussed in Silver & Syverud, *supra* note 2, at 341, and Silver & Quinn, *Second-Class Clients*, *supra* note 2.

75. *AIA*, 917 S.W.2d at 572.

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third-party payor relationships to meet certain conditions into a rule that prohibits them outright.

Perhaps the court meant to say only that a third-party payor cannot limit a lawyer's budget to an amount less than 100 percent of the payor's wealth. This position would also be extraordinary. To retain a lawyer for another on even a small matter, a third-party payor would have to be willing to sacrifice food and medical care, to take out a second mortgage, to pledge an interest in his or her retirement fund, to tap into monies set aside to send children to college, etc. Any lesser commitment would violate Rule 1.8(f). And could a payor ever complain about the size of a lawyer's bill? Suppose a lawyer charged $500,000 for work on a matter in which a client had only a $500 stake. If the lawyer actually spent time worth the billed amount, would the third-party be obligated to pay? If no budgetary restrictions were permitted, the answer would be Yes. Obviously, this is a ridiculous view that can only be calculated to enrich lawyers at the expense of third-party payors.

Both suggested readings of the court's remarks are wrong for the simple reason that budgetary restrictions and other ordinary payment terms do not and cannot interfere with a lawyer's independence of professional judgment. In theory, budgetary restrictions can be so severe as to prevent a lawyer from delivering services, including advice, of minimally acceptable quality.[76] But they cannot restrict lawyers' freedom to employ their best 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 Rule 1.8(f).[77] The Kentucky Supreme Court erred when interpreting Rule 1.8(f) because it confused freedom of judgment with freedom of action.[78]

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76. The facts before the Kentucky Supreme Court did not permit it to make a finding on this point. The court was not informed of either the amount the State Farm company offered the defense lawyer or the fee needed to provide a minimally acceptable defense to liability suits against insureds.

77. This is the position taken in the tentative draft of the Restatement (Third) of the Law Governing Lawyers § 215 cmt d, Third-person direction of representation: "The principle that a lawyer must exercise independent professional judgment on behalf of the client generally requires that no third person control or direct a lawyer's professional judgment on behalf of a client." RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §215 cmt. d (Prop. Final Draft No. 2, 1998).

78. The comment to Kentucky Rule 1.7 draws the proper distinction. "The critical questions are the likelihood that a conflict will eventuate and, if it does, whether it will materially interfere with the lawyer's independent professional judgment in considering alternatives or foreclose courses of action that reasonably should be pursued on behalf of

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Lawyers must always have the former, but they rarely, if ever, have the latter and no rule requires clients to give it to them.

It is easy to forget, but essential to remember, that lawyers are first and foremost agents and advisors, not decision makers.[79] 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.[80] 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. 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.

The freedom clients have to offer flat fees in first-party payor situations demonstrates that flat fees do not constrain lawyers' independence of judgment. Like its Model Rule counterpart, Kentucky Rule 2.1 states that "[i]n representing a client, a lawyer shall exercise independent professional judgment and render candid advice." If flat fees interfere with lawyers' judgment and prevent them from fulfilling this obligation, it would have to follow that clients could not offer them in first-party payor representations. In fact, every jurisdiction—including Kentucky, I predict, despite *AIA*—permits clients to pay flat fees. It therefore follows as surely as night follows day that flat fees do not prevent lawyers from exercising independent judgment. It also follows

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the client." KENTUCKY RULES, *supra* note 55, Rule 1.7 cmt. 3. By using the disjunctive form of expression, the comment recognizes that freedom to make judgments is one thing, the ability to act quite another.

79. This is not to deny that clients can and often do authorize lawyers to make decisions. It is just to point out that they need not do so. Clients can retain decision making authority and insist that lawyers respect their lawful wishes. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 28(1) (Prop. Final Draft No.1, 1996) ("a lawyer must . . . proceed in a manner reasonably calculated to advance a client's lawful objectives, as defined by the client after consultation").

80. Kentucky Rule 1.2(a) requires a lawyer to "abide by a client's decision concerning the objectives of representation, . . . and [to] consult with the client as to the means by which they are to be pursued." KENTUCKY RULES, *supra* note 55, Rule 1.2(a). The rule specifically requires a lawyer to "abide by a client's decision whether to accept an offer of settlement of a matter," to enter a plea, to waive a jury trial, or to testify in a criminal case. *See id.*

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that flat fees are equally permissible in first- and third-party payor situations.

Nor do flat fees constrain lawyers' freedom of action, as becomes clear when the matter is properly considered. Suppose a lawyer thinks that a particular legal issue ought to be researched. Any fee arrangement will leave the lawyer equally free to do the work. It is true, indeed obvious, that different fee arrangements will compensate the lawyer differently for the time and effort the task requires. Some fee arrangements will not compensate the lawyer at all. Still, it is one thing to say that a person has no incentive to do X and quite another to claim that a person is not free to do X. I am free to play basketball even though, owing to diminished athletic ability, worn-out knees, and complaints from my wife (who had to put up with my injuries before I stopped playing), I no longer do. I might return to the court if someone offered me a lucrative shoe contract, but no sponsor has yet appeared and I doubt that one will.

Control arrangements, not fee arrangements, govern lawyers' freedom to act, and it is well-settled that lawyers always operate subject to client control. A client may tell a lawyer not to settle a claim, not to take a deposition, not to retain an expert witness, or not to do legal research. If the instruction is lawful, the lawyer must comply, even if the lawyer thinks the client is being short-sighted. It is also well settled that policyholders can give liability carriers legally enforceable contractual rights to control the defense for them. Every jurisdiction permits insurers to control the defense. Because insurer-control is permitted, and because flat fee arrangements do not change the terms of control, insurers' use of flat fees has no effect on defense lawyers' freedom of action.

Just as the *AIA* court wrongly conflated freedom of judgment with freedom of action, it also missed the distinction between professional responsibility law and insurance law. In Advisory Ethics Opinion KBA E-368, the Ethics Committee wrote:

> The obligation to defend is an independent duty or promise of the insurer under the insurance contract. Yet, here the insurer wants to continue to promise the insured a defense in the contract of insurance, while limiting the extent of its undertaking a side contract between the insured's lawyer and the insurer to which the insured is not a party.[81]

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81. Advisory Ethics Opinion KBA E-368, 58 KY. BENCH & BAR 52 (Fall 1994) (internal citations omitted).

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These remarks, which are quoted in part in *AIA*,[82] convey the impression that the insurer attempted to use the flat fee arrangement to escape or qualify its duty to defend the insured, rather than simply to control defense costs. The Kentucky Bar Association made this assertion forthrightly in its Supreme Court brief. It argued that standard policy language obligates an insurance carrier to provide "an independent lawyer who is paid a reasonable and necessary fee to conduct an adequate defense . . . *without any budgetary limitation affecting his effort on behalf of the insured.*"[83] The Bar further asserted that by proposing the flat fee arrangement, the insurance carrier sought to act "contrary to the best interest of the insured," again purportedly in violation of Kentucky insurance law.[84] In the Bar's judgment, the insurer's lawless attitude "compel[led] a need for the insured to be protected by independent counsel."[85] Thus did the Bar characterize defense lawyers as private police officers who force liability carriers to perform their contractual obligations. The court swallowed this story hook, line, and sinker, even though the actual role of *defense* lawyers is to *defend* policyholders on liability claims and even though no client or third-party payor is required to give a lawyer an unlimited budget.[86]

Is it more remarkable that the Kentucky Bar Association made these assertions or that the Kentucky Supreme Court went along? The Ethics Committee had neither obvious authority nor particular expertise to pronounce upon insurers' contractual obligations to policyholders.[87] The

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82. *AIA*, 917 S.W.2d at 569.

83. Brief For Respondent, Kentucky Bar Association, American Ins. Assoc. et al. v. Kentucky Bar Assoc., 95-SC-191-KB, Aug. 9, 1995, at 10-11 (emphasis added).

84. *Id.* at 11.

85. *Id.*

86. Lawyers' roles are determined by agreements with parties who retain them. Insurers retain defense lawyers to beat up on claimants, not to beat up on themselves. *See* Silver & Quinn, *Wrong Turns*, *supra* note 2, at 5.

87. Kentucky Supreme Court Rule 3.530 limits requests that may be made to the Ethics Committee to those involving conduct a lawyer either contemplates taking or believes to involve the unauthorized practice of law. *See* KY. SUP. CT. R. 3.530 (1993). The rule seems not to anticipate that the Committee will have the power to give free-ranging opinions on questions of law. *See* Advisory Ethics Opinion KBA E-297 (stating that "[t]he ethics committee does not answer questions relating to past or anticipated conduct of opposing counsel or other third parties, or an attorney's own past conduct unless it is tied to his future conduct, nor does it answer questions of laws, resolve disagreements between attorneys, attorneys and clients, or attorneys and third parties, respond to media inquiries regarding

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Committee's province is professional responsibility, not insurance law. It should therefore have remained agnostic on the duty-to-defend question, making alternative assumptions about the duty if need be, and should have focused on the propriety of bundled, flat fee arrangements under the law governing lawyers. The Kentucky Supreme Court should have done the same. The occasion of reviewing KBA E-368 did not present the court with a concrete example of a flat fee accompanied by an alleged violation of the duty to defend. Any shortcoming in the defense of a policyholder was left entirely to the Justices' imagination. Even the professional responsibility question was badly developed. The specifics of the proposed fee arrangement were not presented to the court, as the Bar conceded in its brief.[88] To avoid the obvious danger of making terrible law on the basis of hypothetical questions, the Kentucky Supreme Court should have given the narrowest possible ruling in the case, if it had to issue any ruling at all.

Instead, the court accepted the Bar's invitation to let professional responsibility law dictate insurance law. Flat fees create potential conflicts for lawyers; therefore, liability carriers violate the duty to defend by using them. Both halves of the syllogism are flawed, and there is no relation of logical entailment between them. Violations of professional responsibility law neither constitute, entail, nor require as predicates violations of insurance law, and vice versa. A defense lawyer can act wrongfully in a context where an insurer has acted in accordance with its rights and obligations,[89] and an insurer can commit a breach of duty in a context where a defense lawyer's conduct is blameless. Only a person with a lawyer-centered view of the world would credit the view that insurance law requires carriers to manage their operations so as to make life as comfortable as possible for lawyers.

It is farfetched in any event to believe that flat fee arrangements create conflict problems for insurance defense lawyers. The Kentucky Supreme

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pending requests for opinions, or render legal analysis of the powers of government officials"). 49 KY. BENCH & BAR 44 (Apr. 1985).

88. The Kentucky Bar Association admitted that KBA E-368 was based on sketchy facts. *See* Brief For Respondent, Kentucky Bar Association, American Ins. Assoc. et al. v. Kentucky Bar Assoc., 95-SC-191-KB, Aug. 9, 1995, at 1 ("In hindsight, perhaps the Bar should have requested that a specific factual proposal be presented to it along with the question. This omission makes the Court's task more difficulty in that it is asked to opine, *in the abstract*, concerning that which is fraught with complexity . . .") (original emphasis).

89. *See, e.g.*, Rogers v. Robson, 407 N.E.2d 47 (Ill. 1980) (where the court found that the lawyer, who settled a claim over an insured's stated objection, was liable to the insured but the carrier was not because the carrier was entitled to settle without the insured's consent).

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Court observed that the Kentucky Bar Association identified "nineteen such conflicts, including representation of the insured which becomes more complex than anticipated, resulting in financial hardship for the attorney; policy and/or coverage defenses asserted by the insurer against the insured; and disagreement between the insured and the insurer with regard to settlement negotiations."[90] The court added that "[i]nherent in all of these potential conflicts is the fear that the entity paying the attorney, the insurer, and not the one to whom the attorney is obligated to defend, the insured, is controlling the legal representation."[91]

Obviously, coverage conflicts and settlement conflicts have nothing to do with flat fees. It is difficult to imagine why these conflicts are even mentioned in the opinion. It is also hard to divine the motive behind the reference to insurer control of the defense. The right to control is provided for contractually, as is the duty to defend, and contracts giving insurers the right to defend are routinely enforced. Because the right to control the defense is one thing and the duty to pay for it another, the fact of insurer-control has no bearing on the propriety of flat fees (or other compensation arrangements). Finally, it is true that flat fees can cause attorneys to lose money on individual cases, but only on a superficial analysis of lawyer's incentives is that a cause for concern, as already explained. Neither sound economics nor any principle of professional responsibility law requires that a lawyer make a profit on every case. The most one can reasonably contend is that the terms of defense lawyers' compensation should be disclosed to insureds.[92]

It is equally implausible to suggest, as the Kentucky Bar Association did, that standard duty-to-defend language prohibits carriers from paying lawyers flat fees or obligates them to offer compensation at hourly rates. Even when a policy puts no cap on an insurer's exposure to defense costs,[93] an insurer is obligated neither to pay an attorney without limitation nor to forget about managing defense costs. An insurer can select a less expensive attorney rather than a pricier one, and it can indulge its preference for the cheaper attorney even if the insured objects. It can also

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90. *AIA*, 917 S.W.2d at 573.

91. *Id.*

92. "With client consent, most third-party fee arrangements cause barely a swell on the sea of legal ethics." ABA/BNA LAWYER'S MANUAL ON PROFESSIONAL CONDUCT 51:901 (1996). I do not mean to be endorsing a disclosure requirement.

93. Increasing numbers of liability insurance policies contain defense-within-limits provisions that eliminate the duty to defend when defense costs exceed a specified amount, usually the remaining policy limits.

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bargain with a lawyer for better terms, as insurers routinely do and have done for years. It can offer a defense lawyer a reverse contingent fee.[94] An insurer can do all these things without violating the duty to defend because the duty requires only that an insured actually be competently defended.[95] If an insurer provides a competent defense, it satisfies the duty to defend regardless of the amount it spends. It is folly to contend that stock duty-to-defend language locks insurers into particular compensation arrangements with defense lawyers.[96]

Might one not complain that a duty to defend that does not require an insurer to devote a substantial minimum of economic resources to the defense of a liability claim is worthless to policyholders and insufficiently burdensome to insurers? This objection is unfounded, I believe, because it ignores the affect the duty to indemnify has on insurers. Before making that point, however, it is worth noting that *AIA* does not put a floor beneath defense costs. It prohibits flat fee arrangements, but it does not require carriers to spend money. Nothing in *AIA* prevents a carrier from settling a claim without paying a lawyer a dime or from paying a defense lawyer $50 an hour for a few hours work. Nor does *AIA* condition the use of flat fee arrangements on the size of the fee being offered. An insurer would violate Kentucky law by offering a lawyer $1 million to defend a $5000 claim, even though a $1 million fee would clearly exceed any floor that might reasonably be imposed. The fit between "the insurers must spend at least some minimum" argument and the decision to prohibit flat fee arrangements is poor.

The complaint is invalid, in any event, because the duty to indemnify encourages insurers to defend prudently. The indemnity obligation requires an insurer to bear the judgment-related financial risk up to the policy limits, which usually are high enough to cover most or all of the expected loss. A carrier that is liable for a judgment on a covered claim helps itself—not just its insured—by spending wisely on the defense. If a $1 outlay in defense costs would yield a $2 reduction in the expected judgment, an insurer would save a dollar by spending a dollar and would

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94. *See* Taylor, *supra* note 39, at 1 (describing an instance in which a defense lawyer worked for a percentage of the amount by which a case was resolved below the insurer's settlement threshold; the lawyer successfully defended the case at trial).

95. If the insurer is willing to pay a default judgment, it need not provide a defense.

96. Liability insurance has been sold in the United States since the late 1800s. *See* Kent D. Syverud, *On the Demand for Liability Insurance*, 72 TEX. L. REV. 1629, 1639 (1994). Hourly billing became popular only after World War II. *See* Litan & Salop, *Alternative Billing Methods*, *supra* note 30, at 191 & n.1.

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lose a dollar by defending less than vigorously. Thus does the duty to indemnify create an artificial harmony of interest between an insurance company and its insured. A company helps an insured by helping itself. To encourage insurers to make prudent litigation investments, enforcement of the indemnity obligation will usually suffice.

This harmony of interest can break down in many situations, including when an insured faces considerable excess exposure or there is a coverage dispute. Fortunately, the possibility of breakdown is irrelevant to the matter at hand, which is whether flat fees should be barred. It is one thing to be concerned that a breakdown will cause underspending and quite another to outlaw flat fees. Like hourly rates and contingent percentages, flat fees can be lavish or Liliputian. A desire to discourage underspending no more warrants a prohibition on flat fees than it does any other fee arrangement. It warrants a rule against underspending, enforcement of which would require a fact-sensitive inquiry in every case, regardless of the method of compensation employed.[97]

II. THE ECONOMICS AND LEGAL ETHICS OF STAFF COUNSEL OPERATIONS

Liability insurance companies began using staff attorneys to defend lawsuits against policyholders at least a century ago.[98] One company boasts of establishing its Los Angeles, California staff counsel office in 1947, "long before the current concern over deteriorating relationships between insurance carriers and the defense bar."[99] Another reports that its operation "began back in the 1930's."[100] Many insurers also have

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97. There is a highly developed body of cases on the liability of insurance companies for negligence in the conduct of the defense. *See* Joseph E. Edwards, *Liability Insurer's Negligence or Bad Faith in Conducting Defense as Ground of Liability to Insured*, 34 A.L.R.3d 533 (1970).

98. Affidavit of Oliver B. Dickins, Jr., Deputy General Counsel of the Travelers Insurance Company (Oct. 27, 1993), submitted in In re Petition of Youngblood, 895 S.W.2d 322 (Tenn. 1995) [hereinafter Dickins Affidavit] (stating that "Travelers [Insurance Company] actually began its staff counsel program in 1892 in Metropolitan New York and has had experience in that location with staff counsel since that time"). *Id.* at ¶ 9. Another source suggests that Liberty Mutual also employed staff attorneys in the 1800's. *See* State Farm Insurance Companies Claim Litigation Counsel 1 (unpublished manuscript, on file with author) [hereinafter State Farm].

99. Anonymized Report presented to NAII Claim Legal Seminar, Aug. 19, 1992, at 1 (on file with author) [hereinafter Anonymized Report].

100. Confidential letter on file with the author.

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longstanding relationships with so-called captive law firms. These are nominally outside firms that devote one hundred percent of their time to handling a particular insurer's cases.

Many insurers' staff counsel operations are large and growing.[101] In 1986, one company had 35 staff attorney offices in 18 states with a total of 450 employees. By 1992, the number of offices had grown to 58, the number of states had risen to 25, and the number of employees had increased by 63 percent.[102] A second company began its staff counsel operation in New York in 1962. By 1988, this company had 75 lawyers practicing in 16 states. As of the beginning of 1995, the same company had 501 lawyers practicing in 38 law offices and handling more than 29,000 cases.[103] Travelers Insurance, the company whose staff counsel operation is more than 100 years old, kept 330 attorneys going in 42 offices in 19 jurisdictions in 1993.[104]

Industry-wide statistics are not available,[105] but piecemeal evidence suggests that extensive operations exist in the states where they are permitted. A 1988 report "recognized that at least 60 groups of attorneys in New Jersey [were] employed by and operating as salaried counsel for insurance companies representing the companies' insureds."[106] Another source reported that "[b]y the late 1980's, approximately 25 of the largest insurance carriers had established staff counsel programs to meet the duty to defend their customers."[107] A third states that some major liability carriers assign more than half their cases to staff lawyers.[108] These

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101. *See* MALLEN & SMITH, *supra* note 3, § 28.5 at 498; Robert L. Robinson & Stephen J. Paris, *Will The Move to Staff Counsel Continue?,* FOR THE DEF., Sept. 1994, at 17.

102. *See* Anonymized Report, *supra* note 99, at 4.

103. *See* State Farm, *supra* note 98, at 2.

104. Dickins Affidavit, *supra* note 98, at ¶ 2.

105. A study conducted by ISO DATA, Inc. of claims closed in either the third-quarter of 1990 or the first quarter of 1991 found that 22 percent of all claims were referred to in-house lawyers. *See Legal Defense: A Large and Still Growing Insurance Cost,* ISO INSURANCE ISSUES SERIES (Insurance Services Office, Inc.) Dec. 1992, at 14-15 [hereinafter *Legal Defense*].

106. Jeffrey W. Jackson & Roy Allen Cohen, Legal and Ethical Considerations in Defending the Insured with Salaried Counsel 12 (citing Unpublished Report of Ad-Hoc Supreme Court Committee on Law Firm Names (Jan. 9, 1990)) (unpublished manuscript on file with author).

107. Dickins Affidavit, *supra* note 98, at ¶ 3.

108. *See* Howland & Pritula, *supra* note 39, at 14 (stating that "Cigna and Liberty Mutual have more than doubled their staff counsel operations in the past decade," and that "[c]arriers like Allstate and The Travelers report that staff counsel handles well over half of

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numbers are likely to grow in the future. A survey conducted by the American Insurance Assocation in 1993 found that nearly half its member companies planned "significant expansions of [their] staff counsel operations."[109]

In an effort to gather better information about staff counsel operations, I asked John Geer, the Chair of the National Committee of Insurance Staff Counsel of the American Corporate Counsel Association, to circulate a questionnaire to participating companies. The following table presents in anonymized form the information thirteen companies provided.

STAFF COUNSEL OPERATIONS OF SELECTED INSURANCE COMPANIES

Company	Staff Attorneys Nationwide	Number of Offices	States with Offices	1996 Budget in Millions	1997 Budget in Millions	Year First Office Opened	Hire More Attorneys?	Open More Offices ?
1	76	16	7	$11.70	$11.80	1958	Yes	Yes
2	180	26	15	$32.80	$37.50	1968	Yes	Yes
3	96	27	19	$14	$14.10	1960	Yes	Yes
4	465	46	22				Yes	Yes
5*	13	3	1	$2.60	$2.00	1970	No	No
6	50	14	10	$7.80	$9.90	1985	Yes	Yes
7	119	19	10	$11	$13.00	1955**	Yes	Yes
8	537	86	31			1946	Yes	Yes
9	165	28	20			1968	Yes	Yes
10	313	28	13	$45.00	$56.00	1939	Yes	Yes
11	430	67	25					
12	539	39	20			1962	Yes	Yes
13	64	12	6	$16.20	$17.60	1984		
Totals	3047	411		$141.10	$161.90			
Count	13	13		8	8			

Blank spaces indicate that a company did not provide information.
* This company does business in only one state.
** Date New York office opened. All other offices opened after 1988.

These numbers are impressive. Two companies were neck-and-neck for the largest, at 539 and 537 attorneys, and excluding one company that does business in only one state, all maintained operations that would qualify as medium to large law firms. Collectively, the 13 companies

their litigated cases"). *See also* Gary Taylor, *supra* note 39, at 26 (citing Howland & Pritula).

109. Memorandum from Janet Bachman, Vice President, Claims Administration, AIA, to Claims Administration Committee, June 22, 1993 (on file with author).

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employed more than 3,000 attorneys and maintained more than 400 offices in fiscal 1997. On average, each company supported 234 attorneys and 32 offices. This works out to 7 attorneys per office, a figure that appears to be larger than the size of the average law firm in Texas.[110]

Only 8 companies provided budget data. These companies kept 911 staff attorneys employed in 145 offices at a cost of more than $160 million. They thus averaged 113 attorneys per company (small by comparison with the non-reporting companies), 6 attorneys per office, and $178,000 per attorney. The 1997 budget figures are $20 million higher, or almost 15% larger, than the 1996 numbers. Given the frequency with which the companies expressed an intent to hire more staff attorneys and to open new offices, it is reasonable to expect the budgets for staff counsel operations to continue to grow.

In January, 1998, the American Insurance Association (AIA) released its own study of staff counsel operations.[111] The AIA's findings are quite similar to mine. AIA learned that "[a] typical staff counsel office has a managing attorney, 6 to 7 trial attorneys, 6 legal secretaries, 1.5 paralegals, and one additional support person."[112] They also found that the number of attorneys grew 6% in 1995 and 16% in 1996, with large and very large insurers accounting for most of the increase.[113]

Judging from the size of staff counsel operations, the length of time they have been around, and their recent growth, one would have to conclude that insurance companies (and therefore premium-paying policyholders) derive great value from them. They have withstood the test of time, and they have survived vigorous competition from outside law firms. The existence of alternative suppliers of legal services, i.e., outside law firms, is especially important. From an economic perspective, an insurance company's decision to bring its defense work in-house is an example of a shift from a market to a regime of command-and-control. It is a shift of the kind Ronald H. Coase discusses in his classic article *The Nature of the Firm*.[114] In Coase's view, a firm will provide a good or service internally rather than obtain it in a market when "the cost of using

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110. *See* Cynthia Spanhel, *Statistical Profile of the State Bar of Texas Membership, 1997-98*, STATE BAR OF TEXAS DEPT. OF RESEARCH & ANALYSIS (State Bar of Texas, Austin, TX), Feb. 1998, at 3 (reporting a median size of 4 attorneys per law firm in Texas).

111. *See* American Insurance Association, Management of Staff Counsel in the Property/Casualty Industry (Jan. 1998) (on file with author).

112. *Id.* at 4.

113. *See id.*

114. *See* Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

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the price mechanism," including the expense "of discovering what the relevant prices are" and "[t]he costs of negotiating and concluding a separate contract for each exchange transaction," exceed the cost of production in-house.[115] A firm will purchase from an outside supplier when the reverse is true. The decision to rely on the invisible hand of the market or the visible hand of the manager reflects the relative cost of alternative modes of supply.[116]

If costs drive the decision to provide legal services internally or to buy them from external suppliers, then it is logical to expect insurers to make different decisions in response to changing costs. As outside defense costs rose throughout the 1980s and early 1990s, more and more insurers found it advantageous to bring legal work in-house.[117] The available evidence suggests that these insurers saved a lot of money.[118] One company found that cases handled by outside defense lawyers settled for 32 percent more money, took 45 percent longer to close, consumed 144 percent more attorney time, and cost 156 percent more in fees than similar cases handled by staff attorneys.[119] For this company, staff attorneys were less expensive and delivered more bang for the buck. Another insurer's study of claims closed in 1995 found that the mean settlement size (which includes trial judgments) in cases handled by staff attorneys and outside defense counsel were roughly the same, but that outside attorneys were one and a half times as expensive as staff attorneys in automobile cases and nearly three times

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115. *Id.* at 390-91.

116. For a brief introduction to the affect of transaction costs on the use of markets and organizational structures to provide goods and services, see Steven N. S. Cheung, *Economic Organization and Transaction Costs, in* THE NEW PALGRAVE: ALLOCATION, INFORMATION, AND MARKETS 77 (John Eatwell, Murray Milgate, and Peter Newman, eds., 1989).

117. For an assessment of changes in defense costs during this period, see generally *Legal Defense*, *supra* note 105.

118. *See* Anne B. Fisher, *How to Cut Your Legal Costs*, FORTUNE, Apr. 23, 1990, at 185 (citing estimates that corporate staff lawyers can cost 40 percent less than outside attorneys); *Managing the Corporate Legal Function: The Law Department, Outside Counsel and Legal Costs*, 13 BUS. LAW MONOGRAPHS (MB) 1-4 (1991) (discussing a 1981 study by a consulting firm showing that in-house lawyers tend to cost 30 to 50 percent less per hour than outside counsel). In *King v. Guiliani*, 1993 WL 284462 (Conn. Super. Ct. July 27, 1993), the court agreed that credible evidence was presented that defense costs are "substantially reduced when liability companies use employee attorneys rather than" outside attorneys. *Id.* at *11.

119. *See* Anonymous Report, *supra* note 97, Slide 1.

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as expensive in other liability matters.[120] A third insurer estimated that it saved it $26 million in 1992.[121] In 1993, a survey of member companies of the American Insurance Association indicated that staff counsel operations saved carriers an average of $32 million annually (from a low of $10 million to a high of $72 million), that outside counsel cost 2.89 times more per case ($4,983 dollars more per case in real terms), and that indemnity costs for both groups of attorneys were roughly the same.[122] A survey conducted by the American Corporate Counsel Association found that insurers who maintain staff counsel offices "can secure legal services at significant cost savings, somewhere approaching 40%-50% . . . by lowering overhead and removing profits."[123]

The Insurance Services Office has conducted three closed-claim surveys in which the relative efficiency of staff counsel operations 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."[124] 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.[125] Again, the suggestion is that staff attorneys deliver more bang for the buck.

Most of the studies referred to above are of unknown quality, so it would be dangerous to give them too much weight. Still, the consistency of the findings is impressive. Moreover, there is no reason to think that insurers would transfer work away from outside defense lawyers who provide better service than staff attorneys at comparable cost. Insurers are motivated by the bottom line. To compete successfully for business, they must minimize claim costs and keep premiums low. Because defense costs

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120. *See* Confidential letter on file with the author. This study, the most sophisticated one of which I am aware, rendered the mixes of cases sent to in-house and outside counsel comparable by holding constant claim reserves, a proxy for expected loss.

121. *See* Dickins Affidavit, *supra* note 98, at ¶ 5.

122. *See* Memorandum from Janet Bachman, *supra* note 109.

123. Jackson & Cohen, *supra* note 106, at n. 2.

124. *Closed Claim Survey for Commercial General Liability: Survey Results, 1995,* ISO INSURANCE ISSUES SERIES (Insurance Services Office, Inc.), May 1996, at 16 [hereinafter *Closed Claim*]. The prior studies are *Closed Claim Survey for Commercial General Liability: Survey Results, 1991,* ISO INSURANCE ISSUES SERIES (Insurance Services Office, Inc.), Dec. 1991; *Closed Claim Survey for Commercial General Liability: Survey Results, 1993*, ISO INSURANCE ISSUES SERIES (Insurance Services Office, Inc.), March 1994.

125. *See generally Closed Claim, supra* note 124.

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contribute significantly to claim costs, insurers have incentives to avoid expensive providers. Because high quality legal services reduce claim costs, insurers have incentives to demand quality. One should therefore expect insurers to obtain legal services from providers who offer the best combination of quality and price. Sometimes, the search for value will lead them to outside defense firms. Sometimes, it will lead them to staff attorneys. Insurers should not care much where they wind up.[126]

Many defense lawyers understand that the shift to staff counsel is a matter of economics. They see expanding staff counsel operations as

> a sound response to higher litigation expenses. Properly managed, staff counsel cost less than outside firms, partly because of lower personnel and marketing costs, as well as the absence of "partner rents." Also, staff counsel's focus on one client should make compliance with litigation management standards and procedures easier. And staff counsel operations are typically free of economic incentives to prolong cases in order to increase billing levels.[127]

Other defense lawyers take the matter more personally. They find the proliferation of staff counsel operations threatening, at least partly because these operations compete with them for business.[128] "The most vocal critics of house counsel today are the automobile and general liability lawyers who have long relied upon insurers as their principal client base."[129] These lawyers are, however, in a precarious position. They "have no interest in declaring war on the insurance industry" because they rely on insurers for business, but they have every reason to criticize staff

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126. Obviously, the decision to change providers is more complicated than I have made out. Transaction costs and sunk costs undoubtedly discourage insurers from adopting new arrangements in response to small changes in marginal costs.

127. Howland & Pritula, *supra* note 39.

128. A particularly hostile article is James L. Crandall, *And the Winner is the Plaintiff Bar!*, CLAIMS, Mar. 1992, at 53. For a reply, see Jon L. Levy, *Crandall Article Demeaning to Staff Counsel*, CLAIMS, Aug. 1992, at 7.

129. R. Gaylord Smith & Judy Davis, *Have Criticisms of In-House Counsel Put Outside Counsel in the Dog House?* INS. LITIG. REP., Nov. 1995, at 512. *See also* Ronald E. Mallen, *Defense by Salaried Counsel: A Bane or a Blessing?*, 61 DEF. COUNS. J. 518, 518 (1994) (stating that "[m]ost critics" of staff counsel operations "are other lawyers—usually defense lawyers").

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counsel operations.[130] They need smart bombs they can lob at staff attorneys without seeming to target insurers, even though insurers ultimately bear the brunt of the blast.

Professional ethics rules make perfect smart bombs. They apply only to lawyers. Consequently, disgruntled defense lawyers can use them against staff attorneys without seeming to be anti-insurer. They also enable defense lawyers to claim the high ground. Once the debate is framed in terms of lawyers' ethics, discussion will focus on professionalism, consumer protection, interest conflicts, fears of unauthorized corporate practice of law, potential interference with attorney-client relationships, and incompetence. By suggesting dangers in these areas, lawyers who oppose staff counsel operations can cast themselves as defenders of high professional standards and as consumer advocates. Insurance companies will have difficulty countering this gambit. Not being lawyers, their competency to speak on these matters will be questioned. Their self-interest will also be transparent, and they will have difficulty countering assertions to the effect that, in the pursuit of economic gains, they will gladly sacrifice policyholders' welfare and staff attorneys' professionalism.

Plaintiffs' attorneys have also attacked staff counsel operations in Ohio, Texas and other states. Their concern appears to be staff attorneys' willingness to take small cases to trial. Being low cost providers, staff attorneys can profitably try cases that are too small for outside counsel to try. By trying small cases, though, staff attorneys make it hard for plaintiffs' attorneys to make money. Many plaintiffs' attorneys are successful only because they can settle large numbers of small cases without investing significant resources in any case. By trying small cases, staff attorneys threaten to put these plaintiffs' attorneys out of business.

With outside defense lawyers and plaintiffs' attorneys allied against them, it is surprising that challenges to staff counsel operations have fared as poorly as they have. The vast majority of opinions issued by courts and advisory bodies permit staff attorneys to defend liability suits against insureds.[131] Only two states prohibit the practice. North Carolina struck

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130. Comment of John Drath, quoted in Eleanor Kerlow, *Captive Law Firms Capturing Insurance Bar's Ire,* 12 OF COUNS. 13 (1994)

131. For lists of authorities and discussions, see Smith & Davis, *supra* note 129, at 517 n.49; MALLEN & SMITH, *supra* note 3, § 28.5 at 500 n.8; Jackson & Cohen, *supra* note 106, Leo J. Jordan & Hilde E. Kahn, *Ethical Issues Relating to Staff Counsel Representation of Insureds*, 30 TORT & INS. L.J. 25 (1994).

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first in *Gardner v. North Carolina State Bar*,[132] a 1986 decision. Kentucky followed suit a decade later in *AIA*.

Why did the Kentucky Supreme Court embrace the minority view? The short answer is that court was not persuaded to change existing Kentucky law. In 1981, the Kentucky Unauthorized Practice of Law Committee issued Opinion U-36, prohibiting insurers from using staff attorneys to represent insureds. There had been no staff counsel offices in the state since then, and the deadline for challenging Opinion U-36 via the courts had long ago expired. The *AIA* opinion indicates that the court might have invalidated U-36 anyway if the insurance industry had pointed to a change in circumstances that generated a pressing need for staff counsel operations. As it was, insurers could not show that any matter of consequence had changed. The court therefore upheld Opinion U-36, saying "if it ain't broke, don't fix it."[133]

Resort to cliche is often a symptom of a failure of intellect.[134] Such a failure clearly occurred in *AIA*. To say that a machine "ain't broke" is to assert that it is operating within acceptable limits. To say that the law governing insurance defense arrangements "ain't broke" is to say the same thing. This naturally leads one to ask how the Justices knew that insurance defense arrangements are operating acceptably in Kentucky. It is impossible to say. They asserted that everything is hunky-dory but they offered no factual basis for this assessment.

What symptoms of inadequate performance should one expect to see when insurance defense arrangements deteriorate? Riots in the streets? Headlines in the press? Gunfights, or at least lawsuits, between insurers and defense lawyers? State bar investigations? Declines in insurers' profits? A hard liability insurance market? A shift from unlimited defense cost coverage to coverage within limits? Insurers leaving the state? Activity of some kind in the legislature or the insurance commission? None of the above? Unless one knows what symptoms to look for, how can one know whether the law is "broke"?

In my judgment, the clearest and most reliable signal that defense arrangements in Kentucky are not working well is that insurers want to

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132. 341 S.E.2d 517 (N.C. 1986).

133. *AIA*, 917 S.W.2d at 571.

134. My favorite example of this appears in Kay v. Ehrler, 499 U.S. 432, 438 (1991), where the United States Supreme Court denied a fee award to a pro se lawyer-litigant, remarking that "a lawyer who represents himself has a fool for a client." The colloquialism blinded the Court to the fact that the pro se lawyer-plaintiff had beaten the represented defendant *twice*.

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change them and are willing to bear the costs of doing so. It is expensive for liability carriers to run staff counsel offices for many of the same reasons it is costly for lawyers to start up and maintain firms. It is also risky. Insurers must gamble on being able to use staff attorneys efficiently, which means, among other things, being able to keep them busy handling claims. Because some insurance companies have taken this gamble and lost,[135] the willingness of others to set up staff counsel offices is strong evidence of their belief that large economic savings are at stake. Kentucky law is "broke," then, because it prevents insurers from providing for their legal needs efficiently.

Why does Kentucky professional responsibility law prevent liability carriers from using the lawyers they want on terms that satisfy the companies and the lawyers as well? Professional responsibility law does not usually restrict clients' freedom this way. To the contrary, it strives mightily to maximize clients' freedom of choice. It allows clients to select the attorneys they want, including in-house attorneys in the case of corporations, and to bargain for the best deals they can get. It preserves the option of changing horses midstream by recognizing the inherent right of discharge and by prohibiting lawyers from penalizing clients who exercise this right. It prevents lawyers from using restrictions on the right to practice to make themselves unavailable to clients. It allows referral arrangements that encourage attorneys to send clients to other attorneys who can better serve them.[136] It allows advertising, which enables clients to choose counsel more intelligently.[137] In view of the weight professional responsibility law attaches to clients' freedom of choice, a doctrine that prohibits sophisticated clients from using particular lawyers is presumptively wrongheaded.

In *AIA*, the court argued for constraining freedom of choice on the ground that the use of staff attorneys violates the maxim that "[n]o man

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135. *See* Robinson & Paris, *supra* note 101, at 19 (reporting that "one large stock company which has relied heavily on staff counsel operations for several generations has recently closed 15 of its 52 staff offices"). Difficulty in keeping its staff attorneys employed also led CIGNA to restructure its staff counsel operation. CIGNA attorneys can now take in outside work through separate law firms while remaining CIGNA employees.

136. *See* Stephen J. Spurr, *Referral Practices Among Lawyers: A Theoretical and Empirical Analysis*, 13 L. & SOC. INQUIRY 87, 88 (1988).

137. *See* Stephen J. Spurr, *The impact of advertising and other factors on referral practices, with special reference to lawyers*, 21 RAND J. ECON. 235, 240 (1990).

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can serve two masters."[138] Another cliche signalling another failure to puzzle things through. Lawyers frequently and properly represent co-clients in innumerable situations and in all jurisdictions, including Kentucky.[139]

Nor do interest conflicts prevent staff attorneys from representing carriers and policyholders concurrently. Like outside defense lawyers, staff attorneys defend claims. They look for weaknesses in liability suits against insureds in an effort to minimize the amounts likely to be lost at trial or paid in settlement. This activity benefits carriers and insureds, including, in most instances, carriers and insureds who disagree about coverage, settlement, or other matters. Only conflicts concerning the manner in which claims are defended make joint representation inappropriate. Such conflicts can arise, but they are rare.[140] And when they do arise, their implications for staff attorneys and outside defense lawyers are the same because all attorneys operate under the same conflict rules. When outside defense lawyers can concurrently represent carriers and insureds, staff attorneys can too.[141]

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138. *AIA*, 917 S.W.2d at 571. One need only look in the chapter on multiple client representations in the ABA/BNA Lawyer's Manual on Professional Conduct to see that the "no man can serve two masters" mantra is thoroughly discredited. *See* ABA/BNA LAWYERS' MANUAL ON PROFESSIONAL CONDUCT § 51.301 (1993) ("Unlike the words of the Bible, the words of the ethics rules and of the case law are not so absolute when it comes to representing two or more different clients in the same case on transactions").

139. KY. SUP. CT. R. 3.130 (1993).

140. For a discussion of defense-related conflicts, see Silver & Syverud, *supra* note 2, at 303-63.

141. In *AIA*, the Supreme Court of Kentucky did not say whether it regards a defending insurance carrier as a co-client of the defense lawyer retained to protect the insured. In this respect, the opinion contrasts sharply with the brief submitted by the State Bar of Kentucky and with Kentucky Advisory Opinion KBA E-368, both of which express the view that "the insured is defense counsel's clients [sic], and not the insurer." KY. BENCH & BAR, Fall 1994, at 52; *see also* Brief for Respondent, Ky. Bar Ass'n at 30, American Ins. Ass'n v. Kentucky Bar Ass'n, 917 S.W.2d 568 (Ky. 1996) (No. 95-SC-190-KB). In fact, Kentucky law on this subject is unclear. Opinion U-38, from the Kentucky Unauthorized Practice of Law Committee, states both that "the client . . . is the insured" and that "the representation is one in which the attorney has dual representations." Advisory Ethics Opinion KBA U-36, KY. BENCH & BAR, Jan., 1982, at 37. O'Bryan v. Leibson, 446 S.W.2d 643, 644 (Ky. 1969), the only Kentucky case on point, also recognized the "dual allegiance" of an insurance defense lawyer.

My own view, explained at length in numerous articles, is that liability insurers and policyholders are ordinarily co-clients. I draw this conclusion because attorney-client relationships are consensual and because the evidence suggests that defense lawyers routinely agree to serve both carriers and policyholders as clients.

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Why did the Kentucky Supreme Court conclude that staff attorneys cannot be trusted to protect insureds? It did so because the Kentucky State Bar Association urged this position upon it.[142] This simply forces one to why the Bar held this view. This is a serious question. The Kentucky Bar Association gave staff attorneys a slap in the face. It questioned their commitment to norms of professional conduct that forbid lawyers from abandoning their clients. One who would level so serious an accusation at so large a group of lawyers should have evidence to support it.

The Kentucky Bar had no evidence. It had neither statistics nor anecdotes showing that any staff attorney ever harmed an insured. The omission is striking. There are innumerable reported cases in which *outside* lawyers of various kinds are found to have wrongly favored one co-client over another. But the State Bar of Kentucky could not identify a single case, much less an empirical study, showing that any staff attorney ever deserted a policyholder under pressure from an insurer. Nothing brought forward by the Kentucky Bar Association would have disproved the assertion that staff attorneys favor policyholders over insurers one hundred percent of the time.

Such evidence as I am aware of, all of it anecdotal, suggests that staff attorneys serve policyholders well. When the Florida bar reviewed staff counsel operations in that state, the insurance commissioner reported that his office had received no complaints about staff attorneys. A background check of sixteen staff attorneys in two offices in Texas found that none had been disciplined for professional misconduct; that only one grievance had ever been filed against any attorney; that no insured had ever sued for malpractice; and that staff attorneys compared well to the average member of the Texas bar in terms of credentials, years of experience, salary, and other characteristics.

These findings should not be surprising. Most staff attorneys are former outside defense lawyers with years of experience trying and settling liability cases.[143] 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.[144] Most

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For present purposes, however, it does not matter whether one regards an insurer as a co-client or a third-party payor. As long as the status of insurers vis-a-vis staff attorneys and outside defense lawyers is the same, the same conflict rules apply to both attorneys and fungibility is maintained.

142. *AIA*, 917 S.W.2d at 571.

143. *See* Jackson & Cohen, *supra* note 106, at 14.

144. *See* State Farm, *supra* note 98, at 2-5.

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staff counsel offices are indistinguishable in basic respects from outside law firms.[145] They have libraries, computers, paralegals, secretaries, procedure manuals, conflict-checking systems, continuing legal education programs, retreats, letterhead, receptionists, and business cards.[146] Some staff counsel offices even use surveys to gauge policyholder satisfaction with services they provide.[147] 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.

Another reason for thinking that staff attorneys may be more able than outside defense lawyers to protect insureds' rights is that staff lawyers who are discharged for acting as their professional responsibilities require can bring wrong discharge actions against their employers. This point was made in *King v. Guiliani*,[148] a Connecticut case in which the court observed that

> the salaried employee attorney . . . has protection against losing his or her job for refusing to violate the Rules of Professional Conduct. [Connecticut law] allows an employee to sue for damages when terminated by an employer for refusing to violate a law designed to protect the public welfare. This rationale is broad enough to give a discharged or disciplined attorney a strong damage case against an insurer employer who attempts to for the attorney to violate the rules, as such violations would clearly be contrary to the public's strong interest in ethical conduct by attorneys. If a company stops referring cases to an [outside] attorney as a punishment for refusing to violate the rules, [however,] that attorney does not have [the same right of] recourse as there is no employer-

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145. *See* MALLEN & SMITH, *supra* note 3, § 28.5 at 499. Staff attorneys do differ from outside lawyers in having to worry less about the business aspects of the practice of law and in being able to focus more intently on their legal work. *See* Letter from Sally J. Field, President, Legal Professional Liability Division, Great American Insurance Companies, to Charles Silver 4 (Mar. 31, 1997) (on file with author).

146. *See* AIA, *Management of Staff Counsel in the Property/Casualty Industry*, at 4-11 (describing characteristics of staff attorneys and their offices).

147. *See id.* at 8.

148. 1993 WL 284462 (Conn. Super. Ct. July 27, 1993).

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> employee relationship. That attorney may have no remedy at all.[149]

It is also worth noting that outside defense lawyers may suffer more disasterous consequences when they lose insurance company referrals than staff attorneys do when they are fired. Generally speaking, a discharged employee can find a new job more easily than a discharged law firm can find a new income stream. When an outside law firm relies on an insurance company for a large part of its work, termination means that lawyers, paralegals, and secretaries must be let go, that payrolls may not be met, that office space subject to long-term leases may not be needed, that bank loans may be difficult to repay. It must be harder for an outside defense lawyer to risk these consequences than it is for a staff attorney to risk losing a job.

That staff attorneys sometimes bend over backwards to protect insureds is also evident from a dispute brewing in New York.[150] At many insurance companies, claims personnel regularly audit defense lawyers' files. Even so, when Sentry Insurance Company's home office attempted to audit the files of Huwel & Mulhern, its New York staff counsel, the attorneys put up a fight. They feared that claims personnel would discover information that could be used to the detriment of their insured-clients. For example, Sentry might withdraw its defense after discovering coverage-related information or information concerning an insured's failure to cooperate. The attorneys therefore sought an opinion on the permissibility of the proposed audit from Bruce Green, a professor of legal ethics at Fordham Law School. He told them that they could not allow Sentry to examine their files without policyholders' consent. When Sentry persisted in its effort to conduct the file audit, Huwel & Mulhern applied for a preliminary injunction restricting Sentry's access and for a declaratory judgment stating that policyholder consent had to be obtained first.

Whatever one thinks of the merits of Huwel & Mulhern's position—a matter that is open to debate[151]—their willingness to act as they did

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149. *Id* at *7.

150. *See,* Huwel & Mulhern v. Sentry Insurance, No. 97-004478 (N.Y. Spec. Term filed February 18, 1997).

151. Because I participate in an attorney-client relationship with Edwin Mulhern, I will refrain from commenting on the merits. All of the information about the dispute mentioned in this article is available in the pleadings and is cited here with Mr. Mulhern's consent.

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demonstrates that staff attorneys are aware of their professional responsibilities and sometimes make independent judgments about them. Having talked with dozens of staff attorneys and heads of staff counsel operations, I can attest that Edwin Mulhern and George Huwel are not unusual in this respect. As a group, staff attorneys are sensitive to ethical issues. Insurance companies like them that way. Both because staff counsel operations are still somewhat controversial and because insurers are on the hook for staff attorneys' mistakes, insurance companies want their lawyers to be above reproach and to serve insureds well. Most staff attorneys I have met are happy to comply with these directives.[152]

Heightened awareness of ethical issues and commitment to policyholder service may help explain the impressive record of policyholder satisfaction staff attorneys have achieved. After scouring the literature on the ethics of staff counsel operations and presenting drafts of this essay to numerous audiences of law professors and lawyers, I can state with confidence that there are no reported cases in which policyholders have successfully sued staff attorneys for legal malpractice or other breach of duty. The compendious Legal Malpractice, in its 1996 edition, lists only one reported opinion, *Bevevino v. Sydjari*,[153] finding negligence on the part of a staff attorney, and *Bevevino* was not a malpractice case. It was a case in which a judge cited a staff attorney's negligence as a reason for refusing to set aside a verdict against an insured. Importantly, the lawyer's negligence did not harm the insured. The "burden" of the judgment "f[ell] exclusively upon the [insurance] carrier."[154] If *Bevevino* shows anything, it is that insurers have incentives to encourage staff attorneys to defend cases skillfully because insurers suffer when they do a shoddy job.

The dearth of cases finding misconduct by staff attorneys completely undercuts the Kentucky Bar Association's claim that these lawyers cannot be trusted to protect insureds. If that were true, one would expect to find a record of adjudicated complaints. But there is no record. Whether because

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152. Because of the high-mindedness and professionalism of the many staff attorneys I have encountered, I am greatly disturbed by the willingness of judges to assume the worst about them. Thus, the dissenting opinion in *In re Allstate Insurance Co.*, 722 S.W.2d 947 (Mo. 1987) (en banc), observed "that anyone who believes that in conflict of interest situations, a salaried lawyer employee of Allstate would not place the welfare of the corporation above that of the policyholder . . . probably also believes in the Tooth Fairy and the Easter Bunny." *Id.* at 959. Comments like these reflect gross ignorance of staff attorneys and the manner in which they conduct themselves.

153. 76 F.R.D. 88 (S.D.N.Y. 1977), *cited in* MALLEN & SMITH, *supra* note 3, § 28.5 at 498 n.3.

154. *Id.* at 94.

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staff attorneys consistently provide superior service, because insurers refer cases with significant conflict potential to outside attorneys,[155] or because insurers make good on staff attorneys' mistakes,[156] policyholders are safe in staff attorneys' hands.

The last possibility is worth exploring. In the course of preparing this article, I talked with many high-level officers in staff counsel operations. All assured me that staff attorneys occasionally make mistakes but that their companies immediately cover any losses to policyholders that result. Why do companies automatically rescue their insureds? Partly to maintain good relations, and partly because they know they must. Courts will hold them liable for staff attorneys' mistakes because staff attorneys are employees. In the technical language of agency law, they are servants, and it is blackletter law that an employer is liable for torts a servant commits when acting within the scope of employment.[157]

By contrast, outside defense lawyers are independent contractors, and the blackletter law is that "a principal is *not* liable for torts committed by an independent contractor in connection with his work."[158] In keeping with this rule, courts in many jurisdictions have refused to hold insurers impliedly liable for outside defense lawyers' mistakes.[159] It may well be, then, that insureds are better protected against malpractice and other lawyer-errors when they are represented by staff attorneys. Liability carriers have stronger incentives to ensure that staff attorneys act correctly in the first place and can be relied upon to protect insureds from the consequences of misconduct because their liability for staff attorneys' errors is clear.

Another argument advanced in *AIA* against staff counsel operations is that they involve liability insurers in the corporate practice of law, which is illegal in Kentucky and many other states.[160] The gist of the argument is

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155. *See, e.g.*, State Farm, *supra* note 98, at 7 (stating that staff attorneys are not to handle cases "where coverage questions and/or policy violations exist which are not resolved before assignment").

156. A third possibility is that suits involving staff attorney misconduct take the form of bad faith actions against insurance companies rather than malpractice actions against staff attorneys themselves. The number of these lawsuits is not known, but insurer liability for staff counsel blunders is not a prominent theme in the literature on bad faith.

157. *See* ROBERT W. HAMILTON, BUSINESS ORGANIZATIONS §§ 2.6 & 2.7 (1996).

158. *Id.* at § 2.7, 16 (emphasis added).

159. For an exhaustive list of cases refusing to imply liability, see MALLEN & SMITH, *supra* note 3, § 28.4 at 495 n.7.

160. Unauthorized practice issues connected with staff counsel offices are now being studied in Texas and West Virginia.

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that corporations cannot be licensed to deliver legal services to the public, and that insurance carriers that use employed staff attorneys to defend insureds run afoul of this prohibition. The overwhelming majority of jurisdictions have rejected this argument,[161] as has the ABA Committee on Professional Ethics. In a 1950 opinion, it rejected the assertion that staff attorneys "lend [their] services to the 'unauthorized practice of law'" by defending insureds.[162]

Although the line between the authorized and the unauthorized practice of law can be difficult to draw, here it is clear. Corporations act permissibly when they use employee-attorneys to represent themselves on matters in which they are directly interested. Corporations act impermissibly when they use employee-attorneys to provide legal services to others on matters in which they are not directly interested. Because staff attorneys protect insurers' interests in cases in which insurers have clear, pre-existing financial stakes, insurance companies do not engage in the corporate practice of law by using staff attorneys to defend liability suits against insureds. "[A] salaried insurance company lawyer is a true house counsel" who helps protect an employer's interests.[163]

A typical case applying the analysis just described is *Strother v. Ohio Casualty Insurance Company*,[164] decided in 1939.

> In my opinion the insurance company has a right to protect [its] pecuniary interest, and has a right to do so by attorneys of its own choosing; that such procedure is not the practice of law in any sense of the word. The company is simply protecting its own rights in that litigation by having counsel of its own choosing to represent it; it makes no difference whether the attorneys are hired by the case, whether they are hired by the year or whether they are the same attorneys in each and every case, or whether the company changes attorneys with each and every case,

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161. For a careful presentation of the cases and advisory opinions, see Jackson & Cohen, *supra* note 106, at 3-6. *See also* Jordan & Kahn, *supra* note 131, at 27 n.8 (listing cases).

162. ABA Comm. on Professional Ethics and Grievances, Formal Op. 282 (1950). See also ABA Comm. on Ethics and Professional Responsibility, Informal Op. 1402 (1977) (affirming Formal Op. 282).

163. Ted Schneyer, *Professionalism and Public Policy: The Case of House Counsel*, 2 GEO. J. LEGAL ETHICS 449, 463 (1988).

164. 1939 Ohio Misc. LEXIS 1184 (Ohio C.P. Jan. 3, 1939).

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> so long as the company does not employ laymen to do any of these acts, it is not engaged in the practice of law.[165]

Strother is important for its age as well as its message. The primary purpose of unauthorized practice restrictions is to ensure that the public receives legal services of appropriate quality. For at least 58 years, staff attorneys have defended insureds in Ohio and the state has perceived no danger to the public sufficient to warrant a change in policy.[166]

Kentucky law formerly distinguished between permissible and impermissible corporate activities in the same manner as other jurisdictions. An opinion recognizing the distinction and relied upon in *AIA* is *Hobson v. Kentucky Trust Co. of Louisville.*[167] *Hobson* observed as follows:

> Other matters of a legal nature which are held to be an illegal practice of law by a corporation include the maintenance of a legal department to give free legal advice, the furnishing of legal services for members of a protective association, and the maintenance of a collection agency, *but not the mere fact of paying the expenses of a particular litigation or the retainer of an attorney on an annual salary basis to attend to and conduct a corporation's own legal business.*[168]

In turn, *Hobson* relied upon *Hexter Title & Abstract Co. v. Grievance Committee,*[169] a Texas case. In *Hexter Title*, a title company was attacked by the bar for preparing "deeds conveying land in which it own[ed] no interest, . . . notes, mortgages, and deeds of trust in which it ha[d] no interest as borrower or lender, . . . mechanic's and materialmen's lien

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165. *Id.* at *10-11 (quoted in Jordan & Kahn, *supra* note 131, at 27-28).

166. Ohio recently flip-flopped on a different issue, namely, whether staff attorneys can permissibly pursue subrogation claims and recover deductibles from tortfeasors on behalf of insureds. *Compare* Ohio Discipline Op. 94-9 (1994) (disallowing collection of deductibles) *with* Ohio Discipline Op. 95-14 (1995) (allowing collection of deductibles and reversing Op. 94-9). The controversy centered on conflicts of interests, not unauthorized practice of law. *See* Robert J. Johnson, Comment, *In-House Counsel Employed by Insurance Companies: A Difficult Dilemma Confronting the Model Code of Professional Responsibility*, 57 OHIO ST. L. J. 945 (1996).

167. 197 S.W.2d 454 (Ky. 1946).

168. *Id.* at 460 (emphasis added).

169. 179 S.W.2d 946 (Tex. 1944).

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contracts to which it was not a party, and . . . releases, transfers, subordination agreements and other instruments affecting title to real estate and liens thereon in which it does not own and is not acquiring an interest therein."[170] In upholding the bar's challenge, the Texas Supreme Court emphasized both that the title company prepared legal "papers relat[ing] to the rights of third parties in which the corporation ha[d] no present interest" and that the papers concerned matters other than searching and insuring titles, the business in which the company was directly involved.[171] The defendants in *Hobson* had engaged in analogous behavior. They were banks and trust companies that drafted wills, deeds, trust instruments, and other legal documents for customers.[172] Because the defendants were not protecting their own financial interests by drafting these documents, they were delivering legal services to the public and engaging in the unauthorized practice of law.

Kentucky cases decided after *Hobson* also recognize this distinction. For example, in *Frazee v. Citizens Fidelity Bank & Trust Co*[173]., the Court of Appeals stated that "[s]ince our opinion in the *Hobson* case, we have held that preparing and filing petitions for probate of wills, appointment of administrators and final settlement in county court, is unauthorized practice of law *when done voluntarily by persons without a beneficial interest in the corpus of the estate.*"[174] *Kentucky State Bar Association v. First Federal Savings & Loan Association of Covington*,[175] a pre-*Frazee* case, is not to the contrary. In *First Federal*, the Court of Appeals prohibited a lender from having a salaried attorney provide title opinions to borrowers on properties submitted for mortgage loans. It did so after expressly finding that the bank charged borrowers for the service and that title examinations were "made primarily for the benefit of the borrower" rather than to protect an existing financial interest of the corporation.[176]

Clearly, Kentucky precedent gave the Supreme Court considerable freedom to permit insurance companies to use staff attorneys to defend liability suits. Suits against policyholders directly impact insurers' pre-existing financial interests. Therefore, insurers can use employee-

170. *Id.* at 950.
171. *Id.* at 952.
172. *Hobson*, 197 S.W.2d at 456.
173. 393 S.W.2d 778 (Ky. 1964).
174. *Id.* at 782 (emphasis added).
175. 342 S.W.2d 397 (Ky. 1960).
176. *Id.* at 398.

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attorneys to protect themselves without engaging in the unauthorized practice of law.

This conclusion is fully consistent with the purpose of Kentucky's unauthorized practice statute, which is to protect the public from the incompetent, the untrained, and the unscrupulous in the practice of law.[177] Insurance companies number among the most sophisticated consumers of legal services. They can be expected to outfit themselves with competent attorneys when their own interests are at stake. There is simply no reason to fear that, when insurers use staff attorneys to defend claims, either insurers or policyholders will be disserved.

CONCLUSION

As the debate over the professional responsibilities of insurance defense lawyers continues, it is important to remember that nothing less than the freedom of clients and lawyers to enter into consensual relationships is at stake. Restrictions on flat fees and staff counsel operations cut into the freedom insurance carriers and policyholders have to arrange for their legal needs on terms that they find advantageous and that lawyers are willing to accept. These restrictions therefore pose the straightforward danger of forcing carriers and policyholders to endure deficient arrangements.

The interests of lawyers who want to work as staff attorneys and who like flat fees must also be considered. Some lawyers win when flat fees and staff counsel operations are barred, but other lawyers lose. The losers are lawyers who want to work as staff attorneys because they are tired of rainmaking, because they wish to log fewer hours, because they want to specialize in particular kinds of cases, or because they like the salaries and benefits insurance companies provide. The losers are also lawyers who are willing to accept a degree of risk in return for a large volume of work and a promise of being paid promptly on the completion of every case. Absent a reason for favoring some lawyers over others, the law should leave all lawyers free to find the employment and compensation plans they prefer.

When thinking about issues relating to the defense of liability suits against policyholders, it is important to put aside any preconceived notions one may have about policyholders, insurers, and lawyers. There are no bad guys here. There are only lawyers and clients, each possessing important interests, obligations, and rights and each participating in relationships

177. *See Frazee*, 393 S.W.2d at 782.

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with others. It can be hard to trace the relationships and to figure out what the interests, obligations, and rights require. The task becomes easier when one approaches it with an open mind, with patience, and with real respect for the ability of the participants to figure out what works best for them.

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THE ETHICAL DUTIES OF INSURANCE DEFENSE LAWYERS: ARE SPECIAL SOLUTIONS REQUIRED?

*Nancy J. Moore**

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INTRODUCTION

> *These relationships among a liability insurer, its insured, and the attorney chosen by the insurer to represent the insured, are sui generis. The canons and disciplinary rules do not address themselves frankly and explicitly to this special set of relationships, and there is awkwardness in attempts to apply the canons and rules.*
>
> *–Moritz v. Medical Protective Company of Fort Wayne, Indiana*[1]

[C]onflict rules, the application of which turns on client identity, apply straightforwardly to insurance defense lawyers when both insurance companies and insureds are defense lawyers' clients. We see no reason to treat insurance lawyers

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1. 428 F. Supp. 865, 871 (W.D. Wis. 1977).

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different from other lawyers with respect to the conflicts described.

–Charles Silver & Kent Syverud[2]

When Professor Silver called to invite me to serve as a commentator on his paper,[3] he was kind enough to suggest that I need not limit myself to the issues he was addressing, but rather that I was free, indeed even encouraged, to comment on the full range of issues being addressed by these papers on the professional responsibilities of insurance defense counsel. I would like to take advantage of his gracious offer, and so I propose to address several (although not all) of the issues raised in this impressive collection of papers. However, in addressing these particular issues, I have one overarching question in mind, and that is the extent to which any or all of these professional responsibility issues are adequately addressed by applying general principles developed with respect to other types of representation, or whether insurance defense representation is in fact so unique that special solutions are required.

There are five issues that I propose to address. In Part I, I discuss the three questions that have most troubled the profession historically, perhaps because they concern the fundamental nature of the relationship among the three parties to the so-called "tripartite relationship,"[4]—the attorney, the insurer, and the insured. These questions are: (1) how many clients does the attorney have; (2) if the attorney has two clients, how are conflicts issues resolved; and (3) if the insured is the only client, what is the ethical propriety of the attorney permitting the insurer to direct the representation? I conclude that neither the two-client nor the one-client model works satisfactorily under current professional responsibility law. Nevertheless, there appears to be a consensus that any radical departures from current insurance defense practices would entail far more cost than any expected benefits would justify. As a result, most courts and commentators seem willing to settle for something less than "ideal"compliance with the requirements of typical lawyer codes.[5] I agree that

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2. Charles Silver & Kent Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 DUKE L.J. 255, 314-315 (1995).

3. *See* Charles Silver, *Flat Fees and Staff Attorneys: Unnecessary Casualties in the Continuing Battle Over the Law Governing Insurance Defense Lawyers*, 4 CONN. INS. L.J. 205 (1997).

4. *See* RONALD E. MALLEN & JEFFREY M. SMITH, LEGAL MALPRACTICE § 28.3 (4th ed. 1995) (discussing the "tripartite relationship").

5. *See* Thomas D. Morgan, *Whose Lawyer Are You Anyway?* 23 WM. MIT. L. REV. (forthcoming 1998) (a version of this article was presented as the 1996 Pirsig Lecture at William Mitchell College of Law on Apr. 11, 1996). *See* Part I.D.

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accommodations may be warranted, but I am concerned that they not be readily extended to other types of third-party payment situations, many of which pose dangers far more serious than does insurance defense representation.[6]

In Part II, I address the two questions raised by Professor Silver in his present paper: 1) the ethical propriety of an attorney entering into a contract with an insurer agreeing to do all the insurer's defense work for a flat fee; and 2) the ethical propriety of an insurer using staff attorneys to represent its insureds. These latter two questions are relatively new and thus have not yet received the intense attention and passionate debate that the former questions have already received. Regarding the ethical propriety of flat fees, I agree with Professor Silver that under traditional professional responsibility law, an absolute prohibition on this practice is probably unjustified. Nevertheless, arguably this is a situation where the unique aspects of insurance defense representation warrant taking *additional* precautions in order to protect the interests of insureds. As for the use of insurer staff attorneys to defend lawsuits against the insured, I am similarly skeptical of the extent to which this practice is ethically warranted. In any event, the current practice of many such staff attorneys of attempting to falsely portray themselves as independent attorneys is clearly unethical, and insureds are, at the very least, entitled to know the precise status of their attorney as a salaried employee of the insurance company.

I. THE NATURE OF THE TRIPARTITE RELATIONSHIP

A. Who Does the Insurance Defense Attorney Represent?

There has been much debate, both historically and recently, whether the insurance defense attorney represents one client or two,[7] or perhaps even "one-

6. I address these dangers at greater length in Nancy J. Moore, *in Third-Party Payment: Beyond the Insurance Defense Paradigm*, 16 REV. LITIG. 585 (1997). That paper was prepared for and presented at a Symposium on Conflicts of Interest co-sponsored by the Review of Litigation and the Texas Center for Ethics and Professionalism in February 1997 in Austin, Texas.

7. *See, e.g.*, Stephen L. Pepper, *Applying the Fundamentals of Lawyers' Ethics to Insurance Defense Practice*, 4 CONN. INS. L.J. 27 (1997) (although not unproblematic, the one client view is preferable); Charles Silver, *Does Insurance Defense Counsel Represent the Company or the Insured?*, 72 TEX. L. REV. 1583 (1994) (lawyer represents both insured and insurer if retainer agreement so provides); Scott L. Machanic, *Insurance Defense Counsel: Who Is the Client?*, 43 FED'N INS. & CORP. COUNS. Q. 45 (1992) (parties and courts typically assume the lawyer represents both insured and insurer); Richard L. Neumeier, *Serving Two Masters: Problems Facing Insurance Defense Counsel and Some Proposed Solutions*, 77 MASS. L. REV. 66 (1992) (majority rule is that attorney represents both insured and insurer); Robert E. O'Malley, *Ethics Principles for the Insurer, the Insured, and Defense Counsel: The Eternal*

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and-a-half."[8] Most of the debate concerns the difficulty of resolving the conflicts of interest issues that arise under these scenarios.[9] However, Professor Silver now suggests that this entire debate is misguided because it mistakenly ignores fundamental law regarding the formation of the attorney-client relationship.[10] Thus, Professor Silver notes that under contract law these relationships are determined by the agreement of the parties themselves, not by ethics committees or (even worse) ethics scholars indicating their own preference as to what those relationships should be.[11]

As a result, Professor Silver's answer to the age-old question is quite simple: "Because attorney-client relationships arise consensually, whether

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Triangle Reformed, 66 TUL. L. REV. 511, 512 (1991) (insured should be the only client in every case); Debra A. Winiarski, *Walking the Fine Line a Defense Counsel's Perspective*, 28 TORT & INS. L.J. 596, 597 (1993) (better view is that lawyer's only client is the insured).

8. Charles Silver & Michael Sean Quinn, *Wrong Turns on the Three Way Street: Dispelling Nonsense About Insurance Defense Lawyers*, 5 COVERAGE 1, 11-13 (Nov./Dec. 1995) (ridiculing the position taken in State Bar of Cal. Standing Comm. on Professional Responsibility and Conduct, Formal Op. 1995-139 [hereinafter Cal. Formal Op. 1995-139]). *See infra* notes 79-83 and accompanying text. *See also* Pepper, *supra* note 7, at 68-71 (discussing and ultimately rejecting what he characterizes as the "defeasible client" model). According to this third alternative, initially the lawyer may be deemed to represent both insurer and insured, but when a conflict arises, the insurer ceases to be a client, at least in the usual sense. *See* Cal. Formal Op. 1995-139, *supra*; Pepper, *supra* note 7 at 68. *See also* Karon O. Bowdre, *Conflicts of Interests Between Insurer and Insured: Ethical Traps for Unsuspecting Defense Counsel*, 17 AM. J. TRIAL ADVOC. 101, 111 (1993) (in conflict settings defense counsel's only client is the insured).

9. *See, e.g.*, Pepper, *supra* note 7.

10. *See* Silver, *supra* note 7, at 1603-06. *See also* Silver & Syverud, supra note 2, at 273-75.

11. Silver states:

> Bearing in mind the contractual nature of attorney client relationships, it begins to seem extraordinary that judges, rule-makers, advisory committees, and commentators would presume to declare—for all times, places, and purposes – whether an attorney-client relationship exists between defense counsel and a primary carrier. It seems arrogant to espouse either the one-client or the two-client view. What standing has an outsider to assert or to deny that a lawyer represents a company or an insured when the interested parties are free to decide the matter for themselves?

Silver, *supra* note 7, at 1606. *Compare with* Nancy J. Moore, *Expanding Duties of Attorneys to 'Non-Clients': Reconceptualizing the Attorney-Client Relationship in Entity Representation and Other Inherently Ambiguous Situations*, 45 S.C. L. REV. 659, 679-87 (1994) (arguing that courts should shift from a contract- to tort-based standard for determining the attorney-client relationship).

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defense counsel has one client or two depends upon the agreement that counsel enters into when retained."[12]

Of course, Professor Silver is absolutely right. At one level, whether the insurer is a client of the attorney is a decision for the insurer (and the attorney) to make. The attorney-client relationship, like other agency relationships, generally arises by agreement,[13] and "[a] defense lawyer who undertakes to represent both a company and an insured has two clients and is a fiduciary with respect to both parties."[14] I have no doubt that most proponents of the "one-client" view would be happy to acknowledge this point, so long as it is clearly understood that it does not entail a view as to the ethical propriety of any joint representation.[15] Thus, they would probably agree that an attorney-client

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12. Silver & Syverud, *supra* note 2, at 272. *See also* Silver, *supra* note 7, at 1604 ("whether and to what extent defense counsel represents an insurance company depends on the retainer agreement between the two"). My apologies to Professor Syverud and to Professor Silver's other co-authors for consistently omitting their names in the text of this article. I have attributed to Professor Silver the view expressed in a body of work, some authored solely by him and some co-authored, and for ease of reference have decided to use him as my sole "target."

13. *See* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 26(1)(a) (Prop. Final Draft No. 1, Mar. 29, 1996) (hereinafter RESTATEMENT) (relationship arises when a "person manifests to a lawyer the person's intent that the lawyer provide legal services for the person" and "the lawyer manifests to the person consent to do so"). The Restatement also acknowledges that an attorney-client relationship sometimes arises even in the absence of mutual consent; for example, when "a person manifests to a lawyer the person's intent that the lawyer provide legal services for the person" and "the lawyer fails to manifest lack of consent to do so, and the lawyer knows or reasonably should know that the person reasonably relies on the lawyer to provide the services." *Id.* § 26(1)(b). While this situation is unlikely to arise in the insurance defense context—because the insurer is a sophisticated repeat player likely to enter into formal retainer agreements with the lawyer—it may indeed be significant in other instances of third party payment. *See* Moore, *supra* note 6 (discussing the applicability of Restatement § 26 in situations where lawyer is hired by an employer or parent to provide representation involving the interests of an employee or child). *See generally* Moore, *supra* note 11 (arguing in favor of a tort based reasonable reliance test to supplement the more traditional contractual basis of the attorney-client relationship).

14. Silver & Syverud, *supra* note 2, at 275.

15. *See* Silver, *supra* note 7, at 1606 (acknowledging the normative argument that accepting the one client view might avoid potentially impermissible conflicts but insisting that normative arguments are unwarranted when the sole question is whether the attorney-client relationship has been established). Professor Pepper argues that even " the *creation* of a joint client relationship requires informed consent from both clients . . . ." Pepper, *supra* note 7, at 29. However, what I think he means here is that creation of an *ethically proper* joint client relationship requires informed consent from both clients, since it is clear to me that an attorney could create an *ethically impermissible* joint client relationship in a number of ways; for example, by failing to properly advise multiple clients of a conflict of interest, by secretly agreeing to represent one party while representing another, or by unknowingly representing multiple parties with conflicts of interests, as when different lawyers in the same firm agree to represent multiple parties without doing an adequate conflicts check. In all these situations, the

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relationship can exist *even when the relationship blatantly violates conflict of interest rules*. Moreover, it is important to acknowledge this fact because such attorneys would owe duties to both their clients, each of whom would then be in a position to sue the attorney for legal malpractice if these duties are breached.[16]

Under this view, what is involved thus far is simply a miscommunication between Professor Silver and his critics: they are talking past each other. What the "one-client" proponents really mean to say is that representation of both clients is (or ought to be) deemed unethical and therefore prohibited under applicable rules of professional responsibility. Similarly, if a court holds that the attorney represents only the insured and not the insurer, what it really means is that the attorney could not *ethically* represent both, and therefore, the attorney owes the insured its undivided loyalty *as if it had agreed only to represent the insured.*[17] Of course, all this does is shift the discussion from how many clients does the lawyer represent to how many clients may the lawyer *properly* represent under the law of professional responsibility. Even here, however, it may be important to note a distinction between two possible conclusions that a "one-client" proponent might make: 1) joint representation necessarily violates current professional responsibility rules;[18] or 2) joint representation does not necessarily violate current rules but is sufficiently problematic that in order to avoid rule violations, attorneys should either refuse to represent more than one client (i.e., for prudential reasons) or the rules should be interpreted (or amended) to prohibit joint representation, as a prophylactic measure.[19]

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lawyer has breached a fiduciary duty owed to each client, and each client should be able sue the lawyer for malpractice if as a result of this breach (or of some other failure to conform to the appropriate standard of care) the client has suffered legally compensable damages.

16. *See, e.g.* RESTATEMENT, *supra* note 13, at 73 (addressing the limitations on lawyers' duties to non-clients).

17. In those decisions in which courts have held that the attorney does not represent the insurer, the insurer typically has not made arguments similar to those made by Professor Silver. Indeed insurers have often simply assumed, as do many commentators, that the existence of a conflict determines whether there is an attorney-client relationship with the insurer. *See, e.g.*, Atlanta Int'l Ins. Co. v. Bell, 475 N.W.2d 294, 300 (Mich. 1991) (insurer had argued that "[s]ince there was no conflict of interest between the insured and the insurer, a concurrent attorney-client relationship existed between the attorney and the insured and the insurer" (quoting the dissent); although the court rejected this argument, the majority permitted the insurer to sue the attorney for malpractice on the theory of equitable subrogation).

18. This appears to be the position taken by Professor Pepper. *See* Pepper, *supra* note 7, at 33-42. *See also* Silver, *supra* note 7, at 1608 ("[I]f there is a place for a normative argument, it must be to show that, for some reason, it is impermissible for defense counsel and the insured at the same time").

19. *See, e.g.*, 1 GEOFFREY C. HAZARD, JR. & W. WILLIAM HODES, THE LAW OF LAWYERING: A HANDBOOK ON THE MODEL RULES OF PROFESSIONAL CONDUCT § 1.7:303 at 256.1

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One final caveat. Professor Silver is clear that the attorney-client relationship begins, both for the insured and for the insurer (if the insurer so desires), not at the time of the signing of the insurance contract between the insured and the insurer, but rather at the time that the insurer, upon the request of the insured, enters into a retainer agreement with the attorney.[20] If it is solely up to the insurer and the attorney whether the attorney represents two clients instead of one, then what do we make of the fact that the insured is not a direct party to these discussions?[21] Professor Silver agrees that the provision of the insurance contract authorizing the company to select counsel does not in itself imply the insured's consent to any joint representation and that further argument is necessary.[22] Professor Silver further argues the following:

> [A]n insured who demands a defense thereby consents both to representation by company-selected counsel and to joint representation *because of the context in which the demand is presented.* The company is entitled to control the defense. The company expects to take the helm and can defend the liability suit effectively only if it is a co-client.... In these circumstances, it is proper to conclude that the insured, by demanding a defense, impliedly agrees to allow the company to become a co-client.[23]

There is considerable disagreement whether the insurer's right to control the litigation depends on its status as a co-client. More important, even if it were true that the insurer's status as a co-client is "a pre-condition for the company's exercise of the powers the liability contract conveys,"[24] this is not a fact that the average insured is likely to know. While it may be sufficient under general contract law to imply terms essential to performance of the contract,[25] it would certainly not be sufficient to constitute informed consent to a conflict of interests under professional responsibility law.[26] Professor

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(1996 Supp.) ("[s]ome of these [conflicts] problems may be obviated by treating the lawyer as attorney for the insured alone"). *See also* John K. Morris, *Conflict of Interest in Defending Under Liability Insurance Policies: A Proposed Solution*, 1981 UTAH L. REV. 457, 465.

20. *See* Silver, *supra* note 7, at 1604.

21. *See* Pepper, *supra* note 7, at 39.

22. *See* Silver & Syverud, *supra* note 2, at 284 & n.72.

23. *Id.* at 284-85 (emphasis added).

24. Silver & Syverud, *supra* note 2, at 285.

25. *See id.* at 285 n.75 (citing RESTATEMENT (SECOND) OF CONTRACTS § 204 (1981)).

26. *See infra* notes 28-31 and accompanying text.

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Silver would probably agree;[27] however, it appears that it is further his opinion that in most instances of insurance defense representation, there is no conflict of interest that requires the kind of truly informed consent anticipated by professional responsibility law, at least at the outset of the representation.[28] Here we must confront the conflicts question directly.

B. Conflicts of Interest Under the "Two-Client" View

When Professor Silver suggests that there is typically no conflict of interests between insurer and insured at the outset of the representation, he is referring to the vast majority of cases in which "the existence of insurance coverage is clear and the amount of coverage is clearly sufficient to cover the insured's exposure to liability,"[29] i.e., the "full coverage situation."[30]

Even here, however, Professor Silver concedes that there may well be disagreements between the insurer and the insured over the conduct of the litigation. Some examples of this include: (1) the insured's concern over the side effects of litigation, such as publicity, reputation or about a personal or business relationship with the plaintiff; (2) the preference of the insured for a more expensive effort than the insurer is willing to make; (3) the possibility that the insurer has some additional interest in the outcome of a particular lawsuit, such as its desire to obtain a precedential ruling that will benefit the insurer in other cases; and (4) the possibility that either insurer or insured will seek to manipulate or coerce the other into agreeing to perform beyond its requirements under the insurance contract.[31] However, the professor's view appears to be that conflicts requiring informed consent do not arise unless and until these possibilities become at least a significant likelihood.[32]

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27. *Cf.* Silver, *supra* note 7, at 1621 ("ordinary and reasonable expectations of insureds" has a bearing on the appropriate default rule regarding the proper scope of representation of the insured).

28. This position is not stated directly in Professor Silver's prior publications, although it is clearly implied. *See, e.g.*, Silver & Syverud, *supra* note 2, at 327-28 (authors do not discuss applicability of Model Rule of Professional Conduct 1.7(b) until they confront post-retention developments signaling that the insurer and the insured in fact have differing interests in the conduct of the litigation, e.g., where in an initial client interview, the insured informs the attorney that he strongly prefers avoiding having to testify because his wife will learn that he was with another woman at the time of the events subject to the lawsuit).

29. Silver & Syverud, *supra* note 2, at 263.

30. *Id.* Even in the situation where the insured faces excess coverage, Professor Silver apparently believes that excluding settlement from the scope of the lawyer's retention avoids raising even a potential conflict of interests under Rule 1.7(b). *See id.* at 296-298.

31. *See id.* at 266-67.

32. *See id.* at 326-328 (authors' first discussion of Rule 1.7(b) comes in contexts of conflicts arising in course of representation); *See also* Counsel Connect posting by Charles Silver, Mar. 25, 1996 (on file with author) ("As far as I can tell, MR 1.7(b)(2) would not apply at the outset in most insurance defense representations. . .").

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Professor Silver is undoubtedly correct that this view is apparently supported by an absence of either cases or ethics opinions indicating that informed consent under applicable conflicts rules is required at the outset of insurance defense representation, at least in the "garden variety full-coverage situations." But along with proponents of the "one-client" view, I question whether this is a conclusion warranted under professional responsibility law. Under Model Rule of Professional Conduct 1.7(b), informed consent is required whenever the representation of a client "may be materially limited by the lawyer's responsibilities to another client."[33] It has not always been clear how probable it must be that the material limitation will occur before this provision is triggered;[34] however, the Restatement of the Law Governing Lawyers suggests that there is no conflict of interest unless there is a "substantial risk" that a material adverse effect will occur.[35] Clearly consent is required whenever the material adverse effect is "immediate, actual, and apparent."[36] When the risk is only "potential or contingent," however, it is enough if the risk is "significant and plausible, even if it is not certain or even probable that it will occur."[37] How is one to evaluate the significance of the risk of material limitation at the outset of insurance defense representation?

Professor Steven Pepper believes it is sufficient that "there are obvious *potential* conflicts of interests between the two clients at the inception of the relationship."[38] His theory relies on a literal reading of the "may be materially limited" language in Rule 1.7(b). This language, however, is not very helpful, since it is hard to imagine an instance of dual representation in which a conflict

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33. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7(b) (1983) (hereinafter MODEL RULES):

> (b)A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests unless
>
> (1) the lawyer reasonably believes the representation will not be adversely affected; and
>
> (2) the client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.

34. *See, e.g.*, Kevin McMunigal, *Rethinking Attorney Conflict of Interest Doctrine*, 5 GEO. J. LEGAL ETHICS 823, 843-53 (1992) (ambiguity in defining "conflict of interest" stems from failure to maintain clear distinction between risk and resulting harm).

35. *See* RESTATEMENT, *supra* note 13, § 201 cmt. c(iii) (1996).

36. *Id.*

37. *Id.*

38. Pepper, *supra* note 7, at 29.

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is not theoretically *possible*. Thus, the Restatement adopts the alternative language of "substantial risk."

Further, Professor Pepper relies on two examples which seem clearly inapposite. He suggests that dual representation of insurer and insured is analogous to a lawyer putting together a partnership on behalf of investors with different interests or to a lawyer representing spouses seeking an amicable divorce who have already agreed on the terms of any custody or property settlement.[39] But surely both these situations involve a far greater likelihood that actual conflicts will emerge than in the routine insurance defense case. Indeed, in the divorce situation, Professor Pepper himself concedes that many lawyers believe that "conflict is *so likely* that joint representation ought to be prohibited,"[40] even with the clients' consent. Moreover, regardless of the lack of any present disagreements, it is also clear in both situations that the lawyer's independent professional judgment in helping each party determine what agreement would be in his or her best interest is materially limited from the very outset of the representation. This is so even in the divorce situation, where it is assumed that the parties have already worked out an agreement, since an independent lawyer for either the husband or the wife would necessarily review such an agreement for any obvious inequities and point them out for the client's consideration.[41]

Let me posit what I believe to be a better analogy. The most common situation in which lawyers represent multiple clients in the same transaction is the drafting of agreements necessary for the sale of residential real estate.[42] Assuming that the contract of sale has already been signed, the likelihood that any material limitation will occur is highly remote.[43] Nevertheless, joint representation has traditionally been allowed, *so long as there has been disclosure and consent.*[44] Most typically, courts and commentators have agreed to permit the representation because subsequent disputes between the parties arise only infrequently; however, none suggest that the infrequency of such disputes means that disclosure and consent are not required, from the very outset of the representation. This is probably because although subsequent conflict is rare, the harm caused in those few cases can be quite severe;[45] moreover, it is virtually impossible to identify at the outset the cases in which

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39. *See* Pepper, *supra* note 7, at 30.

40. Pepper, *supra* note 7, at 4 (emphasis added).

41. *See* Nancy J. Moore, *Conflicts of Interest in the Simultaneous Representation of Multiple Clients: A Proposed Solution to the Current Confusion and Controversy*, 61 TEX. L. REV. 211, 250 (1982).

42. *See id.* at 258.

43. *See id.* at 260.

44. *See id.* at 258-59.

45. *See id.* at 259-60.

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such harm is likely to occur. Moreover, when unresolvable problems do arise, the joint attorney may be uncertain how to proceed, and while attempting to accommodate the interests of both clients, the attorney might cause one or both clients to suffer harm, including but not limited to the expense of retaining new attorneys.[46]

Ordinarily, there is a strong public interest in casting the net broadly in the determination whether even a potentially impermissible conflict is present. While "a mere possibility of adverse effect" may be insufficient,[47] in most cases it is important for clients to understand even the remote possibility of significant risk, in order for such clients to make appropriately informed decisions in selecting their attorneys. Thus, it is unthinkable that an attorney could accept representation of the buyer in a residential real estate transaction while *secretly* representing the seller in that very same transaction. Yet, absent a conflicts trigger under Rule 1.7(b), disclosure of even the fact of the multiple representation is nowhere required. Surely it is just as unthinkable that an attorney could agree to represent an insured *while secretly representing the insurer*, and yet absent acknowledgment that a conflicts analysis is triggered under Rule 1.7(b), it is unclear how such disclosure is required.[48]

For example, Professor Silver argues that an attorney representing two clients is obligated to inform each client of any relevant information disclosed by the other client.[49] Assuming that this proposition is correct, it would seem critical for both clients to understand *from the outset* that they can have no expectation of confidentiality with the common attorney. Professor Silver does not concede this point: for him, the duty of confidentiality need not be waived because the duty does not exist in a situation involving co-clients.[50] This rather

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46. *See id.* at 262.

47. *See* RESTATEMENT, *supra* note 13, § 201 cmt. c(iii).

48. Professor Pepper, although strongly in favor of acknowledging a Rule 1.7(b) trigger, also suggests that Rule 1.4(b) requires essentially the same disclosure and consent process. Pepper, *supra* note 7, at 33. Rule 1.4(b) requires a lawyer to "explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation." MODEL RULES, *supra* note 33, Rule 1.4(b) (1998). However, Professor Pepper does not explain which rule requires the client to decide whether or not to accept joint representation with the insurance company, and unless the client has the right to make that decision, there is no duty to inform under Rule 1.4(b). I suggest that the client's right to decide exists under Rule 1.7(b), in which case Rule 1.4(b) becomes superfluous.

49. *See* Silver & Syverud, *supra* note 2, at 346 n.214.

50. *See id.* at 344. Professor Silver mistakenly believes that the lack of duty of confidentiality to the insured is *logically* derived from the lawyer's duty, under her retainer agreement with the insurer, to keep the insurer informed of matters relating to the representation. *See id.* at 342. ("A lawyer who is required to communicate certain information to one client cannot simultaneously have a duty to another client to keep the same information confidential." *Id.*) This view is mistaken because it ignores the fundamental fact that it is the existence of conflicting duties, such as the duty of loyalty to both clients, that gives rise to the

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formalist position is certainly unappealing. Indeed, even William Barker concedes that although the insured consents to the formation of the attorney-client relationship when the insurer retains the attorney, "when the insured actually consults with the attorney, the no-secrets point must be disclosed (or the attorney may develop inconsistent obligations later on, leading to liability whether or not disclosures are passed on to the insurer."[51] Yet, there may be no legal duty to make such disclosures, just as there can be no legal duty to disclose even the fact of the dual representation, unless it is agreed that Rule 1.7(b) applies.[52]

Neither Professor Silver nor William Barker suggests any legal basis for a lawyer's duty to inform the insured either of the fact of dual representation or of the absence of a duty of confidentiality. Such a basis is indeed suggested in the most recent foray into this arena by the ABA's Standing Committee on Ethics and Professional Responsibility in Formal Opinion 96-403.[53] The specific question posed in that opinion is the ethical responsibility of a lawyer hired by the insurer to defend the insured pursuant to a contract that authorizes the insurer to control the defense and settlement of the claim in its sole discretion without consultation with the insured. The conclusion is that the lawyer may proceed with the representation of the insured at the direction of the insurer, but only if the lawyer has made "appropriate disclosure sufficient

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notion of a potentially impermissible conflict of interests under Rule 1.7(b). *Compare* ABA Comm. on Professional Ethics and Grievances *with* Canons of Professional Ethics ann. *and* Canons of Judicial Ethics ann., Canon 6 (1946) ("[A] lawyer represents conflicting interests when, on behalf of one client, it is his duty to content for that which duty to another client requires him to oppose."). *Id.* Thus a lawyer who impermissibly represents conflicting interests without getting informed consent breaches her duty (of loyalty or confidentiality) to one or both clients.

51. Counsel Connect posting by William Barker, Apr. 25, 1996 (on file with author). Mr. Barker is a practitioner and member of the International Association of Defense Counsel. He has written extensively on the professional responsibilities of insurance defense lawyers. *See* Silver & Syverud, *supra* note 2, at 257 n.4.

52. Perhaps Mr. Barker is making not a legal argument but rather a prudential one; that is, that lawyers certainly *should* make that disclosure or else they risk a subsequent legal malpractice suit. And yet, the duty must be legal or else it is unclear how the lawyer could incur inconsistent obligations with regard to confidentiality. The argument does seem to rely on the assumption that the duty of confidentiality exists to each client, unless the client waives the duty. Mr. Barker would probably then argue that it is sufficient for such a waiver that the lawyer makes the disclosure and the client does not object, just as it is sufficient for Professor Silver that an insured impliedly consents to the fact of dual representation because such representation may be necessary for the contract to be effectively performed. *See supra* note 22 and accompanying text. However, to the extent that both waivers are necessitated by the risks of dual representation, it is hard to understand why Rule 1.7(b) has not been triggered.

53. ABA Standing Comm. on Ethics and Professional Responsibility, Formal Op. 96-403 (1996) ("Obligations of a Lawyer Representing an Insured Who Objects to a Proposed Settlement Within Policy Limits") [hereinafter Formal Op. 96-403].

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to apprise the insured of the limited nature of his representation as well as the insurer's right to control the defense in accordance with the terms of the insurance contract."[54] However, according to the Committee this disclosure is required not by any conflicts rule but rather under Rule 1.2(c),[55] which provides that a "lawyer may limit the objectives of the representation," but only "if the client consents after consultation."[56] The opinion further notes that "'Consultation' denotes communication of information reasonably sufficient to permit the client to appreciate the significance of the matter in question,"[57] which is the same standard applied to disclosures required under Rule 1.7(b).[58] However, because the disclosure is not directed to any of the other risks of any joint representation (and must be made even if the attorney represents only one client, the insured), the actual disclosure required under this standard is not nearly as comprehensive as would be required under Rule 1.7(b).[59] As a result, although the Committee is unwilling to assume that disclosures made in the insurance policy are themselves sufficient,[60] it declares itself satisfied with "a short letter clearly stating that the lawyer intends to proceed at the direction of the insurer in accordance with the terms of the insurance contract and what this means to the insured," noting that no "extended discussion is required or, indeed, that any oral communication is necessary," and further that [n]o formal acceptance or written consent is necessary."[61]

Perhaps then it would suffice to conclude that a few further disclosures may be required under Rule 1.2(c), including the fact of any dual representation (which the insured cannot be expected to have understood simply from reading the policy) and the lack of any obligation of confidentiality, and that these disclosures, too, need not entail any extended discussion or even any oral communication. However, this conclusion is not at all satisfactory. First, both the fact of dual representation and the lack of any

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54. *Id.*

55. *See id.*

56. MODEL RULES, *supra* note 33, Rule 1.2(c).

57. Formal Op. 96-403 (citing MODEL RULES, *supra* note 33, Terminology Section).

58. *See* MODEL RULES, *supra* note 33, Rule 1.7(b)(2) (requires that client "consents after consultation").

59. *See id.* The rule further requires that [w]hen representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved." *Id.* For a discussion of some of the most common risks of representing both the insurer and the insured, *see supra* note 30-31 and accompanying text.

60. *See* Formal Op. 96-403, *supra* note 53. ("We cannot assume that the insured understands or remembers the insurance policy (if he read it at all), or that the insured understands that his lawyer will be acting on his behalf but at the direction of the insurer without further consultation with the insured").

61. *Id.*

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obligation of confidentiality to the other client are disclosures typically associated not with limitations on the scope of the representation but rather with some of the risks of the dual representation itself.[62] And, if the lawyer must disclose some of the risks of dual representation, why is it not also necessary to describe at least some of the other important risks of dual representation; for example, the risk that disclosures made by the insured to attorney might indicate a lack of coverage in situations in which the insured may not understand the significance of the information,[63] or the risk that the attorney's ongoing relationship with the insurer may cause the attorney to favor the insurer over the insured in any subsequent disagreement?[64] These are precisely the sorts of disclosure that would be required under Rule 1.7(b), and at this point it is hard to see why the disclosure is said to arise under Rule 1.2(c).

Moreover, other parts of the ABA opinion itself undercut the viability of any argument that disclosing either the fact of any dual representation or any lack of confidentiality fall under Rule 1.2(c) rather than under Rule 1.7(b). Thus, at the outset of the opinion, the Committee notes that it takes no position on the precise identity of the client or clients the lawyer represents.[65] Indeed, the Committee notes that the parties might agree that the lawyer is representing either the insured alone, the insured and the insurer, or perhaps even the insured and the insurer for all purposes except settlement, and, with respect to

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62. *See, e.g.*, RESTATEMENT, *supra* note 13, § 112 cmt. l, (1989) ("[w]hen a conflict of interest exists, as part of the process of obtaining consent, the lawyer is required to inform each co-client of the effect of joint representation upon disclosure of confidential information.").

63. An example raised by Professor Silver concerns a lawyer who sends the insurer a copy of the insured's deposition in which the insured testified to prior occurrences similar to the claims asserted in the current liability suit. Unknown to the lawyer (and in all probability forgotten by the insured), the insured failed to disclose the prior occurrences when applying for the insurance. *See* Charles Silver & Michael Sean Quinn, Are Liability Carriers Second-Class Clients? No, But They May Be Soon—A Call to Arms Against the Restatement (Third) of the Law Governing Lawyers 21 (prepared for University of Texas School of Law Insurance Law Institute program, Lawyers as Targets, Sept. 26-27, 1996 (on file with author). An adaptation of this article appears as Charles Silver & Michael Sean Quinn, *Are Liability Carriers Second-Class Clients? No, But They May Be Soon—A Call to Arms Against the Restatement (Third) of the Law Governing Lawyers*, 6 COVERAGE 21 (Mar./Apr. 1996).

64. *See, e.g.*, Silver, *supra* note 7, at 1606 (citations omitted):

> Many authorities express the fear that economic incentives will lead defense counsel to sacrifice the interests of the insured when the interests of the company and the insured conflict. Defense lawyers concede the point. Because the company hires the lawyer, pays the bills, can fire the lawyer at will, and is a source of repeat business, counsel will naturally be inclined to favor the company over the insured.

65. *See* Formal Op. 96-403, *supra* note 53.

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settlement, the insurer alone.[66] However, the Committee further notes that "any of these arrangements would be permissible," "*[p]rovided there is appropriate disclosure, consultation, and consent.*"[67] Now, of course, what this does is to bring us back full circle, since one is left to ask under what rules this "appropriate disclosure, consultation, and consent" would be required other than Rule 1.7(b). And, if the appropriate disclosure, consultation and consent are required under Rule 1.7(b) (or indeed under any other rule), when and how do they occur? If "we cannot assume that the insured understands or remembers, if he ever read, the insurance policy" for purposes of any limitation on the mere scope of the representation,[68] then surely we cannot depend on the contract to supply the more rigorous disclosures and consent required under conflicts of interest rules.[69]

In my opinion, this analysis inevitably leads to the conclusion that Rule 1.7(b) is indeed triggered in every instance of dual representation of an insurer and an insured, even in the full coverage situation. Although perhaps remote, the risks are simply too many and too significant to suggest that the "substantial risk" requirement of Restatement § 201 has not been met.[70] Moreover, it is important to note that while I have agreed to limit the discussion to the "full coverage situation," it is almost impossible to tell at the outset which cases are in fact full coverage cases.[71] For example, full coverage assumes not only that the amount of the policy is adequate to cover any judgment, but also that the insurance policy in fact covers any judgment in the case; that is, that there is no basis on which the insurer could attempt to deny coverage. As Professor Silver concedes, insurance defense attorneys are not experts on insurance coverage and indeed typically represent insureds "without obtaining or reviewing copies of insureds' applications for insurance, policy forms, or correspondence discussing coverage."[72] As a result, it is not uncommon for these attorneys to obtain information from the insureds which

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66. *See id.*

67. *Id.* (emphasis added).

68. *See id. See supra* note 58 and accompanying text.

69. *See infra* notes 73-75 and accompanying text.

70. *See supra* note 30 and accompanying text. Moreover, aside from the risks attributable to the dual representation, there are the additional risks associated with the fact that the insurer is paying the attorney's fees. These are risks that must be disclosed under rules regulating third-party payment of a lawyer's fees. MODEL RULES, *supra* note 33, Rule 1.8(f). *See infra* note 88 (refuting argument of Professor Silver that Rule 1.8(f) does not apply to insurers who are also co-clients).

71. *See* Pepper, *supra* note 7, at 36. *See also supra* note 62 (discussing hypo supplied by Professor Silver in which the lawyer inadvertently discloses to the insurer information indicating a lack of coverage due to the failure of the insured to report prior similar occurrences on the insurance application).

72. *See* Silver & Quinn, *Second Class Clients*, *supra* note 63.

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might be used by the insurer to deny coverage, without either the insured or the attorney understanding the significance of the information.[73] If the attorney cannot know at the outset whether or not this is a full coverage case, then the argument is even stronger that the risk of harm arising from the dual representation is substantial and ought to be disclosed under Rule 1.7(b).

If, then, it is agreed that Rule 1.7(b) is triggered every time an attorney agrees to represent both an insurer and an insured, then the question arises how (or if) its requirements can be met. There is certainly consensus by now that any meaningful disclosure and consent cannot possibly be deduced from the insured's agreement to enter into the contract of insurance.[74] Even Professor Silver concedes that when it applies, the disclosure and consent process embodied under Rule 1.7(b) appears to require defense counsel to confer with the insured and:

> Explain the nature of the potential conflict.
>
> Identify defense counsel's obligation to the company to defend the liability suit in a manner that will minimize the loss.
>
> Identify defense counsel's duty to the insured not to act in disregard of the insured's express desires.
>
> Explain that the joint representation can continue, despite the conflict, because the conflict is unlikely to prevent defense counsel from satisfying his obligations to the company or the insured.
>
> Explain the costs and benefits to the insured of waiving the conflict.

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73. *See supra* note 62. Professor Silver's solution is to limit representation of the insured so that coverage issues are not included and thus the attorney would violate no duty to the insured in passing along information relevant to the insurer on matters involving liability as well as coverage. *See* Silver & Quinn, *Second Class Clients*, *supra* note 63 at 19-20. I do not understand why Professor Silver believes that limiting the scope of the representation avoids the conflict. First, Rule 1.6 requires the lawyer to keep confidential all information "relating to the representation." MODEL RULES, *supra* note 33, Rule 1.6(a). Even if the lawyer is not representing the insured on coverage matters, surely information that is pertinent to both liability and coverage is "related to the representation," and thus any duty to inform the insurer of this information conflicts with the duty of confidentiality owed to the insured. Second, even if limiting the scope of the representation meant that there was no duty of confidentiality toward the insured, surely the risk that the lawyer would then be obligated to pass along possibly damaging information to the insurer is an important risk which ought to be disclosed at the outset of the representation.

74. Even William Barker states that the attorney must disclose the limits on confidentially during the first interview with the insured, although he apparently does not concede that this disclosure must be made in the context of seeking informed consent to a potentially impermissible conflict of interest under Rule 1.7(b). *See supra* note 52 and accompanying text.

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> Explain that a time may come when defense counsel's responsibilities to the company and the insured will actually conflict. When this happens the insured will have to decide whether to protect the identified interest or to compromise that interest and permit counsel to proceed with a defense that is calculated to minimize the loss on the liability claim.
>
> Explain that defense counsel will respect the insured's decision, but may withdraw if the insured decides to do otherwise than as required to defend the liability claim effectively.
>
> Explain that the decision facing the insured involves coverage questions or other questions (if it does) on which defense counsel cannot advise the insured but concerning which the insured may obtain advice from independent counsel retained and paid for by the insured.[75]

If this is the level of disclosure required under Rule 1.7(b), then it seems an impossible standard to meet under the current practice, where many attorneys never meet with the insured at all, while others meet them only after significant effort has already been expended on the case.[76] And surely it would

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75. Silver & Syverud, *supra* note 2, at 331.

76. Professor Pepper questions the effectiveness of any consent not on the ground that full is disclosure is impractical, but rather on the ground that if adequate disclosures could be made in a timely fashion, a rational insured would never consent. *See* Pepper, *supra* note 7, at 34. He is concerned that there is no "advantage" of the dual representation to the insured, only to the insurer, and thus there is no reason for the insured to give its consent. *See id.* Of course, there is no requirement under Rule 1.7(b) that the dual representation be advantageous to both clients, only that the lawyer reasonably believe "the representation will not be adversely affected." MODEL RULES, *supra* note 33, Rule 1.7(b)(1). Indeed, clients often agree to dual representation as a simple accommodation to the lawyer; for example, when the two clients are being represented by different lawyers in the same firm.

Professor Silver presumably would argue that the advantage to the insured is representation by an attorney paid for by the insurer; i.e., that absent the insured's consent, the insured would have to hire its own attorney. *Cf., e.g.*, Silver & Syverud, *supra* note 2, at 354 (insured can revoke demand for defense at any time; insured can take control of defense if insured is willing to bear the expense). Professor Pepper does not believe that insurance contracts presently require dual representation. *See* Pepper, *supra* note 7, at 37. Even if they did, he argues that such a provision is not binding on the lawyer, who would still be required to make the requisite disclosures and get the client's consent. *See id.* at 37-38. Part of that disclosure would undoubtedly include Professor Pepper's suggestion that the lawyer advise the insured that the contract is not self-executing, *see id.* at 27, but it seems clear that if the insured refused consent, it would not get a lawyer provided by the insurer. Whether such a contract provision would be upheld under insurance law probably depends on whether dual representation, even with potential conflicts, is deemed ethically permissible.

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substantially raise the cost of insurance to require face to face meetings in every instance.

Proponents of the "one-client" view agree and then conclude that since the disclosure required under Rule 1.7(b) cannot be met, it is (or should be deemed) unethical for lawyers to represent anyone other than the insured.[77] But this is not the only possible solution, particularly if one is willing to be flexible and bend the rules a bit.[78] As an example of such rule-bending, Professor Richard Zitrin proposes that the lawyer be deemed to represent both the insurer and the insured until something goes wrong, at which time the insurer would no longer be a client, at least in the usual sense.[79] This view, ridiculed by Professor Silver as the "one and one-half client" view,[80] in fact reflects what Professor Silver himself describes as a long-standing concern on the part of courts and ethics committees, as well as commentators, that "counsel must show special regard for the interests of the insured,"[81] perhaps by treating "the insured as the 'primary client,' whose protection must be the attorney's 'dominant' concern."[82] Of course, this proposal does not really solve the problem as I have described it, since it still does not explain how it is that the lawyer ethically represents two clients even at the outset of the representation. However, we could get around this difficulty by proposing that, *for purposes of insurance defense representation only*, the initial disclosures could be satisfied by a short (but slightly expanded) letter along the lines suggested by the ABA Standing Committee on Ethics and Professional Liability.[83] Putting aside for a moment the merits of any such proposal, or any other proposal that does not involve a straightforward application of professional responsibility law *as it is applied to all other clients*, we should consider whether such drastic solutions are necessary. Perhaps the needs of the insurance community (including not only insurers and their present insureds, but also the public

77. *See id.* at 72 (concluding that two client model is inadvisable because it is "very risky both for the lawyer and for the unsophisticated insured").

78. *See* Charles W. Wolfram, Insurance-Defense Lawyers as Targets: The Restatement as the Cross Hairs?? 5 (prepared for University of Texas School of Law Insurance Law Institute program, Lawyers as Targets, Sept. 26-27, 1996 (on file with author). *See also supra* note 4 and accompanying text.

79. *See supra* note 7 and accompanying text. Professor Zitrin was chair of the committee that drafted Calif. Formal Op. 1995-139, *supra* note 8.

80. *See id.*

81. *See* Silver, *supra* note 7, at 1587.

82. *Id.* (citing an Oregon formal ethics opinion, which in turn cited an ABA informal ethics opinion). *See also* Silver & Syverud, *supra* note 2, at 335-41 (rejecting what some authorities have endorsed as what the authors call the "Primary Client Rule (PCR)"); Pepper, *supra* note 7, at 68-71 (responding to what author recharacterizes as the "defeasible client model").

83. *See supra* notes 59-60 and accompanying text.

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community of potential insureds) can be met by viewing the insurer as a non-client third-party payer. Professor Silver thinks not, but perhaps he is wrong once again.

C. Conflicts of Interest Under the "One-Client" View

Proponents of the "one-client" view typically regard the insurer as a mere third-party payer of an attorney who represents one client, the insured.[84] Professor Silver regards this status as unsatisfactory for a number of reasons, including possible adverse effects on the insurer's ability to sue the attorney for malpractice,[85] as well as on the insurer's ability to protect its own confidential communications to the attorney from the scrutiny of outsiders.[86] These issues will not concern me here, and I will simply assume that they can be resolved in a manner satisfactory to the insurance companies.[87] What does concern me here is Professor Silver's further argument that under current professional responsibility law, attorneys may not be permitted to take directions from a non-client and thus "a company's status as a joint client legitimates company control of the defense of the insured."[88]

Support for this argument appears to lie in Model Rule 1.8(f), which provides:

> A lawyer shall not accept compensation for representing a client from one other than the client unless:
>
> (1) the client consents after consultation;
>
> (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and
>
> (3) information relating to representation of a client is protected as required by [confidentiality rules].[89]

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84. *See* Pepper, *supra* note 7, at 71 ("single client" model preferable to "defeasible client model" because it can be more effectively integrated into current law in most jurisdictions).

85. *See* Silver, *supra* note 7, at 1591, 1602.

86. *See id.* at 1591.

87. *See, e.g., id.* at n.34. (noting authorities that permit non-clients and "quasi-clients" to assert malpractice claims); Michael Sean Quinn, *The Advice-of-Counsel Defense: A Response to Fischer*, 72 TEX. L. REV. 1487, 1498, n.39 (1994) (availability of subrogation mitigates need to allow insurer a direct cause of action for malpractice: denies importance of finding that insurer is a "client").

88. Silver, *supra* note 7, at 1586. *See also* Silver & Syverud, *supra* note 2, at 277, 284, n.74.

89. MODEL RULES, *supra* note 33, Rule 1.8(f). Similarly, Rule 5.4(c) provides that "[a] lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services." *Id.* at Rule 5.4(c).

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Read strictly and literally, it would seem clear that Professor Silver is right that subsection (2) does not permit an attorney to accept direction from a third-party payer, even with the client's consent.[90]

This conclusion, however, is probably untenable, even outside the insurance defense context. As others have noted, surely a client may properly designate an agent to make decisions on the client's behalf.[91] That the agent happens to be the one footing the attorney's bill should not be a disqualifying factor, since there are many reasons why clients would be willing to authorize their benefactors (or someone else) to make representation related decisions; for example, the client may plan to be out of the country or otherwise indisposed for a period of time. If the client can revoke the agency at any time, and if both the lawyer and the agent are bound to consider only the *client's* interests in the representation, then the prohibition of subsection (2) probably does not apply, since under these terms arguably there has been no

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90. *See* Wolfram, *supra* note 78, at 4 (referring to state rule based on Model Rule 1.8(f), concludes that on face of rule condition of no interference with independent judgment is not subject to client consent). Thus, Professor Pepper is mistaken in arguing that the "not. . . too difficult" solution to the potential barrier of Rules 1.8(f) and 5.4(c) is for the lawyer to obtain informed consent from the client/insured. *See* Pepper, *supra* note 7, at 49.

Professor Silver asserts that Rule 1.8(f) does not apply when the payer is also a co-client. *See* Silver, *supra* note 3, at 27 n.65. *See also* Silver, *supra* note 7, at 1584 (one of consequences of denying that company is co-client is to raise uncertainty about company's right to direct counsel on liability claim); Silver & Syverud, *supra* note 2, at 277, 284-285 & n.74 (insurer's right to control litigation depends on its status as co-client); William T. Barker, *ALI Draft Questions Insurer's Right to Control Defense*, reprinted in 60 DEF. COUNS. J. 611 (1993); MALLEN & SMITH, *supra* note 4, § 28.11 at 542-43. It is unclear why Professor Silver believes this to be so. He appears to assume that an insurer is *either* a co-client or a third party *non-client. Cf., e.g., id.* at 543 (predicate of Rule 1.8(f) is accepting payment from "one other than the client" and where joint representation exists, insurer is advancing its own interests). But there is nothing in Rule 1.8(f) itself that precludes an insurer (or other person) from being *both* a co-client *and* a third-party payer. Indeed neither Rule 1.8(f) nor Rule 5.4(c) even mentions the term "third-party." By its terms, Rule 1.8(f) applies to lawyers accepting compensation "for representing a client from one other than *the client*", MODEL RULES, *supra* note 33, Rule 1.8(f) (emphasis added), which literally includes co-clients. Nor is there any other support for the proposition that one client has the right to make decisions not only for itself but also for any co-clients, or that when one client instructs the lawyer on a matter involving a co-client that the lawyer does not continue to have the obligation to inform and take direction from the co-client; that is, unless the co-client has designated the paying client as its agent for purposes of decision-making. *See* MODEL RULES, *supra* note 33, Rules 1.4, 1.2. Thus, I believe Professor Pepper is clearly correct when he similarly concludes that the difficulties posed by Rules 1.8(f) and 5.4(c) cannot be avoided by giving the insurer co-client status. *See* Pepper, *supra* note 7, at 50-51. *See also* Wolfram, *supra* note 78, at 3-4 (reaching same conclusion).

91. *See, e.g.*, Counsel Connect posting by Stephen Pepper, Apr. 20, 1996 (giving example of elderly client who instructs lawyer to follow daughter's instructions on day to day details of real estate transaction) (on file with author).

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"interference" with either the lawyer's independent professional judgment or the lawyer-client relationship.[92] This is apparently what Professor Pepper has in mind when he suggests viewing the insurance contract as an attempt to create a limited purpose agency, which could avoid the difficulties posed by Rule 1.8(f).[93]

But what about third party payers who want to exercise greater control; for example, employers who have agreed both to defend an accused employee and to indemnify the employee against any judgment? Such a person has a strong interest in keeping the lawyer on a reasonable budget, even if a more expensive defense might be marginally beneficial to the employee-client.[94] Given that at

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92. Similarly, under Rule 5.4(c), the third-party payer-agent would not be directing or regulating the lawyer's professional judgment by making decisions on the client's behalf if, after listening to the lawyer's advice (itself based on the lawyer's independent professional judgment of the client's best interests), the third-party payer-agent made the decision based on its own view of what the client would have wanted. On this agency theory, if the lawyer believes that the payer-agent is basing its decisions not on its views of what action is most beneficial to the client, but rather on the payer-agent's own interests, then the lawyer is probably obligated either to inform the client (who could then revoke the agency) or refuse to follow the recommendation. This will not be a satisfactory arrangement from the point of view of an insurance company claiming a contractual right to control the litigation and protect *its own* financial interests.

93. *See* Pepper, *supra* note 7, at 49 ("The insurance contract as supplemented by the subsequent informed consent would essentially make the insurance company the agent of the insured for the limited purpose of controlling the litigation."). It is clear that Professor Pepper believes that the lawyer is bound to consider only the insured's best interests, since he states explicitly that "if a situation were to arise in which the lawyer has doubts as to whether what the company directed was in the best interest of the insured, the lawyer would no longer feel bound by the client's direction to follow the instructions of the company." *Id.* at 50. Thus, Professor Pepper would have difficulty with the illustration that was the subject of some controversy at the 1996 annual meeting of the ALI. *ALI Approves Almost Half of Restatement on Lawyers,* ABA/BNA LAWYERS' MANUAL ON PROFESSIONAL CONDUCT, Current Reports 170, 176 (May 29, 1996). Under the illustration, the lawyer is said to properly comply with an insurer's direction not to take additional depositions, when the lawyer "believes that doubling the number of depositions taken, at a cost of $5,000, would somewhat increase Policyholder's chances of prevailing" and the lawyer reasonable believes that foregoing the additional depositions can be foregone without violating the standard of care owed to the insured. *See* RESTATEMENT, *supra* note 13, § 215 cmt. f, illus. 4. Admittedly this is a full coverage situation where the insured has no financial exposure. Nevertheless, the insured may have reputational or other interests in being exonerated and thus, it is clearly in the insured's best interest to take the additional depositions regardless of the cost (which will be borne by the insurer). If the insurer is obligated to make decisions in the best interests of the insured, as Professor Pepper says it is, then the lawyer would not be permitted to comply with the insurer's direction.

94. *Cf. supra* note 93 (illustration involving insurance representation where there is only a marginal benefit to insured-client of extra expenditure by insurer-payer). Like insureds, employees may have strong reputational interests in the conduct of the defense. Indeed, an employee's interests may be even stronger than an insured's, since the employer's agreement

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least some of the directions in such a context will be in furtherance of the employer-payer's interest alone (and not in the interest of the employee-client), accepting the direction would indeed appear to violate Rule 1.8(f).[95]

If such directions are reasonable, then this result seems clearly wrong as a matter of policy. The benefit to the client of obtaining both indemnification and a defense is obvious, but this benefit might not be available if the payer is informed that it can have no control over the lawyer's expenditures. In order to accommodate what appear to be the reasonable interests of a third-party payer, § 215 of the Restatement now provides that

> A lawyer's professional conduct on behalf of a client may be directed by someone other than the client when:
>
> (a) the direction is reasonable in scope and character, such as by reflecting obligations borne by the person directing the lawyer; and
>
> (b) the client consents to the direction under the limitations and conditions provided in § 202.[96]

To my knowledge, case law neither supports nor undermines such a re-interpretation of Rule 1.8(f);[97] however, as Chief Reporter and Professor

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to indemnify will not protect the employee against either losing her job or having difficulty obtaining a new one. *See generally* Moore, *supra* note 6.

95. *See supra* note 88 and accompanying text. Rule 5.4(c) is also implicated. *Id.*

96. RESTATEMENT, *supra* note 13, § 215(2).

97. The Reporter's Note to this section refers the reader to the Reporter's Note to Comment f, which deals with insurance representation, and then cites two groups of cases. *See* RESTATEMENT, *supra* note 13, § 215 cmt. d, Reporter's Note. The first group of cases involves lawyers for public interest causes, in which courts have recognized the right of a public interest organization to provide legal services. Even here, however, the Reporter notes only that "courts have implicitly sustained the right of the organizations to specify the legal issues to be tested," not the right of the organizations to make other decisions regarding the conduct of the litigation. *Id. See also* Moore, *supra* note 6 (more extensive discussion of application of Rule 1.8(f) in context of legal services and other public interest lawyers). The second group of cases involves criminal cases in which courts have refused to permit third-party payment of a criminal defendant's fee out of fear that the payer (who is typically an employer) will impermissibly (and unreasonably) attempt to direct the lawyer to protect the interests of the employer. These cases similarly do not support the text of subsection (2) to § 215.

As for the Reporter's Note to Comment f, it cites cases approving the right of the insurer to direct the litigation, particularly settlement, but gives no indication that these cases even addressed the ethics problems raised by Rule 1.8(f). *See* RESTATEMENT, *supra* note 13, § 215 cmt. f, Reporter's Note (substantive law resolves settlement problem by holding insurance company liable for any damages awarded in excess of policy limits).

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Charles Wolfram notes, it "accord[s] quite well with general conflict concepts and surely provides ample protection for the [client]."[98]

So far so good. Perhaps viewing the insurer as a non-client third-party payer is the obvious solution to the dilemma of insurance defense representation.[99] But there are other problems as well, particularly those that arise because of the potential for conflicts of interest between insurer and insured. For example, there is the question of confidentiality. Unlike co-clients generally,[100] third party payers have no right to receive information related to the representation.[101] Clients can authorize the lawyer to keep the payer informed,[102] and such authorization will be necessary if the insurer is to direct the litigation (with the contractually required cooperation of the insured). But there is always the danger that the client will inform the lawyer of some fact that might create a coverage defense, but that is also relevant on the question of liability.[103] Professor Pepper believes that lawyers should indeed keep this information confidential.[104] He further believes that the lawyer should not be required to withdraw, as might be the case if the insurer and the insured were co-clients, because withdrawal would be a signal to the insurer that there was

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98. Wolfram, *supra* note 78, at 4-5. Of course, whether subsection (2) provides "ample protection" for the client depends to a large extent on what sorts of directions are determined to be "reasonable in scope and character." I argue elsewhere that while this subsection does not actually *require* that the payer be responsible for paying any judgment, we should be very cautious before extending the rule to a non-indemnification situation, particularly when the payer is an employer who is or could be a co-defendant. *See generally* Moore, *supra* note 6.

99. Professor Silver would undoubtedly argue that the "re-interpretation" is made up out of whole cloth and might not be accepted in all jurisdictions as a valid interpretation of Rule 1.8(f); therefore, it is better to have the insurer be a co-client. *Cf.* Silver, *supra* note 7, at 1583 (acknowledging existence of cases extending to non-clients the right to sue the lawyer for malpractice, but nevertheless arguing that granting insurer co-client status is preferable since not all jurisdictions agree). There are two problems with this argument: (1) nothing in insurer's status as co-client gives insurer right to direct lawyer as to representation of other co-client, and (2) Rule 1.8(f) applies, even if insurer is also a co-client under Rule 1.7(b). *See supra* note 91. When the co-client is also one who pays for the representation of both clients, the lawyer must comply with *both* Rules 1.7 and 1.8(f). *See id.*

100. *See* RESTATEMENT, *supra* note 13, § 112 cmt. 1 ("sharing of information among co-clients with respect to matter involved in joint representation is normal and typically expected").

101. *See* MODEL RULES, *supra* note 33, Rule 1.8(f)(3) (information relating to representation of client is protected by ordinary rule of client confidentiality). *See also* RESTATEMENT, *supra* note 13, § 215 cmt. e (lawyer must protect confidential information of client).

102. *See* MODEL RULES, *supra* note 33, Rule 1.6(a) ("[a] lawyer shall not reveal information relating to representation of a client unless the client consents after consultation"). *See also* RESTATEMENT, *supra* note 13, § 114 (using or disclosing information with client consent).

103. *See supra* note 62 and accompanying text

104. *See* Pepper, *supra* note 7, at 58-59.

a problem.[105] Indeed, it is the harmful consequence of such a withdrawal that leads Professor Pepper to conclude that representation of the insured alone is far preferable to dual representation.[106] But this argument is not convincing. Lawyers are often required to withdraw, and the fact that their withdrawal may be the equivalent of alerting an opponent of some difficulty has not traditionally been viewed as a substantial impediment.[107] More important, why should the insurer be required to pay for an attorney to represent a client who may be attempting to defraud the insurer?[108] I see no reason why the insurer may not properly condition its compliance with the insurance contract (that is, by providing the defense) with the willingness of the insured to keep up its end of the bargain (that is, by cooperating in the defense and providing information to the insurer relevant to the question of liability, even when that information might suggest problems with coverage).[109] Failing to give the insurer co-client status might well endanger the insurer's ability to limit its obligations to those it assumed under the contract of insurance, while simultaneously giving the insured far more than it bargained for.[110]

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105. *See id.* at 57-58.

106. *See id.* at 58 (even indirect violation of confidentiality in this context as applied to "an unsophisticated insured...seems intolerable").

107. *See, e.g.,* RESTATEMENT, *supra* note 13, § 112 cmt. 1 (lawyer required to withdraw when one co-client directs lawyer not to disclose adverse information to another co-client: lawyer has discretion to keep information confidential after withdrawal only when lawyer has not previously informed communicating client that all information is to be shared). *Cf.* MODEL RULES, *supra* note 33, Rule 1.6 cmt. ¶¶ 14-15 (lawyer must withdraw if lawyer's services will be used by client to further criminal or fraudulent conduct: even when lawyer is required to refrain from disclosing client confidences, lawyer may notify adversary of fact of withdrawal and may also "withdraw or disaffirm any opinion, document, affirmation or the like").

108. Admittedly, the insurer is under a duty to defend even when there are possible coverage problems, including a defense under a reservation of rights. *See e.g.,* ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW, 822 (1988). The insurer simultaneously has a "right" to secure to cooperation of the insured, select defense counsel, control the decisions in regard to the settlement and to guide the litigation of an unsettled claim. *See id.* There may be circumstances when the insurer will be obligated to permit the insured to select its own counsel (at the insurer's expense). *See id.* at 824-825. Even in these rare cases, however, the insurer is at least aware of the existence of a conflict of interests.

109. *Cf.* KEETON & WIDISS, *supra* note 108, at 842 (establishing the right of an insurer to deny coverage and refuse to provide a defense under some other circumstances).

110. The question here is not whether the lawyer should inform the insurer of the information harmful to the insured, but whether the lawyer can continue to represent the insured while withholding information necessary for the insurer to exercise its right to control the defense. When the information relates to both coverage and liability, the insured may well have the right to select defense counsel and to direct the defense, *see id.* at 853-857; however, when that happens at least the insurer will not be under the false impression that it is being fully informed of the relevant facts. It is not clear that a lawyer representing the insured alone has any obligation to inform the insurer of the existence of a conflict of interests between the insured and the insurer; therefore, insurers may understandably argue that they need co-client status to

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And what about obtaining the client's consent, both to the third-party payment (and the risks that entails) and to keeping the insurer informed regarding the progress of the representation? Rule 1.8(f) itself requires that the client consent "after consultation,"[111] elsewhere defined as "'communication of information reasonably sufficient to permit the client to appreciate the significance of the matter in question.'"[112] Similarly, § 215 of the Restatement provides for "consent to the direction under the limitation and conditions provided in § 202,[113] which calls for the client to have "reasonably adequate information about the material risks of such representation to that client or former client."[114] This is *precisely* the kind of disclosure and consent process required under Rule 1.7(b), a process that we have already determined is probably impossible to meet absent radical (and expensive) changes in the day-to-day practice of insurance defense lawyers.[115] Professor Pepper believes that stripping the insurer of co-client status will significantly reduce the nature of the disclosure that must be provided the insured;[116] however, the risks to the insured of an attorney with strong ties to the insurer, as well as the danger of inadvertent disclosures of potentially harmful information are arguably so significant that any difference between a Rule 1.7(b) disclosure and a Rule 1.8(f) disclosure is relatively meaningless.[117]

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fully effectuate their right to defend up to the point where the insured openly asserts its own right to select counsel and direct the defense.

Professor Pepper argues that the lawyer is not required to withdraw unless the lawyer's silence constitutes assisting in a crime or fraud, which is prohibited by Rule 1.2(b). *See* Pepper, *supra* note 7, at 58-59. He then argues that mere silence does not constitute assistance in a fraud. However, what Professor Pepper seems to forget is that the insurer will be directing the litigation, thinking that it is being fully informed by the lawyer as to information material to the liability issue. The lawyer can hardly avoid communicating with the insurer under these circumstances, and it is difficult to imagine that the lawyer will be able to give the insurer any information without making a material misrepresentation; that is, by failing to disclose the information harmful to the insured. *See* MODEL RULES, *supra* note 33, Rule 4.1(a).

111. *See supra* note 90 and accompanying text.

112. MODEL RULES, *supra* note 33, Terminology Section. *See also* Formal Op. 96-403, *supra* note 53, at 3-4; *supra* text accompanying note 53.

113. *See supra* note 95.

114. *See* RESTATEMENT, *supra* note 13, § 202(i) ("Informed consent requires that the client or former client have reasonably adequate information about the material risks of such representation to that client or former client.").

115. *See supra* notes 76-77 and accompanying text.

116. *See* Pepper, *supra* note 7, at 49.

117. Professor Pepper supports his argument that a Rule 1.8(f) disclosure will be less elaborate by stating that unlike dual representation, Rule 1.6 will still apply. *See* Pepper, *supra* note 7, at 49. But in order to fulfill its duty of cooperation and permit the insurer to direct the defense, the insured will necessarily have to agree to permit the lawyer to keep the insurer informed. *See supra* note 105 and accompanying text (under Rule 1.6 client can consent to disclosure of otherwise confidential information). If the lawyer knows that certain information

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D. The Need for a Special Solution

I am willing to simply assume at this point that radical changes in insurance defense representation are unwarranted, given the benefits of the present practice to insurers and insureds alike.[118] I agree then with the Restatement reporters in that what is needed in the way of ethical analysis is "some flex in the joints of lawyer code rules."[119] I will not argue on which particular form this sort of "flex" ought to take, although my instinct is that given that neither the "one-client" or "two-client" view can be applied in the manner traditional to other forms of representation, perhaps the "one and one-half" client view already espoused by some courts and commentators makes the most sense,[120] particularly given other needs of the insurance company, namely its interest in being able to sue for legal malpractice and to receive protection under the attorney-client evidentiary privilege.[121] I do have some concern, however, that whatever the solution might be that it should not routinely be applied to other types of representation, at least absent strong policy reasons and the type of intense scrutiny that insurance defense representation has already received.

For example, whether the lawyer represents one client, two clients, or one and one-half clients, there are going to be sufficient limitations on the lawyer's representation of the insured that the lawyer will need to make some important disclosures to the insured at an early stage of the representation. I am comfortable with the general approach of the ABA Standing Committee on Ethics and Professional Responsibility that what will ordinarily suffice is a letter from the lawyer to the insured setting forth the general parameters of the relationship,[122] perhaps supplemented with additional disclosures if and when the lawyer has a face to face meeting with the insured.[123] I am not comfortable

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is harmful to the insured, then arguably the lawyer need not disclose, but in many instances the lawyer will not know that the information raises coverage problems. *See supra* note 74 and accompanying text. Therefore, there is a significant risk of inadvertent harm that should be part of the disclosure made by the lawyer to the insured even under Rule 1.8(f). Arguably this danger is even more subtle than the danger of causing harm by disclosure under Rule 1.7(b), where the insurer is granted equal status from the outset.

118. Although I have done no independent research and have no particular expertise in the area, the historical willingness of courts to permit the present practice, albeit under different ethical regimes, suggests to me that the system is not in need of any radical reform.

119. *See supra* note 78.

120. *See supra* notes 80-83 and accompanying text.

121. *See supra* notes 86-88 and accompanying text.

122. *See supra* notes 61-62 and accompanying text.

123. I would not be comfortable with this approach if in fact there is already some reason to believe that a specific conflict is likely to arise. *See, e.g.*, KEETON & WIDISS, *supra* note 108,

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with this approach in certain other potential conflict situations involving third-party payers (whether co-clients or not); for example in the situation involving an employer and an employee when the employee has been sued for employment related-conduct.[124] Particularly when the employer is also a defendant, the potential for conflicts is arguably much stronger than in the insurance defense context. Moreover, any agreement by the employer to indemnify the employee might not be sufficient to protect the employee, since unlike insurance contracts, such agreements are not standardized and in many cases are based on oral agreements only.[125] Most important, there is no reason why the disclosure and consent process in the employer-employee context cannot be expected to conform to the "ideal" clearly contemplated under both Rule 1.7(b) and Rule 1.8(f),[126] since these are cases in which lawyers typically meet with their clients prior to taking any action in a lawsuit.[127]

II. RECENT ATTEMPTS TO REDUCE COSTS

A. Bundled Flat Fees

In his present paper, Professor Silver addresses the ethical propriety of two recent innovations in insurance defense representation—bundled flat fee arrangements[128] and the use of in-house staff counsel.[129] These innovations are part of an ongoing effort by insurers to reduce the cost of defending lawsuits filed against their insureds[130] and, as Professor Silver notes, are part of a broader based movement on the part of corporate America to lower the cost of legal services.[131]

To raise the problem of flat fees, Professor Silver attacks a recent Kentucky decision which found the practice unethical. In *American Insurance*

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at 831-832 (once attorney is aware of actual or potential conflict, letter may be insufficient to adequately inform insured of facts and circumstances necessary for a knowledgeable decision about the desirability of seeking independent counsel).

124. I develop this argument in considerable detail at Moore, *supra* note 6.

125. *See id.* Moreover, an agreement to indemnify will not protect the employee from being fired by the employer, particularly if the employer is concerned that failure to terminate the employee may result in an award of punitive damages. Even if the employee is not terminated, disclosure made during the course of the representation might well affect adversely the employee's future employment prospects. *See id.*

126. *See supra* notes 76-78, 114-19 and accompanying text.

127. *See* Moore, *supra* note 6.

128. *See* Silver, *supra* note 3, at Part II.

129. *See id.* at Part III.

130. *See id.* at 216-17.

131. *See id.* at 216, n.38 ("in pressuring lawyers to reduce costs, liability insurers are acting like other commercial purchasers of legal services").

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Association v. Kentucky State Bar,[132] the Kentucky Supreme Court upheld on appeal a finding of an advisory opinion issued by the Ethics Committee of the Kentucky State Bar, to which the question had been put whether a lawyer could properly contract with a liability insurer to handle all the insurer's defense work for a fixed fee per matter, which covered both time and litigation costs. The court agreed with the ethics committee that such a practice was prohibited by the Kentucky Rules of Professional Conduct, which are substantially similar to the ABA Model Rules.[133]

In particular, the court found that the practice violated Rules 1.7(b) and 1.8(f)(2), both relating to conflicts of interest. Rule 1.7(b) prohibits representation materially limited "by the lawyer's own interests" unless "the client consents after consultation,"[134] whereas Rule 1.8(f)(2) prohibits third party compensation unless "there is no interference with the lawyer's independence of professional judgment."[135] The court expressed concern that the set fee arrangement would enable the insurer to exert pressure on the lawyer, thereby interfering with the lawyer's independent professional judgment. Noting the numerous conflicts that might arise between insurer and insured over the course of the representation, the court feared that it would be "the entity paying the attorney, the insurer, and not the one to whom the attorney is obligated to defend, the insured" who would be controlling the legal representation.[136]

I must say I agree with Professor Silver that the Kentucky court's opinion is remarkably unpersuasive. He is correct that legal fees are generally regulated by Rule 1.5, the rule that directly addresses the propriety of various fee arrangements, and not by rules relating to conflicts of interest.[137] This is almost certainly because virtually all fee arrangements pose conflicts of interest between lawyer and client, including the hourly rate typically preferred by most insurance defense lawyers.[138] Thus, more explanation is clearly needed before concluding, as the Kentucky court did, that conflict of interest rules apply to this particular form of fee arrangement, to the apparent exclusion of all other forms of fee arrangements. Moreover, the Kentucky court does not even

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132. 917 S.W.2d 568 (Ky. 1996).

133. *See infra* notes 133, 134 and accompanying text.

134. 917 S.W.2d at 570 (Kentucky rules). *See also* MODEL RULES, *supra* note 33.

135. 917 S.W.2d at 570 (Kentucky rules). *See also* MODEL RULES, *supra* note 33.

136. *See* 917 S.W.2d at 573.

137. *See* Silver, *supra* note 3, at 223.

138. *See id.* at 227 (after reviewing conflicts in various other forms of fee arrangements, including flat fees generally, contingent fees, and hourly fees, Professor Silver argues that it is a mistake to conclude that conflicts rules permit only fee arrangements that "bring lawyers' and clients' interests into perfect harmony" since "[n]o compensation formula meets this standard").

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address the question whether consent by the insured might be adequate to cure the conflict.

On the other hand, the position taken by the Kentucky court is not nearly as indefensible as Professor Silver suggests. There is in fact some support for the argument that conflict of interest rules should be applied to some fee arrangements. Indeed, for an example of a conflict involving the lawyer's own interest, the official comment to Rule 1.7(b) states that "a lawyer's need for income should not lead the lawyer to undertake matters that cannot be handled competently and at a reasonable fee."[139] This comment was cited by a New Hampshire Bar Association Ethics Committee that was similarly considering the question whether fixed fees with an insurance company were unethical.[140] The New Hampshire Committee ultimately decided that such fees were not *per se* prohibited but left open the question whether the result would be the same if the agreement also covered costs and expenses,[141] as was the case in the Kentucky opinion.

Even stronger support may be found in two other ethics opinions addressing the propriety of lawyers accepting flat fees from insurance companies. Although an Oregon Bar Association Ethics Committee also concluded that the practice was not per se unethical, it strongly suggested that at the very least, any such arrangements should be scrutinized on a case by case basis:

> If...the flat fee per case quoted by the Insurer to the Attorney were so low as to compel the conclusion that Insurer was seeking to shift its duties to Insureds and to enlist Attorney's assistance in doing so, Attorney could not ethically accept the representation.[142]

A committee of the Iowa Bar Association went even further and concluded that flat fees are improper unless each of the following conditions are met:

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139. *See* MODEL RULES, *supra* note 33, Rule 1.7 cmt. ¶ 6.

140. New Hampshire Bar Ass'n, Formal Op. 1990-91 (1991) at 5.

141. *See id.*

142. Ore. State Bar Ass'n, Formal Op. No. 1991-98 (1991) at 2. The opinion cited the attorney's obligations under DR 5-108(A) of the Oregon Code of Professional Responsibility, which provides that except with the consent of the lawyer's client, a lawyer shall not:

> (1) Accept compensation for the lawyer's legal services from one other than the lawyer's client; or (2) accept from one other than the lawyer's client anything of value related to the representation of or the lawyer's employment by the lawyer's client.

Id.

> 1. The service is inherently capable of being specifically stated and circumscribed, and
>
> 2. There appears to be no probability of further professional services (other than those specified) being required in handling the matter, and
>
> 3. The agreement provides that in any instance where counsel believes additional professional service has become necessary he shall furnish it at his or her regular hourly rate.[143]

Additional support for the proposition that conflict of interest rules should govern these fee arrangements may be found in the official comment to Rule 1.5, which states that "[a]n agreement may not be made whose terms might induce the lawyer improperly to curtail services for the client or perform them in a way contrary to the client's interest."[144] This comment was also cited by the New Hampshire Ethics Committee in its formal opinion refusing to absolutely prohibit the use of flat fees in insurance defense representation, but was then disregarded after the Committee concluded that any finding that a particular fee or fee arrangement was unreasonably low would run afoul of the United States Supreme Court's opinion in *Goldfarb v. Virginia State Bar*,[145] which prohibited the use of minimum fee schedules by bar associations.[146]

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143. Iowa Ethics Advisory Comm., Formal Op. 86-13 (1987) at 3. In that opinion, the Committee approved an agreement with an insurance company to prepare settlement documents for workers compensation cases for a stipulated flat fee (plus out-of-pocket costs and copy charges), but only on the condition that the lawyer add a provision complying with condition 3 above regarding additional compensation for additional services. *See id.* Regarding the potential conflict, the Committee further stated:

> In matters which involve continuing legal evaluations and more than limited, specific professional service the potential for interference with counsel's exercise of professional judgment or for "cutting corners" or limiting professional service are significant.

Id.

144. *See* MODEL RULES, *supra* note 33, Rule 1.5 cmt. ¶ 3. As an example, the comment states that "a lawyer should not enter into an agreement whereby services are to be provided only up to a stated amount when it is foreseeable that more extensive services probably will be required, unless the situation is adequately explained to the client." *Id.*

The former ABA Model Code prohibited only fees which were "clearly *excessive*." MODEL CODE OF PROFESSIONAL RESPONSIBILITY, DR 2-106 (A) (1980) (emphasis added) (also prohibiting fees which were "illegal").

145. 421 U.S. 773 (1975).

146. *See* New Hampshire Bar Ass'n, Formal Op. 1990-91/5 at 3. Given a realistic danger of harmful conflicts and a case-by-case evaluation of particular flat fee arrangements, the Committee's conclusion regarding the applicability of *Goldfarb* is probably unwarranted.

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There is at least some support for the position taken by the Kentucky court in *American Insurance Association*. Nevertheless, the reasoning behind that position remains weak and in need of further elaboration. The Kentucky court did not even mention Rule 1.5, either because it agreed that *Goldfarb* prohibits the regulation of unreasonably low fees or because it recognized that all Rule 1.5 does is prohibit unreasonable fees in particular matters, that is, on a case-by-case basis, whereas in *American Insurance Association*, the Ethics Committee had banned all bundled flat fee arrangements. As for the conclusion that the risk of underpayment is a risk properly covered by conflict of interest rules, none of the above-mentioned ethics committee opinions satisfactorily addresses the questions raised by Professor Silver.

For example, if flat fees raise risks of underpayment covered by Rule 1.7(b), then presumably *all* significant risks of either underpayment or overpayment are similarly covered by that rule. And, as Professor Silver notes, virtually 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. This lack of support is probably attributable to two facts. First, the existence of a conflict of interest in all fee arrangements is usually obvious to clients and lawyers alike.[147] Second, the purpose of disclosure under conflicts rules is to offer the client the option of conflict-free representation: if there is no fee arrangement that is totally free of conflict,[148] then disclosure accomplishes nothing of any importance.[149] If the goal is to ensure that attorneys do not give in to the temptation to favor their own interests over those of their clients, then presumably the only regulation that will work is the requirement of Rule 1.5 that the fee charged in each particular case be

147. *See* Silver, *supra* note 3, at 225-26 (lawyers and clients are both aware of risks and use arrangements "precisely because they want to assign the risk to the lawyer").

148. *See id.* at 227 (no compensation "bring[s] lawyers' and clients' interests into perfect harmony").

149. Professor Silver is almost certainly correct that the purpose of Rule 1.7(b)'s inclusion of a lawyer's own interest is "to discourage lawyers from accepting representations when their *external interests* conflict with the interests of their clients, regardless of the terms on which they may be employed." *Id.* at 228 (emphasis added). Not only are clients unlikely to know about a lawyer's external interests, but also other lawyers would not be similarly burdened; thus, giving the client the information regarding these interests provides the client with important options. Aside from Rule 1.7(b), Rule 1.8(a) prohibits lawyers from entering into business transactions with their clients unless they comply with certain conditions, including disclosure. *See* MODEL RULES, *supra* note 33, Rule 1.8(a). Some fee arrangements are covered under Rule 1.8(a), such as when a lawyer takes stock in a client's company as compensation for legal services the lawyer provides. Here the dangers are not readily understood and thus must be disclosed under 1.7(b). *Cf. id.* (requirements of specific rule on business transactions are in addition to requirements of general conflicts rule).

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reasonable,[150] as well as the possibility of a malpractice lawsuit if the client is harmed as a result of a lawyer's lack of competence or diligence.[151]

These arguments have their greatest force in the case of a first-party payer, where it is the client who is paying the lawyer's fee and who has the opportunity to negotiate a fee arrangement that entails the particular type and degree of risk favored by the individual client.[152] Thus Professor Silver recognizes that approval of flat fees in the first-party payer situation does not necessarily entail approval of the practice in insurance defense work, where the insurer is a third-party payer[153] (regardless of whether the insurer is also a co-client).[154] Professor Silver further notes that the mere fact that a third party is paying the flat flee is not necessarily a source of concern, since flat fees have been approved in cases involving fee awards and referrals from legal aid offices, the latter including approval to contract out all clients with legal problems in a particular area of law.[155] Moreover, in criminal defense work, flat fees are common for lawyers representing indigent defendants, and the rates are outrageously low, especially in death penalty cases.[156]

If flat fees are routinely approved in both first-party and third-party payer situations, then how could bundled flat fees in insurance defense cases violate either Rule 1.7(b) or Rule 1.8(f)? Professor Silver notes the Kentucky court's reliance on subsection (2) of Rule 1.8(f), in its conclusion that the insurer's ability to limit the defense budget allows it to exert pressure that "'interferes with the exercise of the lawyer's independent professional judgment . . . .'"[157] Professor Silver finds this to be an "extraordinary interpretation of Rule 1.8(f)," because he interprets it as a finding that any and all budget

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150. *See supra* note 136.

151. *See* Silver *supra* note 3, at 227 (acknowledging remedy of malpractice while denying that Rule 1.5 applies to unreasonably low fees).

152. *See, e.g.*, ABA Standing Comm. on Ethics and Professional Responsibility, Informal Op. 1389 (1977):

> There is nothing improper in a lawyer charging and being paid a fixed fee in advance for legal work on tax matters or litigation before the Tax Court if the client and the lawyer choose to do so and it is fully understood that the fixed fee embraces all work to be done, whether it be relatively simple and of short duration, or complex and protracted.

153. *See* Silver, *supra* note 3, at 227.

154. *See supra* note 91.

155. Silver, *supra* note 3, at 228, n.72, *citing* ABA Standing Comm. on Ethics and Professional Responsibility, Informal Op. 1334 (1975).

156. Silver, *supra* note 3, at 228, n.71 *citing* Myrna Oliver, *Hard Work, Low Pay, Death Row: Few Lawyers For Big Task*, L. A. TIMES, Mar. 21, 1988, 1:1 (article on death penalty fee payments in Alabama).

157. Silver, *supra* note 3, at 229.

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requirements by third-party payers are prohibited.[158] Obviously, this interpretation is as ridiculous as Professor Silver makes it out to be, but is this really what the Kentucky court meant? If not, what alternative explanation might there be?[159]

Professor Silver finds no reasonable alternative explanation because it is his belief that "budget restrictions and other ordinary payment terms do not and cannot interfere with a lawyer's independence of professional judgment."[160] But perhaps this is not the case. For example, what distinguishes insurance defense representation from either legal aid referrals or state referrals in criminal cases is the potential for conflict between the interests of the insured and the interests of the insurer.[161] If budget restrictions and other "ordinary" payment terms do not *add* to the possibility that the attorney will favor the interests of the insurer over the interests of the insured, then presumably they do not, in themselves, pose additional risks under Rule 1.8(f). However, perhaps the bundled flat fee arrangements *do* pose additional dangers that lawyers will unduly favor the insurer's interests (e.g., in keeping any liability award and the cost of representation low), at the expense of the interests of the insured (e.g., in avoiding the adverse side-effects of settlements). I take no position on whether these additional dangers do or do not exist; however, if there is an enhanced risk that the fee arrangement will interfere with the lawyer's independent professional judgment on behalf of the insured, then the Kentucky court is correct that the fee arrangement may be improper under Rule 1.8(f)(2).[162]

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158. *See id.* at 229.

159. Professor Silver posits an equally absurd alternative, i.e., that "[p]erhaps the court meant to say only that a third-party payor cannot limit a lawyer's budget to an amount less than 100 percent of the payor's wealth." *Id.* at 230. Clearly this is also not what the Kentucky court meant.

160. Silver, *supra* note 3, at 230.

161 Ordinarily, there is no particular conflict of interest between legal aid clients or criminal defendants and their government funding sources. As a result, budgetary restrictions in the form of flat fees do not typically pose conflicts of interest problems under codes of professional responsibility. However, where funding sources place restrictions on the scope and manner of the representation, serious questions must be raised whether such restrictions are consistent with the ethical rules regulating third-party payments. For a detailed discussion of the application of Rule 1.8(f) to legal services and other public interest lawyers, *see* Moore, *supra* note 6.

162. An analogy would be the prohibition of third-party payment in criminal cases where the third-party payer has conflicts with the client, as in criminal enterprises where the "employer" picks and pays for an attorney to represent the "employee," who might do better to cooperate with the state and testify against the employer. *See* Moore, *supra* note 6, at 607. Section 215 of the Restatement requires that some third-party fee arrangements are non-consentable precisely because of such dangers. *Id.*

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I am not sufficiently familiar with insurance defense work to further speculate on the dangers of bundled flat fees. Moreover, because the practice is relatively recent, there is little written on the subject. Nor do the existing ethics committee opinions shed much light on the problem. Given the lack of empirical evidence, an absolute prohibition on the practice seems harsh and unwarranted. On the other hand, arguably this is a situation where the unique aspects of insurance defense representation warrant taking additional precautions in order to protect the interests of the insured. Of course, I recognize that "taking additional precautions" is exactly the reverse of the manner in which the special status of the tripartite relationship was used in Part I to relax restrictions that might otherwise apply. Nevertheless, given the extent to which the tripartite relationship already seems to favor the insurer over the insured, it may not be unreasonable to want to avoid any new arrangements that further undermine an attorney's loyalty to the insured.

B. Use of In-House Counsel

Unlike bundled flat fees, the use of staff attorneys of an insurer to defend lawsuits against insureds is a long standing practice, dating back at least several decades.[163] However, liability insurers have recently expanded their reliance on such "in-house" counsel.[164] Not surprisingly, the practice has come under increasing attack.[165] Opponents cite two primary objections to the use of staff attorneys: 1) it constitutes the unauthorized practice of law by the insurer;[166] and 2) it involves the impermissible representation of conflicting interests.[167] As Professor Silver correctly notes, these objections have been rejected by the

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163. *See, e.g.*, Silver, *supra* note 3, at 237 (practice began over a century ago).

164. *See id.* at 237.

165. Many of the challenges come as a result of state bar associations requests to declare the practice unethical. *See, e.g.*, American Ins. Ass'n v. Kentucky Bar Ass'n, 917 S.W.2d 568 (Ky. 1996) (motion by insurers to review ethics opinion by state bar association proscribing practice); In re Youngblood, 895 S.W.2d 322 (Tenn. 1995) (insurers seeking review and vacating of ethics opinion condemning practice); In re Allstate Ins. Co., 722 S.W.2d 947 (Mo. 1987) (action by Advisory Committee to enjoin use of employee attorneys); Gardner v. North Carolina State Bar, 341 S.E.2d 517 (N.C. 1986) (request by insurer for reconsideration of earlier ethics opinion prohibiting practice); Ohio Formal Op. 94-9 (Aug. 12, 1994) (practice improper), overruled by Ohio Formal Op. 95-14 (Dec. 1, 1995). *But see* King v. Guiliani, 1993 Conn. Super. LEXIS 1889 (Conn. Super. Ct. July 27, 1993) (action brought by fired staff attorney to disqualify staff attorneys who replaced him in representation of insured); Coscia v. Cunningham, 299 S.E.2d 880 (Ga. 1983) (plaintiff's motion to disqualify staff attorney representing insured in liability action). I have no reason to doubt Professor's Silver's claim that these challenges are brought primarily at the behest of independent insurance defense attorneys dismayed at the extent to which their business is adversely affected by the increased use of staff attorneys. *See* Silver, *supra* note 3, at 243.

166. *See infra* Part II.B.1.

167. *See infra* Part II.B.2.

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vast majority of courts and ethics committees that have considered the issue.[168] However, the reasoning of these opinions is often weak, and there is considerable support for the argument that *absent some special consideration*, any straightforward application of professional responsibility rules would render the practice unethical.

1. Unauthorized Practice of Law

Aside from their general unauthorized practice statutes, most jurisdictions have statutes that specifically prohibit the practice of law by a corporation other than a professional corporation.[169] Under these statutes, a corporation may employee a salaried lawyer to perform legal services on its own behalf, but not to perform legal services for other persons.[170] Despite the fact that an insurer staff attorney necessarily enters an appearance on behalf of the insured (indeed the insurer is not a party to the proceeding), courts and ethics committees routinely reject the argument that the staff lawyer is performing legal services for the insured (a person other than the corporation).[171]

In refusing to find a statutory violation, most opinions reason that the insurer is acting to protect its own financial interest.[172] However, as one dissenting judge noted, while it may be true that an insurer is *in fact* acting to protect its own interest, it is *supposed* to be acting in the interests of the insured; indeed, it is contractually obligated to do so.[173] Some authorities meet this argument by acknowledging (either implicitly or explicitly) that the insurer acts to protect the interests of *both* insurer and insured; however, these authorities then conclude that the statute is still not violated because there is an

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168. *See* Silver, *supra* note 3, at 244 (among numerous authorities, only two states prohibit the practice).

169. *See* CHARLES W. WOLFRAM, MODERN LEGAL ETHICS 840 (1986).

170. *See, e.g.*, King v. Guiliani, 1993 Conn. Super. LEXIS 1889, at *5 (Connecticut statute prohibits the practice of law or appearance as attorney for another); Gardner v. North Carolina State Bar, 341 S.E.2d 517, 519 (N.C. 1986) (North Carolina statute prohibits a corporation from performing legal services for others); New Jersey Supreme Court Advisory Comm. on the Unauthorized Practice of Law, Op. 23 (Oct. 25, 1984).

171. *See, e.g.*, In re Youngblood, 895 S.W.2d 322 (Tenn. 1995); King v. Guiliani, 1993 Conn. Super. LEXIS 1889 (Conn. Super. Ct. July 27, 1993); In re Allstate Ins. Co., 722 S.W.2d 947 (Mo. 1987); Coscia v. Cunningham, 299 S.E.2d 880 (Ga. 1983); New Jersey Supreme Court Advisory Comm. on the Unauthorized Practice of Law, Op. 23 (Oct. 25, 1984). *But see* Gardner v. North Carolina State Bar, 341 S.E.2d 517 (N.C. 1986); American Ins. Ass'n v. Kentucky State Bar, 917 S.W.2d. 568 (Ky. 1996).

172. *See, e.g.*, In re Allstate Ins. Co., 722 S.W.2d 947, 949 (Mo. 1987) ("[a]n insurer has a very substantial interest in litigation involving its insured, and is entitled to retain counsel of its own choosing to protect its interest"); Strother v. Ohio Cas. Ins. Co., 1939 Ohio Misc. LEXIS 1184 (Ohio C.P. Jan. 3, 1939) (insurer has "a direct pecuniary and financial interest in any accident covered by its policies").

173. *See* Coscia v. Cunningham, 299 S.E.2d 880, 883 (Ga. 1983).

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"identity" or "community of interest" between the insurer and the insured, or even that the insurer and insured are "virtually one".[174]

As the previous discussion should have made clear, it is decidedly not the case that the insurer and insured are "virtually one."[175] Professor Silver himself concedes that their interests are not identical, even in the so-called full coverage situation.[176] He further concedes that even a common attorney has at least some obligations to the insured, which cannot be violated in order to further the interests of the insurer. For example, when the attorney learns confidential coverage information that is not necessary for the insurer to know in order to defend the liability claim, even Professor Silver agrees that the attorney has a duty of confidentiality to the insured that the attorney may not violate by revealing the information.[177] At the very least, it should be acknowledged (as one committee opinion candidly does), that the corporate unauthorized statutes attempt to distinguish between "a corporation acting for itself and that same corporation performing activities for others," and that what is involved in the use of staff attorneys by an insurer defending a liability claim is "a hybrid of the two functions."[178]

This same authority then concludes that even though it is true that the insurer provides legal services both for itself and for another person, "the furnishing of legal services to an insured by a liability insurance company involves such a community or identity of financial interest *so as to define the service involved as in the insurer's own interest.*"[179] It is not immediately apparent what this statement means. It could mean simply that common interests predominate and that the chances of any conflict are remote. This is itself a debatable proposition,[180] but even if true, it still does not explain why the staff lawyer is not involving the insurer in practicing law, since what the

174. *See, e.g.*, In re Youngblood, 895 S.W.2d at 330 ("[t]he furnishing of legal services to an insured by a liability insurance company has generally been found not to constitute the unauthorized practice of law because of the identity or community of financial interest between insured and insurer in defending the claim and because of the insurer's contractual obligation to defend the insured at the insurer's expense"); ABA Standing Comm. on Ethics and Professional Responsibility, Formal Op. 282 (1950) ("a community of interest exists between the company and the insured:" "[t]he company and the insured are virtually one in their common interest").

175. *See supra* Part I.

176. *See supra* note 33 and accompanying text.

177. *See* Silver & Quinn, *supra* note 63, at 17-18.

178. New Jersey Supreme Court Advisory Committee on the Unauthorized Practice of Law, Op. 23 (Oct. 25, 1984).

179. *Id.*

180. Professor Silver himself concedes that "[e]ven in full coverage cases, the interests of insurance companies and their insureds *often* diverge." Silver & Syverud, *supra* note 2, at 361 (emphasis added).

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insurer is clearly doing is providing legal services (through its employee) *both* to itself *and* to another person. Indeed, at least one authority approving the practice concedes that if the lawyer were to perform these legal services negligently and injure the insured, the insured would have a legal malpractice claim not only against the lawyer, *but also against the insurer* on a theory of vicarious liability.[181]

Perhaps it is true, as one student commentator argues, that the statute taken literally clearly prohibits the practice, but that to apply the statute literally has the effect of oversimplifying a complex problem.[182] But how? This same commentator argues that the complexity is attributable to the fact that there is also a technical violation of the statute *even if the insurer retains outside counsel.*[183] There is indeed support for this argument in various court and ethics committee opinions,[184] but surely there are significant distinctions between the use of outside and inside counsel. For example, when a salaried employee of an insurer provides legal services to an insured, it is clear that she does so as an agent of the insurer, thus implicating the insurer in the practice of law. However, when an insurer merely retains an outside attorney to provide legal services to an insured, it is not at all clear that it is the insurer who is providing such services.[185] Indeed, ordinarily, we would refer to the insurer as a mere third-party payer. What causes this commentator (and others) to question whether it is not the insurer that is providing the legal services in this situation is the fact that the contract of liability insurance gives the insurer the right to make certain decisions regarding the representation.[186] While it is true

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181. *See* In re Allstate Ins. Co., 722 S.W.2d at 952 ("If the attorney is an employee, the employer is undoubtedly liable jointly and severally, which would not be the case if an independent contractor were retained"). There is some question whether the insurer would be liable for the lawyer's malpractice even if the lawyer is an independent contractor. *See* Ted Schneyer, *Professionalism and Public Policy: The Case of House Counsel,* 2 GEO. J. LEGAL ETHICS 449, 465 (1988). *See also* MALLEN & SMITH, *supra* note 4, § 28.4, at 495-97. For a further discussion of the argument that even as independent contractors, lawyers technically involve insurers in the unauthorized practice of law, *see infra* notes 188-89 and accompanying text.

182. *See* William Kinsland Edwards, Note, *The Unauthorized Practice of Law by Corporations: North Carolina Holds the Line*, 65 N.C. L. REV. 1422, 1439-40 (1987).

183. *See id.* at 1431.

184. *See id.* at 1432, n.91. *See also* Schneyer, *supra* note 181, at 464.

185. Thus, for many jurisdictions, an insurer's liability for the negligence of even an independent lawyer depends on a theory of non-delegable duties, not on a theory of agency; thus, the liability is direct, not vicarious. *See* MALLEN & SMITH, *supra* note 4, § 28.4 at 495-97. Surely it is not incoherent to say that an insurer has a duty under law to provide a competent defense but that an insurer who complies with this duty by retaining an independent lawyer is not thereby practicing law.

186. *See* Edwards, *supra* note 182 at 1433. *See also* MALLEN & SMITH, *supra* note 4, § 28.4, at 496.

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that the established test for employee (versus independent contractor) status is the right to control employees "with respect to *the manner or method of doing work*,"[187] giving the insurer the right to make certain decisions is not the same as giving it the right to control outside counsel in the manner or method of doing their work, certainly not in the same sense or to the same degree that the insurer may control the work of in-house counsel.[188]

A number of jurisdictions permit representation of an insured by in-house counsel, but do so by special statute expressly designed to address this situation.[189] I do not believe that policy concerns necessarily warrant such an exception; however, if a jurisdiction is going to authorize the practice, I believe that it is important to do so by way of such a special statute, rather than by interpreting general statutes in ways that do not seem justified.[190] As with issues previously addressed, there is always the danger that bending the rules for insurance representation, without doing so explicitly, may have unexpected and clearly unwarranted results.[191]

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187. Edwards, *supra* note 182 at 1433 *citing* Page v. Sloan, 183 S.E.2d 813, 817 (N.C. Ct. App. 1971), *aff'd*, 190 S.E.2d 189 (N.C. 1972).

188. For example, as an employer, an insurer can direct its lawyer-employees to maintain files in a particular manner. So long as the directions do not interfere with the lawyer's independent judgment as to a particular case, the lawyer can and must comply, even if there is some additional risk that non-lawyer employees will gain improper access to the files. Insurers have no such control over the manner in which an independent lawyer maintains files, nor do non-lawyer insurance employees have ready access to information in an outside lawyer's files. While it is true that a "properly structured corporate environment" can minimize the likelihood of improper supervision by a non-lawyer, *see* Ronald E. Mallen, *A New Definition of Insurance Defense Counsel*, 1986 INS. COUNS. J. 108, 111, not all staff counsel departments are so structured, nor is there any way courts or the bar can regulate the structuring of such departments. For a further discussion of the significance of the corporate organizational structure on the ethics of staff counsel, *see infra* note 202 and accompanying text.

189. *See, e.g.*, Kittay v. Allstate Ins. Co., 397 N.E.2d 200 (Ill. 1979); Utilities Ins. Co. v. Montgomery, 138 S.W.2d 1062 (Tex. 1940). Some other jurisdictions have statutes which while not expressly directed toward exempting insurers defending their insureds, do contain language that is sufficiently flexible to at least arguably warrant such an exemption. *See, e.g.*, Coscia v. Cunningham, 299 S.E.2d 880, 882 (Ga. 1983) (statute permits corporations to employ attorneys "in and about their own affairs": given provisions of liability policy obligating insurer both to defend and pay judgments, defense of liability suit is "within the purview of the insurance company's immediate affairs"). The language of such statutes is quite vague, and would be far preferable if the legislatures in these jurisdictions would adopt language expressing exempting insurers in these situations, if that is their intention.

190. *See supra* note 189.

191. For example, if an insured can be represented by in-house counsel for an insurer, then arguably an employee sued for sexual harassment could be represented by his employer's in-house counsel, particularly if the employer has agreed to indemnify the employee. The greater dangers involved in this form of third-party representation are further discussed in Moore, *supra* note 6, at Part III.A.

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2. Conflicts of Interest

Opponents of the use of in-house counsel also argue that even when the practice does not violate unauthorized practice of law statutes, it violates rules of professional conduct by involving the lawyer in impermissible conflicts. Although not always articulated as such, the argument is clearly that there is a conflict of interests and that the conflict is non-consentable.[192] As with the unauthorized practice argument, it is indeed the case that the overwhelming weight of authority is that the representation is ethical so long as the interests of the insured and the insurer are not in actual conflict.[193] However, once again there is considerable support for an argument to the contrary, i.e., that the circumstances are such that the risks to the insured are "immeasurably heightened" when the lawyer is a salaried employee of the insurer, perhaps to the point where the insured should not be permitted to consent to the representation.[194] In any event, if the representation is permitted, the lawyer's

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192. Critics often warn of a "possibility of conflicts of interest between insurer and insured." *See* In re Allstate Ins. Co., 722 S.W.2d 947, 952, n.4 (Mo. 1987) (referring to numerous authorities). As the majority opinion in *Allstate* notes, the mere possibility of such conflicts does not necessarily render the representation unethical. *See id.* Nevertheless, under applicable conflict of interest rules, an actual conflict need not exist in order for a lawyer to be under an ethical structure not to accept the representation. *See supra* notes 35-39 and accompanying text. *See also* In re Allstate Ins. Co., 722 S.W.2d at 956 (Rendlen, J. dissenting) (injunction should issue because insurer's actions "place house counsel in a position of inherent conflict of interest".) The better argument would be that there is a potentially impermissible conflict under Rule 1.7(b) whenever a lawyer undertakes to represent both insurer and insured (or under Rule 1.8(f) whenever a lawyer is paid by a third party to represent the insured), *see supra* notes 44-50, 91-92 and accompanying text, and that such conflict is rendered non-consentable when the lawyer is a staff attorney rather than an independent attorney. *See infra* notes 198-210 and accompanying text.

193. *See* MALLEN & SMITH, *supra* note 4, § 28.5 at 505-09.

194. *See* In re Allstate Ins. Co., 722 S.W.2d at 956 (Rendlen, J. dissenting):

> The injunction should issue for the additional reason that respondent's actions place house counsel in a position of inherent conflict of interest. As observed by the Advisory Committee, while independent outside counsel, hired by another to represent a third party, faces the possibility of conflicting interests, this risk is immeasurably heightened in the case of house counsel, who is confronted not only with the appearance of conflict and professional impropriety, but with certain and unavoidable conflicts. An attorney attempting to serve two masters with conflicting interests can provide neither the loyalty they deserve.

While I agree with the conclusion that the conflict is non-consentable, I disagree with the above reasoning. First, under the Model Rules, the mere appearance of impropriety is no longer a significant factor to be considered in determining the issue of non-consentability. *See* Moore, *supra* note 41, at 214. Second, actual conflict and professional impropriety are by no means "certain and unavoidable," nor is it true that "[a]n attorney attempting to serve two masters with

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status ought to be disclosed as part of the process of obtaining the insured's informed consent to the representation.[195]

It should be obvious by now that there is a conflict of interest under Rule 1.7(b) whenever a lawyer represents both an insurer and an insured in defending the insured under a liability insurance contract.[196] Even if the lawyer is representing only one client—the insured—there is still a conflict under Rule 1.8(f), which like Rule 1.7(b) requires the informed consent of the insured.[197] Moreover, it should also be clear that there will be at least some situations in which the conflict will be non-consentable; for example, when there is a coverage issue that cannot be resolved separately from the determination of liability. But what about the more typical full coverage situation in which the lawyer has no particular reason to foresee that coverage issues or other actual conflicts will arise? As set forth in an earlier section of this article, this conflict is certainly consentable when an independent attorney is involved.[198] Therefore, the only question is whether the mere fact that the lawyer is a salaried employee of the insurer is sufficient reason to render the conflict non-consentable.

Those who resolve this issue favorably to the insurer reason that in-house lawyers are bound by the same ethical rules as outside counsel and that there

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conflicting interests can provide neither the loyalty they deserve," since the clients might agree to limit the extent to which the common attorney may agree to help one at the other's expense. *See generally id.* Rather, the problem is that while *independent counsel* might properly represent the two clients (or the insured with the insurer a mere third-party payer), the circumstances under which *staff counsel* operates may be such as to render the conflict non-consentable. *See infra* notes 202-09 and accompanying text.

195. *See infra* notes 209-14 and accompanying text.

196. *See supra* Part I.B.

197. *See supra* note 112 and accompanying text. Some authorities have argued that "[w]here the employer is not also a client, a conflict will not occur unless the attorney is obligated by the terms or circumstances of the employment to protect the interest of the employer even to the detriment of the insured." In re Youngblood, 895 S.W.2d at 328. This is not an accurate statement of the ethical rules governing third party payment of a lawyer's fees. Under Rule 1.8(f), the client's consent is required whenever someone other than the client is paying the lawyer's fees, and under Rule 1.7(b) a fully informed consent is also required whenever the lawyer's ability to represent the client may be materially limited by the lawyer's own interests. *See supra* note 34. Whenever the lawyer's relationship with the insurer is such that the lawyer has a strong financial incentive to favor the insurer, at the possible expense of the insured, this is information that is required to be disclosed under Rule 1.7(b)(2) and that may even render the conflict non-consentable under Rule 1.7(b)(1). *Cf. In re Youngblood* 895 S.W.2d 328 (even with consent after consultation lawyer may not accept representation unless she "reasonably believes that the representation will not be adversely affected"). For a detailed discussion of the difficulties of determining when conflicts are non-consentable, *see generally* Moore, *supra* note 6.

198. *See supra* Part I.D.

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is no reason to treat them differently.[199] I agree that the same ethical rules apply to both sets of lawyers. I also agree that we have no empirical evidence demonstrating that salaried attorneys are less ethical than other attorneys.[200] Certainly there is no reason to believe that salaried attorneys are less ethical in the sense that they are more lacking in moral integrity than other lawyers. However, the issue here is not whether there is a difference in moral character, but rather whether the *circumstances* of their employment are such that given increased pressure on in-house counsel to act in their employer's best interests, insureds should not even be asked to give their consent to such a conflict of interest.[201]

As for the fact that a salaried attorney has only one real client, the employer, it is true that outside counsel are often extremely dependent on one insurance company that supplies all, virtually all, or even a large percentage of their law firm's business.[202] In this respect, the temptation to (impermissibly) favor the interests of the insurer may be just as strong for some outside lawyers as for in-house counsel. However, there is also the problem that the very structure of the organization, as well as the lawyer's position as a salaried employee, may change the dynamics of the relationships in ways that strongly disfavor the interests of insureds.[203] For example, assume a conflict arises such

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199. *See, e.g.*, In re Allstate Ins. Co., 722 S.W.2d at 953:

> Employed lawyers are bound by the same rules of professional conduct as are independent practitioners. If a conflict appears, the lawyer, employed or retained, must immediately resolve it by terminating representation of one or both parties.... If a client suffers damage because his attorney represents conflicting interests, a civil action is available. If the attorney is an employee, the employer is undoubtedly liable jointly and severally, which would not be the case if an independent contractor were retained. The lawyers involved are also subject to professional discipline. There is no basis for a conclusion that employed lawyers have less regard for the Rules of Professional Conduct than private practitioners do.

200. *See* Silver, *supra* note 3, at 247-48 (no evidence of unethical conduct by insurer staff attorneys).

201. *See, e.g.*, In re Allstate Ins. Co., 722 S.W.2d at 956-957 (Redlen, J. dissenting).

202. *See, e.g.*, King v. Guiliani, 1993 Conn. Super. LEXIS 1889 at *19.

203. This fact is conceded by one of the strong proponents of the use of insurer house counsel, Ronald Mallen, who was also one of the first to recognize the potential dangers of the practice. *See* Mallen, *supra* note 188, at 110 (salaried employee has "added relationships which enhance the prospects of a subjective bias in favor of the insurer," including "financial dependence on one client" and control by attorney's superiors). *See also* MALLEN & SMITH, *supra* note 4, § 28.5 at 505. However, Mr. Mallen believes that the dangers can be controlled, indeed that "in a properly structured corporate environment, employed counsel does not face many of the economic pressures which can tempt outside counsel to favor the insured." Mallen, *supra* note 188, at 111. *See infra* note 204 and accompanying text.

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that the lawyer believes both that he or she is ethically obliged to withdraw *and* that the lawyer has confidential information from the insured that she may not reveal to the insurer. Assume further that the non-lawyer supervisor who directs the lawyer[204] disagrees with the decision on withdrawal and wants to know exactly how and why the conflict has arisen. It may well be that there are some in-house counsel who can retain their independence and not let their employers influence their decisions, but it seems far more likely that a salaried employee would feel far greater pressure than an independent lawyer to give in to the demands of the insurer.[205] Moreover, what of the confidential information itself? When an independent lawyer withdraws, that lawyer has complete control over the file. However, when a salaried lawyer withdraws, the file belongs to the insurer. To the extent that the insurer has access to that file, there is certainly greater danger to the insured, regardless of the ethics of the lawyer herself.

The primary dangers then are not really the dangers of Rule 1.7(b) itself, but rather of Rule 1.8(f) and Rule 5.4 regarding the ability of the lawyer to resist the efforts of non-lawyers to influence the independent judgment of the lawyers themselves.[206] Indeed, a primary purpose of statutory and other prohibitions against unauthorized practice by corporations or lawyers working for law firms having nonlawyer partners is to prevent non-lawyers, who are not subject to ethical codes and other strictures of professionalism, from interfering with a lawyer's freedom of action on behalf of a client.[207] Reasonable persons may disagree as to the wisdom of such prohibitions; indeed the primary argument against them is exactly the same argument made by Professor Silver and others—that lawyers can be trusted to conduct themselves ethically even

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204. Mr. Mallen argues that in a "properly structured corporate environment" lawyers would report to more senior lawyers rather than to non-lawyer claims persons. Mallen, *supra* note 188 at 111. However, there is nothing that requires insurers to have separate law departments or to organize them in such a way as to promote "a corporate environment which does not restrict or imperil the ability of staff counsel to comport with ethical requirements." *Id.* at 112. Indeed, Mr. Mallen concedes that "ultimately the operation of staff counsel department will be subject to a superior within the company," *id.*, thereby enhancing the danger that non-lawyer supervisors will attempt to interfere with a lawyer's independent judgment.

205. Professor Ted Schneyer bemoans the fact that judicial assumptions about lawyer behavior, including assumptions about the behavior of insurance and other corporate in-house counsel, are typically made without access to empirical data. *See* Schneyer, *supra* note 181. I agree that it would be better if we had more information about the effect of corporate restraints on the professionalism of in-house lawyers, but in the meantime, we can only make decisions and recommendations on the basis of our best judgments as to the nature of those constraints. Professor Silver puts great stock in the absence of documented examples of unethical behavior. I do not.

206. *See supra* Part I.C.

207. *See, e.g.*, Edwards, *supra* note 182, at 1427.

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when they report to non-lawyers.[208] Nevertheless, efforts to eliminate these rules have not yet succeeded,[209] thus it is difficult to ignore what is generally recognized as a substantial danger that insurance or other corporate staff lawyers will be unduly tempted to favor (even unconsciously) the interests of their employers over the interests of their non-employer clients.

If special exceptions are warranted by the economic exigencies of the insurance defense business,[210] and I am not yet persuaded that they are, then at the very least, insureds should be told of the status of the attorney as staff counsel.[211] Such lawyers often go to great lengths to conceal their in-house status, including the use of letterhead giving the (incorrect) appearance that the lawyer is a member of a traditional law firm.[212] They try to justify their conduct by arguing that "general identification of the attorney-employee with the insurer-employer must be avoided,"[213] and that "public disclosure of the real relationship between the insurer and the attorney would serve no useful

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208. Indeed, preliminary drafts of the Model Rules provided that lawyers *could* practice in firms in which non-lawyers had ownership interests or managerial authority, but only if "the services [could] be rendered in conformity with the Rules of Professional Conduct." MODEL RULES, *supra* note 33, Rule 7.5 (Jan. 1980 draft). These drafts further provided that "[t]he terms of the relationship shall expressly provide that (a) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and (b) the confidences of clients are protected." *Id.*

209. Proposed Rule 7.5 was dropped when during the floor debate it became clear that its effect would be to permit corporations like Sears, Roebuck to open up law offices for the public. *See generally* STEPHEN GILLERS, REGULATION OF LAWYERS 795 (4th ed. 1995).

210. *See generally* Silver, *supra* note 3, at 240-43.

211. *See, e.g.*, In re Weiss, Healey & Rea, 536 A.2d 266, 269 (N.J. 1988) ("clients of in-house counsel should have a full understanding of the kind and caliber of legal services that they are receiving"); ABA Standing Comm. on Professional Responsibility 1402 (Nov. 3, 1977) ("it is important that the [in-house] lawyer fully disclose to the client the lawyer's relationship to the insured"). Other authorities have held that it is improper for an in-house lawyer to hold himself out as a member of an independent law firm, without expressly providing that the lawyer must affirmatively disclose the nature of the relationship with the insured. *See, e.g.*, In re Youngblood, 895 S.W.2d at 331 ("holding out of an in-house attorney-employee as a separate and independent law firm constitutes an unethical and deceptive practice"); Ohio Sup. Ct. Bd. of Comm'rs., Op. 95-14 (Dec. 1, 1995) (attorney-employee of insurance company may not participant in an "in house-law firm" established by an insurance company under a "firm name" consisting of one or more of the names of the attorneys).

212. *See, e.g.*, In re Weiss, Healey & Rea, 536 A.2d 266 (eight full-time employees of insurance company conduct business in the name of "Weiss, Healey & Rea;" insurer's Regional Manager for Legal Services in New Jersey referred to as "senior partner" of group). *See also* King v. Guiliani, 1993 Conn. Super. LEXIS 1889, at *5 n.3 (1993) (discussing a "captive law firm," denoting "a law firm in which all attorneys and staff are employees of an insurance company, the company pays all office expenses and salaries and the attorneys are assigned to represent insureds against whom claims have been made").

213. In re Youngblood, 895 S.W.2d at 332.

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purpose."[214] Why identification of the attorney with the insurer "must be avoided" is not explained. Perhaps the concern is that using their employer's letterhead would give the (according to them incorrect) impression that they are involving their employer in the unauthorized practice of law, but this concern would be specious: if a staff employee is *not* involving the insurer in the unauthorized practice of law, then how could it be impermissible for the employee to (correctly) announce that status to the insured or to anyone else? As for the lack of any "useful purpose" to be served, clients are surely entitled to know with whom they are dealing; moreover, it is deceitful (and therefore unethical) for lawyers to affirmatively *misrepresent* their status.[215]

CONCLUSION

For reasons that have never been clearly articulated, lawyers and judges have for decades given their tacit approval to the various practices of insurance defense lawyers that are the subject of this symposium issue. Perhaps because professional responsibility codes have often been vague, these practices have not always been thoroughly scrutinized under professional responsibility law. Thus, the discussions in the symposium papers are a welcome addition to professional responsibility (and insurance law) scholarship. They have certainly sharpened my own knowledge of the ethics dilemmas of insurance defense lawyers and the applicability of the rules of professional conduct to these dilemmas.

Having examined a broad spectrum of issues, I am increasingly convinced that some of the problems that arise in insurance law defense work may be unique to that context and thus may demand unique solutions. As a result, I am prepared to accept and defend some "flex in the joints" of the ethics codes to accommodate the interests of both insurers and insureds. However, I am increasingly concerned that it would be dangerous to extend solutions developed in the insurance context to other problem areas; for example, situations involving employers and employees, parents and children, and layers hired by public interest organizations to represent individual litigants. Moreover, even in the insurance context, I am concerned that professional responsibility law not routinely be molded to fit the desires of the insurance industry. For example, I have grave doubts about the propriety of using insurance staff counsel to represent insureds, as well as some nagging concerns about the use of bundled flat fees. At the very least, it would be useful to

214. *Id.* Another reason given is to enhance both the public esteem and self-esteem of in-house lawyers, who wish to avoid any impression that they are in some way "second-class lawyers." In re Weiss, Healey & Rea, 526 A.2d at 269.

215. *See* MODEL RULES, *supra* note 33, Rule 4.1(a).

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accumulate some empirical data to determine the actual need for these practices, as well as the nature and extent of the risks they pose to insureds.

I am grateful to Professors Silver and Baker for organizing this symposium and for enlisting me as a participant. The issues raised in the papers are both challenging and important, and thinking about them has enriched my own understanding of both insurance practice and professional responsibility law.

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LEGAL MALPRACTICE INSURANCE AND LOSS PREVENTION: A COMPARATIVE ANALYSIS OF ECONOMIC INSTITUTIONS

*George M. Cohen**

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INTRODUCTION

Legal malpractice is finally getting the recognition it deserves as an important institution for regulating lawyer behavior.[1] Legal malpractice insurance is not—yet.[2] Although scholars have begun to focus on the relationship between malpractice and legal ethics, the effect of malpractice insurance on this relationship has gone largely unexplored.[3] And although legal and economic scholars have examined the theoretical underpinnings and practical uses and limitations of liability insurance generally,[4] no one has yet tried to apply those insights to legal malpractice insurance.

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1. Academic interest in legal malpractice has increased significantly over the last few years. Recent offerings include Manuel R. Ramos, *Legal and Law School Malpractice: Confessions of a Lawyer's Lawyer and Professor*, 57 OHIO ST. L.J. 863 (1996) [hereinafter Ramos, *Confessions*]; Manuel R. Ramos, *Legal Malpractice: Reforming Lawyers and Law Professors*, 70 TUL. L. REV. 2583 (1996) [hereinafter Ramos, *Reforming Lawyers and Law Professors*]; John Leubsdorf, *Legal Malpractice and Professional Responsibility*, 48 RUTGERS L. REV. 101 (1995); Manuel R. Ramos, *Legal Malpractice: No Lawyer or Client Is Safe*, 47 FLA. L. REV. 1 (1995) [hereinafter Ramos, *No Lawyer or Client is Safe*]; William H. Fortune & Dulaney O'Roark, *Risk Management for Lawyers*, 45 S.C. L. REV. 617 (1994); Manuel R. Ramos, *Legal Malpractice: The Profession's Dirty Little Secret*, 47 VAND. L. REV. 1657 (1994) [hereinafter Ramos, *Dirty Little Secret*]. This increased interest is not accidental. Professor Leubsdorf is an Associate Reporter for the pending American Law Institute's RESTATEMENT OF THE LAW (THIRD): THE LAW GOVERNING LAWYERS and chief drafter of the chapter on civil liabilities. *See* Leubsdorf, *supra*, at 101 n.a. Professor Ramos entered the academy after a significant stint as a legal malpractice defense lawyer, and apparently has undertaken a one-man crusade to enlighten the ignorant about the extent of and cures for the legal malpractice crisis he (in my view, correctly) perceives.

2. Recent discussions of legal malpractice insurance include Andrew S. Hanen & Jett Hanna, *Legal Malpractice Insurance: Exclusions, Selected Coverage and Consumer Issues*, 33 S. TEX. L. REV. 75 (1992); Frederic L. Goldfein, *Legal Malpractice Insurance*, 61 TEMP. L. REV. 1285 (1988). Both of these articles were written by practitioners and approach the subject from that perspective. By contrast, Professor Wolfram includes only two pages on legal malpractice insurance in his treatise. *See* CHARLES W. WOLFRAM, MODERN LEGAL ETHICS § 5.6.8, 240-41 (1986).

3. The one significant exception is the recent exchange between Anthony Davis, a practitioner, and Professor Charles Silver. *See* Anthony E. Davis, *Professional Liability Insurers as Regulators of Law Practice*, 65 FORDHAM L. REV. 209 (1996); Charles Silver, *Professional Liability Insurance as Insurance and as Lawyer Regulation: Response to Davis*, 65 FORDHAM L. REV. 233 (1996).

4. *See* Randall R. Bovbjerg, *Liability and Liability Insurance: Chicken and Egg, Destructive Spiral, or Risk and Reaction*, 72 TEX. L. REV. 1655 (1994); Steven W. Pottier & Robert C. Witt, *On the Demand for Liability Insurance: An Insurance Economics Perspective*, 72 TEX. L. REV. 1681 (1994); Kent Syverud, *On the Demand for Liability Insurance*, 72 TEX. L. REV. 1629 (1994); Patricia M. Danzon & Scott E. Harrington, *The Demand for and Supply of Liability Insurance*, *in* CONTRIBUTIONS TO INSURANCE ECONOMICS (Georges Dionne ed.,

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This article attempts to remedy this deficiency and to spark debate over the current and proper role for legal malpractice insurance as an institution of lawyer regulation. My thesis is simple. Legal malpractice insurance, like other liability insurance, can further the deterrence goals of liability by improving the behavior of the insureds. This "loss prevention" function of legal malpractice insurance seems to be increasing in ways that the economics of insurance would predict. In fact, because of their comparative institutional advantages, legal malpractice insurers are increasingly serving as regulators of lawyer behavior and may be beginning to substitute for the firm and the bar in this role. Whether the trend is good or bad is a harder question, the answer to which depends, of course, on how effective this regulation is likely to be, what negative consequences it has, and what plausible alternatives are available.

I begin by offering some historical and institutional background. I then set forth an economic theory of legal malpractice insurance, comparing different insurance institutions. In particular, I try to articulate when market insurance is likely to be a relatively strong institution for shaping the behavior of insureds, and to argue that legal malpractice insurance fits this category. Initially, I make the simplifying assumptions that both lawyers and clients are, or can be treated as, individuals. Later, I relax the assumptions of individual clients and individual lawyers, and argue that the complexities introduced further support the argument that legal malpractice insurance may be a superior institution for regulating lawyer behavior.

I. A BRIEF HISTORY OF LEGAL MALPRACTICE INSURANCE

Although the first policy for lawyers' professional liability written through a United States company was issued in 1945, the history of legal malpractice insurance in this country is usually traced to the 1960s, when it first gained prominence.[5] Legal malpractice insurance was offered by property and casualty insurers as an ancillary service to their main business.[6] For our purposes, two other significant events relevant to the regulation of lawyers occurred in the 1960s. The first event was the California Supreme Court's decision in *Lucas v. Hamm*,[7] which held that lawyers owed a duty of care to non-client beneficiaries of a will, though it rejected the claim on the ground

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1991); Gary T. Schwartz, *The Ethics and Economics of Tort Liability Insurance*, 75 CORNELL L. REV. 313 (1990).

5. *See* Robert T. Reid, *Lawyers' Malpractice Insurance Coverage in the United States*, *in* PRACTISING LAW INSTITUTE, REAL ESTATE LAW AND PRACTICE COURSE HANDBOOK SERIES 2 (1985).

6. *See* Fortune & O'Roark, *supra* note 1, at 632-33.

7. 364 P.2d 685 (Cal. 1961).

that the lawyer did not breach this duty by botching the Rule Against Perpetuities because (try explaining this to a non-lawyer with a straight face) no lawyers understood the Rule. The second event was the ABA's adoption of the Model Code of Professional Responsibility in 1969.

In the 1970s malpractice claims against lawyers increased substantially.[8] In some jurisdictions, such as California, insurers started dropping out of the of the legal malpractice insurance market and focusing on more profitable and stable areas.[9] In other jurisdictions, the availability of insurance increased.[10] Two significant changes in insurance policies took place during this period: the adoption of "claims-made" policies that took insurers off the hook for claims arising long after the policy was issued; and "eroding policy limits," which counted legal defense expenditures against the policy limits.[11] By the end of the 1970s, premiums were increasing sharply.[12] There were several other significant developments. On the insurance side, in 1978 Oregon adopted mandatory malpractice insurance for lawyers, and North Carolina and California formed the first "bar-related," mutual (owned by the lawyers) insurance companies. The following year saw the arrival of the Attorneys' Liability Assurance Society (ALAS), a non-bar-related mutual that limited membership to large (at the time, 40 or more lawyers) law firms outside of New York.

At the same time, the law governing lawyers was undergoing extensive change. In 1976, a state court held that a lawyer for a guardian owed a duty to the guardian's ward as well as to the guardian and could be subject to liability for failing to protect the ward's interests against the guardian's wrongful behavior.[13] In 1977, the ABA's Kutak Commission was formed to consider revising the Model Code; its efforts led to the Model Rules of Professional Conduct in 1983. In 1978, a federal district judge decided *National Student Marketing*,[14] which sent shock waves through the corporate bar with its holding that lawyers violated the securities laws by allowing a merger deal to close despite being in possession of information that suggested trouble (though the

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8. *See* Goldfein, *supra* note 2, at 1286.

9. *See* ISSUES IN FORMING A BAR-RELATED PROFESSIONAL LIABILITY INSURANCE COMPANY 4 (American Bar Association, Standing Committee on Lawyers' Professional Liability ed., 1989) [hereinafter ABA, BAR-RELATED INSURANCE].

10. *See* 1 JEFFREY M. SMITH & RONALD E. MALLEN, LEGAL MALPRACTICE § 33.1, at 277-78 (3d ed. 1989).

11. *See* William C. Moore, Jr. & T. Steven Helms, *The Genesis of Bar-Related Insurance Companies*, in ABA, BAR-RELATED INSURANCE, *supra* note 9, at 13.

12. *See* Goldfein, *supra* note 2, at 1285.

13. *See* Fickett v. Superior Court of Pima County, 558 P.2d 988 (Ariz. Ct. App. 1976).

14. SEC v. National Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978). The case was filed in 1972.

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court watered down this holding by refusing to issue an injunction against the lawyers). Those shock waves intensified two years later, when a federal court found Willkie, Farr & Gallagher liable for $34.8 million in a malpractice suit stemming from the alleged looting of IOS Ltd. and its offshore mutual fund, Fund of Funds, Ltd, by Robert Vesco.[15]

An additional phenomenon that was occurring during the 1970s is worth noting. The Supreme Court was paved the way for greater competition among lawyers by its 1975 decision in *Goldfarb v. Virginia State Bar*,[16] applying the antitrust laws to lawyers for the first time, and its 1977 decision in *Bates v. State Bar of Ariz.*,[17] striking down restrictions on lawyer advertising on First Amendment grounds. Whether these cases caused, ratified, or facilitated competition among lawyers, they led to a greater focus on competition and the effects—good and bad—that competition could have on the profession. One of these effects was the possibility of more malpractice.

In the 1980s the insurance crisis hit legal malpractice insurance, as it did other areas. Premiums increased between 400% and 1500%, coverage decreased, and availability declined.[18] These premium increases were driven in part by lower interest rates and in part by an increase in the frequency and severity of malpractice claims being made against lawyers.[19] Some of these claims were securities actions spurred on by *National Student Marketing*, liability for which insurance companies were unable to avoid completely because of their broad duty to defend. Other claims stemmed from the collapse of the real estate market, and a crackdown on tax shelters by the IRS and SEC.[20] According to one source: "Between 1982 and 1984, estimated losses nationwide, including adjustment expenses, roughly doubled. Between 1982 and 1986, no other area of professional liability insurance experienced anywhere near this rate of severe increase for a similar period."[21] Some insurers responded by dropping out of the market; others restricted coverage and limited the availability of excess insurance. Premiums remained high through the end of the decade, as claims frequency remained high.[22] Lawyers again responded by forming more bar-related mutuals, in part spurred on by the

15. *See, e.g.*, WALL ST. J., July 22, 1980, at 14.

16. 421 U.S. 773 (1975).

17. 433 U.S. 350 (1977).

18. *See* Goldfein, *supra* note 2, at 1285.

19. *See* 1 SMITH & MALLEN, *supra* note 10, § 33.1, at 278.

20. *See* Reid, *supra* note 5, at 3.

21. LONG & LEVIT, LEGAL MALPRACTICE: THE LAW OFFICE GUIDE TO PURCHASING LEGAL MALPRACTICE INSURANCE 39 (Ronald E. Mallen, ed. 1995-96).

22. *See id.* at 40.

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1986 Liability Risk Retention Act.[23] Most notable among the new mutuals were the Association of Trial Lawyers Assurance (ATLA) for members of the trial lawyers' group that has the same acronym, and the Attorneys Liability Protection Society (ALPS), both of which started in 1988.

In the 1990s, the biggest developments so far have not been in malpractice insurance, where rates seem to have stabilized and mutuals continue to grow and thrive, but in the law of lawyering and the law of law firms. Cases arising out of the savings and loan crisis, including the famous *Kaye, Scholer* case, led to huge payouts by malpractice insurers. Currently, the ALI's Restatement of the Law Governing Lawyers is being debated and adopted. On the law firm side, the biggest development is the explosion of Limited Liability Company and Limited Liability Partnership statutes and their application to law firms.

Given this background, I aim in the remainder of the paper to try to understand how and why legal malpractice insurance has developed as it has. In particular, what are we to make of the development and persistence of groups like ALAS and other mutuals? What is the relationship between the evolution of insurance institutions and other developments in the law governing lawyers as well as the general competitive environment facing lawyers? The remaining sections explore these and related questions.

II. THE ECONOMIC INSTITUTIONS OF LEGAL MALPRACTICE INSURANCE

A. What Is Legal Malpractice Insurance?

Legal malpractice insurance is one of many economic institutions that regulate lawyer behavior. It does so indirectly and often incidentally. Like other third-party liability insurance, legal malpractice insurance regulates indirectly in the sense that legal liability—in this case, legal malpractice—provides the primary form of regulation. Legal liability sets the regulatory standard; liability insurance responds to that standard. Legal liability is of course not the only form of regulation. Ethics rules, for example, also serve to regulate lawyer behavior.[24] But in this article, I take legal malpractice liability

23. The purpose of the act was to encourage the formation of Risk Retention Groups (RRGs), which are special purpose insurance companies wholly owned by the policyholders. The major advantage of RRG status is that "after meeting the regulatory requirements of the state in which it is chartered, an RRG can provide insurance to members in other states without first having to meet their individual licensing requirements." ABA, BAR-RELATED INSURANCE, *supra* note 9, at 7.

24. *See generally* David B. Wilkins, *Who Should Regulate Lawyers?*, 105 HARV. L. REV. 799 (1992).

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as the relevant regulatory mechanism. I also take the standard of legal malpractice as given, though recognizing how it has changed.

Liability insurance can either help or hinder the regulatory goals of the liability system, in addition to simply serving the interests of the insured.[25] To understand the regulatory function of legal malpractice insurance, then, we must understand the goals of legal malpractice. Recognizing that other legitimate goals of legal malpractice exist, I want to focus in this paper on deterrence. The economic approach to tort liability posits the goal of minimizing the sum of the costs of reducing harmful behavior and the expected costs of the remaining harms.[26] Expected costs are risks, because when the relevant actor makes decisions about whether to engage in conduct, these costs are uncertain. Liability insurance serves the deterrence goal of the liability system when it reduces the sum of the costs of prevention and expected harm below what would exist in the absence of insurance. Liability insurance disserves the deterrence goal of the liability system when it reduces costs to the insured merely at the expense of increasing costs to the victims of harm.

But what exactly is liability insurance? Although the answer may seem obvious, from an economic institutional perspective it is less clear. In particular, in this part I examine three general economic institutions that lawyers use to respond to the risk of malpractice liability, all of which can be understood as "insurance." In this section, I want to explain how I am using that term. I define liability insurance broadly as any institution whose purpose is to reduce for some person (the insured) any cost associated with liability risk to that person. We tend not to think of liability insurance as *any* institution designed to reduce costs associated with the risk of liability, and to think of liability insurance so broadly is perhaps confusing. But thinking of it more narrowly is also somewhat confusing, or at least confining. The narrow conception of liability insurance views insurance as "loss spreading" services offered by a commercial entity designed primarily to offer such services. Economists, however, have tried to get us to think of insurance more broadly than that to show how other institutions perform the same functions. But even

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25. It is common to think of liability insurance as providing the link between ignorance of the law and deterrence. Even if a person doesn't know the rules of negligence, the deterrence theorist argues, his insurance company does, and will force him to conform his conduct to these rules. *See, e.g.*, WILLIAM M. LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF TORT LAW 11 (1987) (arguing that one way tort law deters is "by forcing up liability insurance rates to the point where people are priced out of driving").

26. *See generally* GUIDO CALABRESI, THE COSTS OF ACCIDENTS (1970); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW (4th ed. 1992); STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW (1987).

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economists seem not to want to adopt the broadest definition. Nor do they seem to agree on how to delimit liability insurance.

For example, one way to think of liability insurance is as a particular method of risk reduction, namely risk pooling or diversification.[27] This definition ties the concept of insurance to risk aversion. Risk aversion is a cost of risk over and above the costs associated with the expected value of the risk. More precisely, risk aversion represents a willingness to pay more than the expected value of some risk (the probability of harm times the size of the loss) to avoid bearing that risk. The amount in excess of the expected value that a risk-bearer would be willing to pay is called the "risk premium."[28] Because of the diminishing marginal utility of wealth, the risk premium is thought to be higher the larger the percentage of total wealth the potential loss represents. Risk pooling eliminates the costs of risk aversion to the insured by substituting the certain costs of pooling for the uncertain risks of harmful conduct and its attendant liability. Defining insurance in terms of risk pooling narrows the concept of insurance in two ways. First, risk pooling does not reduce other costs associated with the risk of liability, such as the costs of preventing harmful conduct (precautions) and the loss associated with the harmful conduct. Second, risk pooling is not the only means of reducing the costs associated with risk aversion. One could also reduce the costs of risk aversion by reducing the magnitude of losses associated with harmful conduct, or by increasing wealth.

For these reasons, economists have sometimes espoused broader definitions of liability insurance. Judge Posner in his treatise seems to define insurance as any effort, not just pooling, to reduce the costs associated with risk aversion as opposed to expected accident costs.[29] Thus, he distinguishes "insurance" from "prevention" by the fact that prevention refers to an expenditure to reduce expected losses when the expenditure is less than or equal to the expected reduction in loss, whereas insurance means any reduction in risk costs beyond such expenditures on preventable losses. For example, if expected losses from an accident are $100, then any expenditure up to $100 to eliminate those expected losses is "prevention." Any (rational) expenditure

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27. *See* KENNETH S. ABRAHAM, DISTRIBUTING RISK 1 (1986).

28. *See* J.W. Pratt, *Risk Aversion in the Small and in the Large*, 32 ECONOMETRICA 122 (1964).

29. *See* POSNER, *supra* note 26, at 103-04. It is somewhat ironic that Posner develops this notion of insurance in the context of discussing the impossibility doctrine in contract law. A good case can be made that this doctrine has nothing to do with providing insurance in the sense Posner describes. *See, e.g.*, MICHAEL TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 130-36 (1993) (summarizing critiques of Posner's theory); Victor P. Goldberg, *Impossibility and Related Excuses*, 144 J. INST. & THEORETICAL ECON. 144 (1988) (developing an explanation for excuse doctrines based on efficient mitigation).

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above $100, however, is not "prevention" but rather "insurance" because the only purpose it serves is to reduce the costs associated with risk aversion. The reason for this somewhat strained definition is to emphasize the idea that if more than $100 is spent on prevention, there is, in some meaningful sense, "too much" prevention, a point I shall return to below.

Another definition that economists have used loosens the concept of insurance from the shackles of risk aversion, though it does not remove the shackles entirely. Professors Ehrlich and Becker, in their classic article, define insurance as any attempt to reduce the size of the loss associated with harmful conduct.[30] They distinguish insurance from "protection," which they define as any attempt to reduce the likelihood of harm. Thus, in the above example, if the expected losses of $100 are the product of a $100,000 harm and a likelihood of .001, then any expenditure designed to reduce the $100,000 (as opposed to reducing the .001) is "insurance," whether such expenditure is more or less than the $100 expected harm, and whether or not it involves pooling. Although this definition is broader than the previous two, it still leaves insurance somewhat tied to risk aversion, because risk aversion, given its connection to the diminishing marginal utility of wealth, is more closely tied to loss reduction expenditures than to probability reduction expenditures, which even a risk neutral party might undertake.[31]

The reason Ehrlich and Becker define insurance in the way they do is to emphasize that self-insurance, which they define as any attempt by an individual to reduce the size of his potential losses without resorting to the market, can be viewed as a substitute for insurance purchased on the market.[32] This focus on self-insurance distinguishes the Ehrlich and Becker definition from another definition of insurance, used by Shavell[33] and Arrow[34], which involves any shifting of risk from one party to another. The risk-shifting definition is useful because it leads one to recognize that many contracts, whether with insurance companies, the potential victims of harm, or with other loss reduction entities such as law firms, provide a form of insurance against the risks associated with legal liability. I will use the term "contract insurance"

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30. *See* Isaac Ehrlich & Gary S. Becker, *Market Insurance, Self-Insurance, and Self-Protection*, J. POL. ECON. 623, 633 (1972).

31. *See id.* at 639-40.

32. *See id.* at 633. Others who do not share this focus look less favorably on the term. *See, e.g.*, Schwartz, *supra* note 4, at 315 (characterizing self-insurance as an "odd euphemism for 'uninsured'").

33. *See* SHAVELL, *supra* note 26, at 192 (defining insurance as an arrangement in which "parties referred to as *insureds* pay *premiums* to an *insurer* in exchange for protection against possible future losses").

34. *See* KENNETH J. ARROW, ESSAYS IN THE THEORY OF RISK BEARING 137 (1970) (defining insurance as any institution designed to shift risks from one party to another).

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to refer to any contract with a party other than an insurance company that serves to shift liability risks.

I have elaborated on these definitions of insurance to make several points. Definitions depend on the purposes to be served. If we want to engage in comparative institutional analysis, then it makes sense to define insurance more broadly than economists have so far done. Thus, I shall use legal malpractice insurance to refer, as suggested above, to *any* institution designed to reduce *any* of the costs associated with the risk of legal liability. That means that self-insurance, contract insurance, and market insurance are all possible forms of insurance. It also means that insurance is not necessarily tied to risk pooling, risk aversion, or size-of-loss reduction. In particular, insurance may involve loss prevention. And to return to the earlier notion of insurance as what insurance companies do, insurance companies do sometimes provide loss prevention services. In fact, sometimes this is the main thing insurance companies do. I will argue that it is an increasingly important thing that legal malpractice insurance companies do. But to preserve the common and regulatory notion of insurance companies,[35] I will reserve the term "market insurance" for firms that provide at least risk pooling services and may also provide loss prevention services. Thus, a law firm is not an insurance company, but may provide insurance services.

With these preliminary matters out of the way, let us consider the possible institutions that provide insurance, broadly defined, against legal malpractice and its associated costs. In the tradition of economics, we will go from the simple to the complex. In this part, I make two simplifying assumptions: both clients and lawyers can be thought of as individuals. I make these assumptions to put aside for the moment agency problems with entity clients and law firms. I relax these assumptions in the next part.

B. Self-Insurance

Self-insurance is the simplest form of insurance. It is also an extremely common one among lawyers, especially among sole practitioners.[36] To isolate

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35. *See, e.g.*, Group Life & Health Ins. Co. v. Royal Drug Co., 441 U.S. 917 (1979) (defining an insurance contract as one that involves "spreading and underwriting of a policyholder's risk," and distinguishing "risk underwriting" from "risk reduction").

36. *See* Ramos, *Reforming Lawyers and Law Professors*, *supra* note 1, at 2587 (suggesting that 40% of lawyers nationwide do not have liability insurance); *see id.* at 2613 (suggesting that available evidence suggests a disproportionate percentage of uninsured lawyers among solo practitioners); ABA Standing Comm. on Lawyers' Professional Liability, *Legal Malpractice Claims in the 1990s* 5 (1996) ("It has been estimated that 30 percent to 50 percent of practicing lawyers carry no malpractice coverage at all") [hereinafter *Legal Malpractice Claims*]; GEOFFREY C. HAZARD, JR., SUSAN P. KONIAK, & ROGER C. CRAMTON, THE LAW AND ETHICS OF LAWYERING 192 (2d ed. 1994). *But see* Ted Schneyer, *Mandatory Malpractice*

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the incentives on lawyers created by self-insurance, let us assume for the moment that clients can neither take precautions nor buy market insurance to reduce the risks associated with legal malpractice.[37]

Lawyers have a variety of risk reduction measures at their disposal.[38] First, lawyers can take steps ex ante to reduce the likelihood that malpractice liability will occur.[39] These steps include precautions, such as an improved calendaring or conflicts-checking system. They also include reducing the activity level of various forms of practice, such as restricting areas of practice or screening for and refusing to service high-risk clients.[40] Second, lawyers can take steps to reduce the size of any loss to them from malpractice liability that does occur. These steps include ex ante precautions, such as double-checking numerical calculations[41] or improving one's system for handling and accounting for client funds.[42] They also include ex post mitigation, such as refiling a claim barred by the statute of limitations in another jurisdiction, or ex post loss reduction.

Not all methods of risk reduction by lawyers are socially beneficial. Some forms of risk reduction by lawyers will increase risk to their clients. In particular, a lawyer could reduce his losses from malpractice liability by making himself more judgment proof, say by maintaining minimal assets or sheltering assets in a way that would make them more costly for a plaintiff to reach.[43] If the client does not know of these expenditures and is not in a

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Insurance for Lawyers in Wisconsin and Elsewhere, 1979 WIS. L. REV. 1019, 1030-31 (noting that 85% of Wisconsin lawyers in full-time practice, other than in government offices or legal departments of corporations, carried legal malpractice insurance).

37. These assumptions are realistic. Client contributory negligence can happen, but it is rare. *See infra* note 53. I will consider the possibility of client contributory negligence in the next section. First party insurance typically does not cover legal malpractice. *See* N. Scott Murphy, *It's Nothing Personal: The Public Costs of Limited Liability Law Partnerships*, 71 IND. L.J. 201, 232, n.192 (1995).

38. *See generally* Fortune & O'Roark, *supra* note 1.

39. In Ehrlich and Becker's terms, this is "self-protection." Ehrlich & Becker, *supra* note 30, at 634.

40. *See* Geoffrey C. Hazard, Jr., *How to Cut the Cost of Malpractice*, NAT'L L.J., Dec. 17, 1990, at 16 (suggesting that lawyers should not "take bad people as transaction clients" or "represent doctors in business deals").

41. For a prominent recent case alleging that insufficient precautions of this type were taken, see Prudential Ins. Co. v. Dewey, Ballantine, Bushby, Palmer & Wood, 573 N.Y.S.2d 981 (N.Y. App. Div. 1991) (malpractice claim by creditor against its law firm as well as against lawyers for co-creditor and debtor, arising out of $92 million typographical error in loan refinancing document), *aff'd in part*, 80 N.Y.2d 377 (N.Y. 1992) (upholding grant of summary judgment in favor of debtor's law firm on the ground that the law firm's opinion letter did not contain any assurance of a specific dollar amount of security).

42. *See* Hazard, *supra* note 40, at 15. This precaution will obviously also tend to reduce the likelihood of malpractice.

43. *See* Ramos, *Reforming Lawyers and Law Professors*, *supra* note 1, at 2613.

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superior position to reduce or bear risks, as we are assuming here, then these expenditures are socially wasteful. Similarly, a lawyer might reduce his malpractice liability risk by increasing his expenditures on defending any malpractice suit, say by hiring a crack malpractice defense lawyer to represent him.[44] Whether these expenditures are socially desirable will depend on how they affect the incidence of errors by clients in bringing malpractice suits and by courts in imposing malpractice liability. Expenditures that do not increase accuracy are socially wasteful; expenditures that improve accuracy may be socially beneficial, but only if they reduce error costs more than the amount of the expenditures. Legal defense expenditures decrease the likelihood that the lawyer will be wrongfully convicted of malpractice, but they also increase the likelihood that the lawyer will be wrongfully exonerated of malpractice.[45] Which of these effects predominates will depend on, among other things, the quality of lawyering that malpractice plaintiffs have available to them, and the quality of judges and juries.

Finally, self-insured lawyers may be able to diversify their risks, that is, to reduce their risk premium associated with risk aversion. Diversification reduces the risk to the lawyer, but leaves the risk to the client unchanged. Diversification may be difficult for sole practitioners, however. They can perhaps diversify by expanding their client base, but diversification requires that risks be uncorrelated, and because the risk of malpractice is generally lawyer-controlled rather than client-controlled, it is possible that the risk of malpractice could *increase* from having more clients. This could occur, for example, if the lawyer has less time to work on each client's case and so is more likely to make an error than if he had fewer clients. Let us assume, therefore, that diversification is not a meaningful option for the self-insured, sole practitioner. We will return to diversification below when we consider market insurance and law partnerships.

A lawyer who bears the full cost of his legal malpractice as a result of liability will be led to minimize the sum of his risk reduction (precaution) costs, expected malpractice costs (represented by the probability of malpractice times the loss, or PL), and risk premium. What this means is that the rational lawyer

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44. *See* Ehrlich & Becker, *supra* note 30, at 634 (noting that legal services are an example of an activity that can reduce both the probability and size of loss).

45. Both Type II errors, erroneous filings and findings of malpractice, and Type I errors, erroneous failures to file and find malpractice, will lead a lawyer to increase his efforts to reduce the size of his loss associated with malpractice. Type II errors do so because they increase the lawyer's risk. Less obviously, perhaps, Type I errors lead the lawyer to increase expenditures on size-of-loss reduction because they increase the value of those expenditures relative to expenditures on prevention. *See* Danzon & Harrington, *supra* note 4; Schwartz, *supra* note 4, at 344-45.

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will allocate risk reduction dollars among the different techniques—pay for insurance services—until the marginal cost of the last act of cost reduction equals the marginal benefit to him in terms of reduced costs. This result differs slightly, but significantly, from the result usually presented in the law and economics literature, which is that the tortfeasor will take precautions until the marginal benefit of those precautions in reduced expected liability equals the marginal cost of the precautions. The difference is that there may be some situations in which it will be desirable for the lawyer to spend $1 on risk reduction even if that $1 is greater than the marginal reduction in expected malpractice costs (PL). The reason for the difference is that the typical economic model, for reasons of analytical convenience as well as the model's focus on the choice of liability rule rather than insurance institution, assumes the risk premium is 0 (the actors are risk neutral), or at least defines the social optimum with reference to that assumption.[46] The justification for the assumption is either the lawyer or the client can diversify the risk at no cost, or equivalently, can purchase market insurance at an "actuarially fair" premium equal to the expected malpractice costs.[47] The importance of this assumption will become clear when we begin to compare alternative insurance institutions.

The final part of the economic analysis of self-insurance asks how lawyers respond to exogenous changes in risk, or what economists call comparative statics. Institutional economists and traditional economists tend to use this analysis in different ways. Institutionalists try to understand why various institutions have developed historically; traditional economists try to examine how some proposed policy change might affect behavior. Prediction about the future is always riskier than explanation of the past, but the latter can often usefully inform the former. As noted in the introduction, the historical picture of legal malpractice is a story of increasing risk over the last thirty years. Let us consider how that increased risk has probably affected self-insurance. An increase in risk can be caused by an increase in the probability of malpractice liability or an increase in the size of the losses associated with malpractice, as well as by an increase in the risk premium of lawyers or clients. The source of this increased risk can be a change in the legal, economic, or social environment, or more likely a combination of all three.

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46. *See* SHAVELL, *supra* note 26, at 206-07; LANDES & POSNER, *supra* note 25, at 57 (assuming that actors are risk neutral because their focus is on the efficiency of tort rules, but noting that such an assumption would be inadequate if the analysis focused on "an institution patently designed to reduce risk, such as insurance").

47. *See* SHAVELL, *supra* note 26, at 192, n.10.

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For example, one plausible explanation of increased risk of malpractice liability is increased competition among lawyers.[48] Although increased competition could reduce malpractice by making lawyers more responsive to their clients' needs, there are other possibilities. One is that if clients cannot distinguish careful lawyering from bad lawyering, competition might lead lawyers to become more neglectful of their clients because lawyers choose to spend more time "competing" for new clients and less time servicing existing clients, or more time engaging in competitive activity that clients can identify, but may not be related to quality, such as price competition or advertising.[49] In economists' terms, the opportunity costs of risk prevention techniques (namely, the time spent on them) have increased. One would predict increased competition to increase the probability of malpractice liability arising from, for example, calendaring problems. The increased liability would in turn lead lawyers over time to adjust their behavior by substituting other, now relatively cheaper, methods of risk reduction. Perhaps lawyers would be led to hire a law office administrator, which seemed extravagant before the change in circumstances. Perhaps lawyers would reduce certain types of particularly risky lawyering activities. Perhaps lawyers would spend more on reducing the size of malpractice liability losses, by sheltering more of their assets, thereby shifting some of the new risk onto his clients. The point is that we would expect lawyers to increase their cost reduction efforts in some direction, and these new efforts might or might not benefit the client, and might or might not be socially desirable.

The same analysis applies if the source of the increased risk is a change in the liability regime and the nature of the increased risk is an increase in the size of malpractice losses. For example, courts have become more willing to allow punitive damages and damages for emotional distress in legal malpractice cases.[50] These changes not only increase expected malpractice liability, but to the extent they put a greater percentage of the lawyer's wealth at risk, they increase the lawyer's risk premium as well. The lawyer will again be led to undertake new risk reduction techniques, such as improving client communications or reducing the number of clients he takes on.

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48. On the increase in competition among lawyers, see generally MARC GALANTER & THOMAS PALAY, TOURNAMENT OF LAWYERS: THE TRANSFORMATION OF THE BIG LAW FIRM 52-54 (1991).

49. A second possibility is that for sophisticated clients, competition will lead lawyers to engage in more activity likely to impose harm on third parties. I discuss the problem of malpractice arising out of third-party harm below. *See infra* pp. 322-23.

50. *See* Ramos, *Dirty Little Secret*, *supra* note 1, at 1691. Treble damages are also typically available under state consumer protection laws, which have been applied to lawyers in some states. *Id.* at 1687.

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This last example is important because it implicates the assumption of the now-traditional economic model discussed earlier. If the change in legal regime increases the lawyer's risk premium, that is, makes him more risk averse, and the lawyer takes extra precautions to reduce that increased risk, is this a bad thing? The traditional law and economics answer is yes, if the additional expenditure on the new precautions exceeds the additional expected malpractice cost (PL) savings. The increased expenditure on precautions is now "excessive."[51] But that analysis depends on the assumption that there is available an alternative insurance institution that can bear the new risk at lower cost, for example, market insurance available at an actuarially fair premium. If, however, there is no such alternative institution, then the extra precautions are excessive only with respect to a nonexistent ideal. One could of course argue that there is an available institution that imposes lower costs, namely the prior liability rules. That is possible, but it depends again on the assumption that perfect insurance was available to *clients* to eliminate the residual risks they bore under the prior rules. Absent such an institution, evaluating whether the change in legal rule was a good one requires analyzing difficult questions of whether clients or lawyers have lower risk premiums, that is, an evaluation of relative risk aversion. But this brings us to the reason for the rule change. Courts do not just change the liability rules willy nilly. Judges do not just wake up one morning and decide after breakfast, to use an overworked metaphor, that it might be nice to adopt punitive damages today. They respond to some perceived need, some perceived inadequacy in the current regime. That does not mean they always respond correctly, but it does mean that it is foolish to ignore the perceived need and what is driving it. In any case, I want to focus here on institutional responses to liability changes, not the reverse.

C. Client Contract Insurance

The existence of a contractual relationship between a lawyer and the client victim of malpractice affects the lawyer's choice of risk reduction methods. At the very least, clients bear the costs of lawyers' risk reduction choices in the fees the clients wind up paying, in the costs to them of enforcing their malpractice rights, and in the failure of the legal system to compensate them fully for their malpractice losses. I want to focus here, however, on the voluntary transfer of malpractice risks from the lawyer to the client.

Contracting parties can use ordinary contracts to provide insurance to each other by transferring risks to the party better able to reduce those risks, the least

51. *See* SHAVELL, *supra* note 26, at 209; Danzon & Harrington, *supra* note 4, at 29.

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cost insurer.[52] But in lawyer-client contracts, the ethics rules severely limit the ability of lawyers to shift malpractice risks to their clients.[53] Do these restrictions make sense? If clients are better able to reduce certain malpractice liability risks, then lawyers and clients would be better off if lawyers could shift these risks to the client in return for lower fees. Are clients ever least cost insurers with respect to their lawyer's malpractice liability?

Let us consider the various risk reduction methods. As for reducing the probability of malpractice liability, if this liability is sensibly applied with some kind of contributory negligence defense,[54] then usually there is little the client can reasonably do that would warrant a contractual shifting of malpractice risks. One possibility that the ethics rules permit is a lawyer's limiting the scope of his representation to areas within his expertise.[55] For example, a lawyer might say to a client, "I am not an expert in tax matters. Before you consummate this transaction, I urge you to consult with a tax attorney." This could be viewed as effectively shifting the risk of the lawyer's "malpractice" (inexpertness in necessary tax advice) to the client, who must now hire a second lawyer. In addition, a client might be willing to waive malpractice liability with its attendant costs if the client's long-term relationship with his lawyer gives the client alternative responses to lawyer malpractice, or if the client is sufficiently knowledgeable about the lawyer's quality that he believes

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52. *See* POSNER, *supra* note 26, at 104-05; Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83 (1977).

53. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.8(h) ("A lawyer shall not make an agreement prospectively limiting the lawyer's liability to a client for malpractice unless permitted by law and the client is independently represented in making the agreement") [hereinafter MODEL RULES]; MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 6-102(A) (1980) ("A lawyer shall not attempt to exonerate himself from or limit his liability to his client for personal malpractice."); Leonard E. Gross, *Contractual Limitations on Attorney Malpractice Liability: An Economic Approach*, 75 KY. L.J. 793, 830-31 (1987). The ethics rules do allow clients to consent to certain conflicts, *see* MODEL RULES, *supra*, Rule 1.7 and Rule 1.9, or to consent to disclosure of confidential information, *see* MODEL RULES, *supra*, Rule 1.6, but whether consent given *ex ante* waives malpractice liability is questionable. *See, e.g.*, In re Boone, 83 F. Supp. 944, 957 (N.D. Cal. 1897); Westinghouse Elec. Corp. v. Gulf Oil Corp., 588 F.2d 1195 (7th Cir. 1978); Kennecott Copper Corp. v. Curtiss-Wright Corp., 584 F.2d 1195 (2d Cir. 1978).

54. *See, e.g.*, Leubsdorf, *supra* note 1, at 138-39. An example of contributory negligence would be if a client fails to supply his lawyer with necessary information, or supplies his lawyer with misleading information.

55. *See* MODEL RULES, *supra* note 53, Rule 1.2(c). The lawyer's ability to limit the scope of the representation is bounded by the lawyer's obligation to provide competent representation under Model Rule 1.1. *See id.*, Rule 1.2, cmt. 5 (noting that "the client may not be asked to agree to representation so limited in scope as to violate Rule 1.1").

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that likelihood of the lawyer's committing malpractice is extremely small.[56] As for reducing the size of the loss, the client might for example maintain sufficiently good relations with its suppliers, customers, creditors, and employees that it could easily smooth over any malpractice that his lawyer committed. Finally, as for diversification, if clients have a continual need for legal services, they might be able to diversify by hiring multiple lawyers,[57] or perhaps by maintaining a portfolio of transactions with uncorrelated risks.

But even if clients might seem to be superior insurers, the restrictions against the shifting of malpractice risk may be justified on the basis of transaction cost problems that would often make contract insurance undesirable if such risk shifting were allowed.[58] Transaction costs is a tricky term, but I will use it here in the institutional economics sense of "costs that are most likely to differ under alternative institutional arrangements."[59] For now, we can use the concept to compare self-insurance to contract insurance.

It will be useful to separate two types of transaction costs: those arising from the behavior of the parties, and those associated with economies of scale and scope. The first type of transaction cost arises out of the fact that in a client-lawyer relationship, as in any principal-agent relationship but in particular in contracts involving professionals and their clients, the parties have asymmetric information about the agent's riskiness and ability to engage in risk reduction. As a result, "there can really be no contract which insures against the agent's failure to do his business properly."[60] Asymmetric information causes the twin problems of moral hazard and adverse selection. Although these terms come from commercial insurance, economists have recognized their applicability to contract insurance as well.[61] Moral hazard means that a lawyer who transfers malpractice risk to his client contractually will have an incentive after signing the contract not to engage in reasonable risk reduction, that is, to act opportunistically by increasing risk to the client-insurer. Clients will find it difficult to monitor and control this behavior. Like other

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56. *See* Gross, *supra* note 53, at 830-31.

57. To see how hiring multiple law firms could of course increase the likelihood of malpractice, as Charles Keating's Lincoln Savings & Loan experience might suggest, see In re American Continental Corp./Lincoln Sav. & Loan Sec. Litig., 794 F. Supp. 1424 (D. Ariz. 1992), though it also might have increased the likelihood of malpractice recovery for Lincoln and its successors-in-interest.

58. *See* Goran Skogh, *The Transactions Cost Theory of Insurance: Contracting Impediments and Costs*, 56 J. RISK & INS. 726 (1989).

59. READINGS IN THE ECONOMICS OF CONTRACT LAW 22 (Victor P. Goldberg ed., 1989).

60. KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 36 (1974) (discussing the doctor-patient relationship).

61. *See, e.g.*, OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 47 (1985).

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contractually insured agents, an insured lawyer might pursue a higher risk strategy than his client would prefer, might favor other clients' or his own pecuniary interests to the detriment of this client, or might increase enforcement costs to the client ex post in the event of malpractice.[62] Adverse selection means that lawyers more prone to malpractice will not candidly disclose their true risk to their clients, and so would be more likely to "purchase" contract insurance if they could. Clients will find it difficult to do sufficient "underwriting" to separate out the good lawyers from the bad. Adverse selection relates, for example, to the lawyer insolvency problem discussed in the last section. Because lawyers who are judgment proof will not reveal this fact to their clients, and lawyers who are not judgment proof may have a hard time convincing clients of that fact, the low risk lawyers may not be able to obtain contract insurance from clients at a price commensurate with their riskiness.

Aside from moral hazard and adverse selection, other transaction costs not so easily controlled by lawyers would hinder their ability to obtain contract insurance from clients were it permissible. Insurance contracts are contingent claims contracts. Drafting such contracts is costly—in particular it might necessitate an additional lawyer to represent the client in negotiating with the first lawyer—and may not be worthwhile, especially if the "claims" are too infrequent, or the losses are too small to be worth contracting over. A related point is that lawyers and clients both may have insufficient information about the relevant risks to be able to determine a "price" (fee reduction) for the insurance or client risk reduction measures.

The concept of transaction costs can help us compare the institutions of insurance on which I have so far focused, self-insurance and contract insurance. Recall our posited historical fact, that the risks associated with malpractice liability have been increasing. Would we expect these increased risks to lead to more contract insurance if it were allowed? That depends on what the sources of the increased risks are. To go back to our prior hypothesis about increased competition among lawyers leading to more client neglect, it seems unlikely that this source of increased malpractice risk would lead to more contract insurance. We might expect just the reverse. Increased competition among lawyers could lead clients to be more suspicious of lawyer requests for malpractice waivers and in a better bargaining position to reject such requests.

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62. *See* David Mayers & Clifford W. Smith, Jr., *On the Corporate Demand for Insurance*, 55 J. BUS. 281, 287-88 (1982). It should be obvious that these concerns motivate numerous ethics rules. *See, e.g.*, MODEL RULES, *supra* note 53, Rules 1.2(a), 1.7, 1.8, 1.9.

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Increased competition among lawyers has led, however, to an increase in an important class of malpractice against which we might expect clients to be willing to provide more contract insurance to lawyers. I refer to the extraordinary rise in malpractice claims by "non-clients" or "ambiguous clients."[63] Lawyer competition has contributed to this type of malpractice by encouraging lawyers to seek out more marginal clients and engage in more marginal activity on behalf of clients to keep them satisfied. Suppose, to take a common example, that the lawyer makes a misrepresentation during a course of a transaction and a party to the transaction, not the lawyer's express client, relies on that misrepresentation.[64] Courts have become more receptive to such suits. The "client" may be perfectly happy to "waive" malpractice rights against the lawyer because the client may be benefited, not harmed, by the lawyer's actions. Thus, although clients might want contract insurance in these cases, contract insurance is not socially desirable. Contract insurance in these cases may increase moral hazard by allowing lawyers and their clients to increase risks to third parties.

I do not mean to suggest by the above discussion that the transaction cost problems associated with contract insurance would always make contract insurance undesirable. Some clients might well have sufficient information about lawyer quality to mitigate the adverse selection problem, or might well be able to control their lawyers' behavior sufficiently to mitigate the moral hazard problem, and might have no interest in using their lawyers to shift risks inefficiently to third parties. But the question is whether there are enough of these clients to justify abandoning the restrictions on contract insurance or whether these clients can be sufficiently categorized that an exception can be crafted for them. One might, for example, try to craft more permissive rules for "sophisticated" or "corporate" or "repeat player" clients. But as I will argue in Section III, there would be additional problems with creating such an exception because of the problems associated with complex clients.

D. Market Insurance

Having set the stage, we are now ready to consider the main subject of our inquiry, market insurance against legal malpractice. A lawyer may purchase insurance services from a commercial provider either because the lawyer unilaterally decides that such insurance is desirable, because the client insists on such insurance as part of the contract, or because the law requires it.[65] In

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63. *See* Leubsdorf, *supra* note 1, at 126-35.

64. *See* Leubsdorf, *supra* note 1, at 134-35. *See, e.g.*, Greycas v. Proud, 826 F.2d 1560 (7th Cir. 1987) (Posner, J.), *cert. denied*, 484 U.S. 1043 (1988).

65. Currently only Oregon requires all of its lawyers to purchase malpractice insurance. *See* OR. REV. STAT. § 9.08(2)(a) (1997). Several states that have adopted statutes recognizing

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this section, I examine the advantages of market insurance over self-insurance and contract insurance that have contributed to the demand for market insurance against legal malpractice. More specifically, I explore when lawyers will demand and market insurers will supply loss prevention services. I also consider the question of when market insurance is likely to be socially desirable.

1. Methods of Risk Reduction

Legal malpractice insurers make use of all the methods of risk reduction I have discussed so far. The primary method is, of course, diversification, which is generally thought to be the main advantage market insurance offers over self-insurance and contract insurance. Diversification is made possible by economies of scale and gains from specialization leading to superior information about risk. To provide diversification, the market insurer must be able to amass a sufficient pool of similar, but sufficiently uncorrelated, risks and to compute the expected losses associated with that pool. Thus, the insurer needs a broad customer base and accurate information. The cost of attracting lawyers and acquiring information about their riskiness must be sufficiently low and the risk to lawyers sufficiently great that market insurance is an attractive option to lawyers compared to alternative insurance institutions. Legal malpractice insurance developed later than other liability insurance, and has been a less stable market, in large part because these requirements have not always been met.[66] For example, some malpractice risks may be correlated; this would occur if a custom or culture developed among lawyers that a court later deemed to be malpractice.

After diversification, the risk reduction method most used by legal malpractice insurers, as well as by other liability insurers, is ex post loss reduction. In insurance jargon, this method goes under the names of claims management and claims repair. Claims management largely refers to the legal defense services provided by the insurer.[67] All legal malpractice insurance policies impose a duty to defend against malpractice claims. It may not be obvious why this is so, especially when one considers the other insurance institutions we have already looked at. A self-insured lawyer would of course

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Registered Limited Liability Partnerships require LLPs to maintain liability insurance. *See infra* note 148.

66. "While the law of large numbers, which is the basis for rate making, can assure fairly accurate rates in life insurance, those large numbers are not available to insurers of lawyers' professional liability. Also, commercial insurers have not kept reliable statistics on their professional liability writings." JO ANN FELIX, A LAWYER'S GUIDE TO LEGAL MALPRACTICE INSURANCE 49 (1982).

67. *See* Mayers & Smith, *supra* note 62, at 285.

have to provide a defense for himself. A lawyer who was permitted to shift malpractice risk to his client contractually could not, because of the conflict of interest problems, impose on the client a duty to defend the client's own malpractice suit, but could in theory contract to have the client reimburse the lawyer for his legal defense expenses, at least if the suit were unsuccessful. By contrast, the duty to defend in most market insurance contracts can be explained on transaction cost grounds. By defending numerous claims, the commercial insurer gains an informational advantage over insureds, and is able to enjoy the contracting advantage of a long-term relationship with legal defense firms,[68] as well as the expertise to monitor lawyer performance.[69] But these advantages seem far smaller for lawyer-insureds, many of whom would be well aware of good lawyers to represent them and would be able to monitor any lawyer chosen by the insurance company fairly closely. Thus, although most legal malpractice policies allow the insurance company the right to choose defense counsel,[70] in practice, most legal malpractice insurers probably allow substantial input from their insureds.[71]

Insurers do, of course, need to worry about the moral hazard problem of an insured insisting on an exorbitantly priced legal defense. Lawyers have a keen interest in protecting their reputations, and so would often insist on the best defense possible. As a result, most legal malpractice insurance policies now have "eroding policy limits," that is, they include legal defense costs in the limits of the policy.[72] Eroding policy limits put the burden on the insured lawyers to monitor their defense counsel by eliminating the incentive of the insurer to monitor legal defense costs for claims at or above the policy limits, as many claims are.[73] They also encourage early settlement by malpractice plaintiffs who are reluctant to seek more than the policy limits in damages, and

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68. *See* POSNER, *supra* note 26, at 436. A less optimistic interpretation is that insurers are able to exploit the ignorance of their insureds to provide low-budget, low-quality legal defense services. This problem may be less prevalent in legal malpractice insurance than in other insurance because of lawyers' greater ability to monitor quality.

69. Professor Schwartz suggests that liability insurance "eliminates the burden that a defendant would otherwise bear in attempting to review or monitor the performance of the lawyer he would need to hire if he were uninsured." Schwartz, *supra* note 4, at 336.

70. *See* LONG & LEVIT, *supra* note 21, at 9.

71. A few current legal malpractice policies expressly allow the insured lawyer to choose his defense counsel, subject to insurer approval, for example, the policy of the Association of Trial Lawyers Assurance, a mutual insurer formed by members of the American Trial Lawyers Association. Other policies say the insured's recommendations will be considered and a few say there must be mutual agreement.

72. *See* LONG & LEVIT, *supra* note 21, at 4.

73. *See* Ramos, *Reforming Lawyers and Law Professors*, *supra* note 1, at 2605 (arguing that claims handling is almost an afterthought and that insurers allow defense counsel to run up costs).

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therefore would, absent an early settlement, see their recovery erode with the policy limits.

In addition to claims management, legal malpractice insurers also try to reduce losses ex post through claims repair, which is essentially a form of mitigation that occurs before a claim is filed.[74] Unlike claims management provisions, however, claims repair provisions in legal malpractice policies do not seem to raise any issues unique to legal malpractice insurance. Notification requirements, such as the requirement to notify the carrier as soon as he or she becomes aware of an act or omission that could be the basis of a suit, may facilitate mitigation.[75] In addition, some carriers maintain a consultation "hotline" for insured lawyers who need help resolving a problem.[76] Other carriers "specifically provide that reporting a potential claim will not affect the insured's future risk assessment with the carrier," or offer discounts on deductibles for early notice.[77] These provisions and services suggest that mitigation may be a more realistic possibility in many cases than one might think.

Finally, many legal malpractice insurers take steps to try to reduce the probability of legal malpractice loss ex ante.[78] Insurers refer to these steps as loss prevention. Types of loss prevention range from general educational services, such as newsletters, seminars, and speeches,[79] to more individually

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74. *See* LONG & LEVIT, *supra* note 21, at 12; Ramos, *Reforming Lawyers and Law Professors*, *supra* note 1, at 2607 (noting that the Oregon State Bar Professional Liability Fund sometimes achieves mitigation); Marsha L. Morrow & Martin T. Lee, *How and When to Submit a Claim Under a Professional Liability Policy*, 3 LEGAL MALPRACTICE REP. 7, 13 (1990) ("the insurance carrier may be able to assist in averting a claim and/or mitigating damages").

75. Goldfein, *supra* note 2, at 1289. Such a provision is currently used by The American International Specialty Lines Insurance Company. *See* LONG & LEVIT, *supra* note 21, at 149. An example of how such early notification could lead to mitigation would be a lawyer who mistakenly thought he missed a statute of limitations deadline, when in fact he had not. *See Malpractice Insurers Help Regulate Lawyers Conduct*, 13 ABA/BNA LAWYERS' MANUAL ON PROFESSIONAL CONDUCT 163 (June 11, 1997) (remarks of Sally Field, president the legal professional liability division of Great American Insurance Companies, at a panel discussion of the ABA National Conference on Professional Responsibility).

76. *See* Morrow & Lee, *supra* note 74, at 13; LONG & LEVIT, *supra* note 21, at 35. The hotline could also be used as an *ex ante* loss prevention technique.

77. *See* Morrow & Lee, *supra* note 74, at 13.

78. Of the 50 legal malpractice insurance carriers listed by Long & Levit in their survey, 32 reported having some kind of loss prevention program, 11 reported having no such program, and 7 did not respond. Of the 32 reporting the existence of a loss prevention program, 20 listed either on-site review or audits as part of the available package. *See* LONG & LEVIT, *supra* note 21, at 159-69.

79. A recent example is a talk by Mary Scott of CNA Insurance at the ABA's annual meeting in San Francisco in the summer of 1997. She appeared on a panel program entitled "Hazards of the Job: How to Recognize Legal Malpractice Pitfalls and Purchase Insurance to

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tailored consulting services, such as firm audits. These services may be provided by in-house insurance personnel, such as a "loss prevention counsel,"[80] or by outside lawyers retained by the insurance company.[81] The services include identifying and seeking to reform "troubled" lawyers or firms, as well as risky practices. As with claims management services, why a legal malpractice insurer would provide loss prevention services to lawyers is something of a puzzle. Legal malpractice insurance protects lawyers against risks for which they are, in theory, expert at avoiding. Loss prevention often involves essentially legal advice. This makes legal malpractice insurance akin to fire insurance purchased by fire safety equipment manufacturers (such as First Alert), whom we might not expect to seek loss prevention services from their insurers. In fact, though, lawyers are not as expert in legal malpractice as many think they are; in particular, they tend not to fully appreciate the extent to which they owe duties to people other than their clients.

Finally, it is important to note that not all "loss prevention" to the insurance company results in loss prevention to society. In particular, the insurance company will engage in underwriting (assessing the risk of a potential insured) before deciding whether to take on a new insured and will reject an applicant it deems too risky. Similarly, the company could fail to renew an existing insured with a bad enough track record. If these lawyers go on simply to commit malpractice elsewhere, then the insurance company has not reduced social loss.[82] I will return to loss prevention below, to try to give a fuller explanation of when a legal malpractice insurer might offer these services. Before doing that, however, I want to examine more closely the demand for market insurance as opposed to self-insurance and contract insurance.

2. The Effect of an Increase in Risk on the Demand for Market Insurance

As a first cut, let us return to the question of how an increase in liability risk, that is expected liability costs plus the risk premium, affects the demand for market insurance. This section identifies three effects that such a change could have. The following three sections try to explore which effects we might expect to dominate.

Cover Them." For a summary of her remarks, see ABA/BNA LAWYERS' MANUAL ON PROFESSIONAL CONDUCT, Aug. 20, 1997, at 253-54.

80. Robert E. O'Malley, *Loss Prevention*, *in* ISSUES IN FORMING A BAR-RELATED PROFESSIONAL LIABILITY INSURANCE COMPANY 118-19 (1989).

81. *See* LONG & LEVIT, *supra* note 21, at 12.

82. Professor Verkerke refers to this phenomenon as "churning." *See* J. Hoult Verkerke, *Legal Regulation of Employment Reference Practices* 65 U. CHI. L. REV. 115, 140 (1998).

The first effect of an increase in risk is the substitution effect. The substitution effect is the typical explanation for the law of demand: as the price of a good or service increases, people buy less of that good or service because they substitute other goods and services that are now relatively cheaper. In the insurance context, an increase in expected malpractice liability risk (PL) will increase the price of malpractice insurance (i.e., premiums), which must be at least sufficient to cover the extra payouts,[83] and therefore will tend to decrease the amount of malpractice insurance purchased. Insureds who previously bought market insurance will now be diverted to substitute activities, such as self-insurance.[84]

The second effect of an increase in risk is the income effect. For most goods and services, the income effect reinforces the substitution effect and the law of demand: as the price of a good or service increases, real disposable income declines, and so does demand for most goods and services, including the one whose price increased. In the insurance context, however, the income effect works in the opposite direction from the substitution effect. If the increase in risk is due to the fact that the magnitude of malpractice losses is increasing, then the potential losses are a larger proportion of wealth. That means the risk premium is likely to increase, which will increase the demand for diversification services and hence the demand for market insurance.[85] This increase in demand could offset the decrease in demand from the substitution effect.[86]

But—and this is the key point for our purposes—there is yet a third effect, which results from the fact that, as we have defined it (hence the importance of the definition), insurance is not only diversification. The third effect is that

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83. If the likelihood of loss (P) increases, premiums will also likely rise because of the added administrative costs necessary to handle the additional claims. Thus, the risks insurers are most likely to insure are low probability, high loss events.

84. *See* Pottier & Witt, *supra* note 4, at 1686, n.31. The "price" of self-insurance does not vary with the probability of loss, as the price of market insurance does, because the actions a self-insured individual could take to reduce risk do not cost more simply because the probability of harm increases. By the same token, if the likelihood of harm decreases, a self-insured person does not face a lower "price." The fact that the price of market insurance declines with the likelihood of loss is one reason that people tend to buy market insurance for low probability events. *See* Ehrlich & Becker, *supra* note 30, at 628, 637.

85. *See* Ehrlich & Becker, *supra* note 30, at 629.

86. Arguably, this is exactly what happened during the liability insurance crisis of the 1980s. *See* Pottier & Witt, *supra* note 4, at 1686. Declining interest rates (meaning lower returns on insurance company investments) and adjusted expectations about future claims costs shifted the supply curve market insurance in, while the increased risk aversion created by the higher potential losses shifted the market insurance demand curve out. The result was extremely high premium increases. Whether the quantity of market insurance demanded declined would depend on the size of the demand shift relative to the supply shift. *See id.*

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the higher risk premium could lead the insured to demand more risk reduction in addition to, or instead of, diversification services. This effect could either increase or decrease the demand for market insurance, depending on whether market insurers or other insurance institutions could provide risk reduction services more cheaply.[87] Thus, the effects of an increase in liability risk on the demand for market insurance are highly ambiguous.

3. The Demand for Legal Malpractice Insurance and the Insurer's Transaction Cost Advantage

Given the ambiguity of the effects of increased risk on the demand for market insurance, I turn in this section to a transaction cost comparison to try to sort out which effects might predominate. In general, lawyers will purchase legal malpractice insurance when they cannot get equivalent benefits at lower cost from alternative insurance institutions. As I said above, insurance companies have obvious transaction cost advantages associated with diversification. But what about the behavioral transaction costs?

Under the standard law and economics analysis of insurance, market insurance creates a moral hazard problem. Unless the insurance company can perfectly observe the behavior of its insureds and adjust its premiums based on these observations, then insureds will engage in too much inefficient behavior.[88] In our context, malpractice insurance will give lawyers too much incentive to commit malpractice. The institutional economics approach is different. Whereas under the traditional approach moral hazard makes market insurance costly, under the institutional approach moral hazard may make market insurance *necessary*.[89] The key point is that the moral hazard problem exists no matter what insurance institution governs behavior. If a lawyer seeks contract insurance, he is still subject to a moral hazard problem. Even if the lawyer self-insures, he may still be subject to a moral hazard problem stemming from the temptation to engage in activities that do not reduce the social cost of malpractice, such as making himself more judgment proof. Thus,

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87. *See, e.g.*, Schwartz, *supra* note 4, at 341-42. (arguing that strict liability will not necessarily increase the demand for liability insurance because substitutes such as self-insurance might be more attractive if insurer cannot effectively monitor insureds).

88. The insurance contract may also create a moral hazard problem for the insurer, which may be able to both disguise its insolvency risk, *cf.* Skogh, *supra* note 58, at 727-28 (noting that insurer must solve the "credibility problem" of proving its solvency), and exaggerate the insured's malpractice risk, *see* Harris Schlesinger & Emilio Venezian, *Insurance Markets with Loss-Prevention Activity: Profits, Market Structure, and Consumer Welfare*, 17 RAND J. ECON. 227, 228 n.2 (1986), to sell more insurance.

89. *See* Skogh, *supra* note 58, at 729 (arguing that "in the pool-of-risks theory, moral hazard is treated as a complication. In the transaction-cost theory, moral hazard is the *raison d'etre* for insurance.").

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market insurance might reduce moral hazard rather than increase it. As a result, the absence of perfect monitoring by a market insurer does by itself not tell us whether market insurance is an inefficient institution.

The difference between the approaches is the relevant baseline. Under the traditional approach, the baseline is perfection; under the institutional approach, the baseline is the next best available institution. Thus, the relevant moral hazard question in the institutional approach is not which institution is the perfect monitor of lawyer behavior, but rather which institution is the best monitor. If the market insurer is the best monitor, then lawyers will buy market insurance; if the market insurer is an inferior monitor, then market insurance will not be available at acceptable prices to lawyers and will not be demanded.[90]

Although the institutional economics theory of insurance developed to explain why corporations, whose shareholders can often diversify risk, buy insurance, the theory has broader application. When legal malpractice insurers are better monitors of lawyer performance—and hence moral hazard—than other insurance institutions, lawyers will buy more malpractice insurance. The reduction in moral hazard will lead insurers to reduce premiums and expand coverage. It will also lead clients to insist that their lawyers purchase malpractice insurance, or buy it at higher levels, as a bonding device to guarantee lawyer performance.

A similar argument applies to adverse selection. The traditional adverse selection argument is that if an insured has better information about his riskiness than an insurer, too many poor risks will end up buying insurance and at the extreme the insurance will not be available. Again, adverse selection is viewed as a cost of market insurance. But under the institutional approach,

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90. *See* Ehrlich & Becker, *supra* note 30, at 642 (arguing that if the moral hazard problem cannot be surmounted either no market insurance will be offered or no self-protection will occur). Professor Schwartz puts this point nicely:

> In our society, there is a tendency for people to assume that for liability insurance to be unavailable signifies some breakdown in the overall functioning of the tort system. But such an assumption may well be misguided. The unavailability of insurance—far from revealing that the system is malfunctioning—may verify that it is functioning very effectively as a deterrence regime: that it is targeting for liability precisely those forms of conduct that are so readily controllable by defendants as to render unacceptable to insurers the moral-hazard prospect of insurance policies.

Schwartz, *supra* note 4, at 343 (footnotes omitted).

The converse of Schwartz's proposition may not be true, however. That is, the *availability* of insurance does not necessarily mean that the system is targeting the wrong types of conduct, because insurers may be better monitors.

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market insurance may reduce the adverse selection problems of alternative insurance institutions. Recall that because clients may be poor underwriters of the riskiness of their lawyers, they would be reluctant to offer contract insurance to their lawyers, even if it were allowed by the ethics rules. But if malpractice insurers are better underwriters than clients, clients have another reason to insist that their lawyers buy malpractice insurance: the lawyers' ability to procure malpractice insurance will provide a signal of lawyer quality.[91] As for self-insurance, the ability of lawyers to make themselves judgment proof may mean that too many high risk lawyers will choose this insurance institution. Thus, the institutional perspective leads to the complete opposite of the traditional adverse selection story: the *good* risks will buy market insurance. On the other hand, if the client is better at judging lawyer quality than the market insurer, the client would view the lawyer's purchase of market insurance as a signal of poor quality; the traditional adverse selection story would then apply.

This last example suggests that the transaction cost story is not yet complete. The fact that malpractice insurers *might* be better monitors of lawyer moral hazard or adverse selection does not mean that they are. Thus, we cannot necessarily infer from the fact that lawyers purchase malpractice insurance that malpractice insurers have transaction cost advantages over other insurance institutions in controlling moral hazard and adverse selection. Unlike the case with corporate insurance, where diversification is not available as an explanation, diversification might explain a fair amount of the motivation for lawyers purchasing market insurance against legal malpractice. Thus, clients might want their lawyers to buy market insurance, fully cognizant of the moral hazard problems created, because they are sufficiently risk averse that they are willing to trade off increased diversification benefits for increased malpractice costs. The short answer to this objection is that legal malpractice insurers have increased their loss prevention services over the last twenty years. Just as diversification cannot fully explain corporate insurance, it cannot explain the rise in loss prevention services offered by legal malpractice insurers. But not all legal malpractice insurers offer loss prevention services, and it is possible that these services are largely public relations and window-dressing. I therefore need to examine more closely under what circumstances lawyers might demand, and insurers might offer, these services from malpractice insurers.

91. The signaling function would, of course, be significantly curtailed if insurance were mandatory.

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4. The Demand for Loss Prevention Services from Malpractice Insurers

The economic theory I have been developing suggests that malpractice insurers will provide loss prevention services if they can do it more cheaply than other institutions. Some academics are optimistic about insurers providing loss prevention services;[92] others are skeptical. In this section I will consider several factors that help determine whether a malpractice insurer will offer loss prevention services.

a. The Incentive Problem

The first hurdle that an insurer offering loss prevention services must overcome is the incentive problem, or what might be termed—to pique academic interest—the paradox of loss prevention. The argument is as follows. If the insurer adjusts premiums based on riskiness, then the insured has an incentive to engage in loss prevention to enjoy lower premiums, but the insurer has no incentive to provide it, because "any reduction in its eventual payouts is offset by a reduction in its premium income."[93] On the other hand, if the insurer does not adjust premiums based on riskiness, the insurer has an incentive to offer loss prevention, but the insured gets no benefit from following the advice.[94] The first of these propositions is theoretically unsound; the second is factually inaccurate.

Take the first proposition, that if the insurer offers what Professor Schwartz calls "perfectly responsive insurance," the market insurer will not want to offer loss prevention. Presumably a market insurer who offered loss prevention services would include the cost of providing them in the premium, including a competitive return on investments in providing those services.[95] Other institutions that provide loss prevention services, such as lawyers, seem

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92. *See* SHAVELL, *supra* note 26, at 199 ("When parties can influence risks, insurers often supply advice about risk reduction and include in policies a great variety of features that serve to induce insured parties to lower risk.").

93. Schwartz, *supra* note 4, at 357; *see also* Henry Hansmann, *The Organization of Insurance Companies: Mutual versus Stock*, 1 J.L. ECON. & ORG. 125, 148-49 (1985).

94. *See* Schwartz, *supra* note 4, at 357; Hansmann, *supra* note 93, at 148. It should be noted that neither Professor Schwartz nor Professor Hansmann accept the paradox fully; both argue there are situations in which it would make sense for the insurer to offer loss prevention services.

95. In fact, some legal malpractice insurers charge insureds separately for loss prevention services. *See* LONG & LEVIT, *supra* note 21, at 60-170 (chart of insurers and coverages).

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to be able to make a profit doing so.[96] Moreover, the fact that loss prevention services could reduce the premium paid by insureds who used those services does not necessarily mean that total premium income to the insurer would decrease. If an insurer can charge lower premiums to its insureds because they follow the insurer's loss prevention techniques and so are better risks, the insurer might very well increase the demand for its services, as insureds substitute more market insurance for other insurance institutions.[97] And if the demand for these services is elastic, the total revenue for the insurer will increase.

The second proposition, that "flat" insurance premiums will give an incentive to the insurer to offer, but not to the insured to adopt, loss prevention measures, is based on the unrealistic assumption that perfectly flat insurance exists,[98] or more precisely that lawyer insureds bear no residual risk of malpractice liability. Even if a market insurer charged perfectly flat premiums, lawyers would bear risk associated with reputational harm, the threat of nonrenewal by the insurer, and the possibility of professional discipline or court sanctions. Moreover, legal malpractice insurers employ a variety of restrictions that have the effect, if not the purpose, of maintaining some risk on lawyers, and thereby encouraging loss prevention by lawyers. Legal malpractice insurers impose deductibles,[99] caps on payments,[100] and exclusions

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96. Professor Schwartz may have something like this in mind when he asserts that competition among insurers might force insurers to offer loss prevention services. *See* Schwartz, *supra* note 4, at 357, n.186.

97. It is true that what we referred to above as the "income effect" could theoretically reduce the demand for insurance. As an insured's riskiness and therefore premium paid decline, and his effective income increases, his risk premium might also decline, so he might buy less insurance. But even if this effect were significant, it could be outweighed by the fact that one's demand for loss prevention services (as distinct from diversification services) might increase as riskiness declines and income goes up. The point is that if insurers are offering loss prevention services, they probably believe that the "income effect" is small.

98. Professor Schwartz makes this point. *See* Schwartz, *supra* note 4, at 357, n.186. But he thinks that liability insurance premiums tend to be more flat than responsive.

99. According to the survey by Long & Levit, minimum deductibles range from $0/claim to $100,000/claim with $1000/claim being the most common minimum. Maximum deductibles range from $25,000/claim to $500,000/claim. *See* O'Malley, *supra* note 80, at 117. The loss prevention counsel of ALAS, describes the purpose of deductibles as "reducing the company's defense costs on frivolous claims and non-frivolous nickel and dime claims, and reducing the company's internal claims handling expenses on such claims." *Id.*

This statement tends to contradict Professor Schwartz's assertion that deductibles are less useful for liability insurance than for first party insurance because deductibles do not serve to eliminate many claims. *See* Schwartz, *supra* note 4, at 316-17, n.18. Schwartz also asserts that deductibles in liability insurance would tend to impose processing costs on an insured who is not in a good position to process claims. *See id.* But this assertion seems less true for lawyers than for other insureds. Finally, Schwartz argues that "if the plaintiff's total loss exceeds the

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from coverage for certain activities they view as too risky.[101] Finally, and most significant, legal malpractice insurers are more and more taking into account the riskiness of individual insureds in setting premiums.[102]

b. Information about Loss Prevention

The resolution of the loss prevention paradox does not of course, guarantee that the market insurer will offer loss prevention services. A second factor is whether the market insurer has better information about loss prevention than

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deductible, the deductible serves to divide the claim between insurer and insured, leading to a costly problem of coordination." *Id.* That is true, but coordination problems exist whenever the insured has an independent interest in the suit, for example to preserve reputation or avoid being subject to professional discipline. And insurers have ways to minimize the coordination problems. For example, most legal malpractice policies require an insured's consent to settle, but the insured must often bear any extra defense costs if he rejects a settlement acceptable to the insurer and the insured's client. *See* LONG & LEVIT, *supra* note 21, § 10.2.23. This provision serves as a kind of *ex post* deductible. Coordination problems may better explain why legal malpractice insurers tend not to use co-insurance. *See* Schwartz, *supra* note 4, at 316 n.17. Legal liability is often more difficult to measure than, say, health care expenses.

100. The Long & Levit survey shows caps ranging from $100,000/claim and $300,000/policy period (with the exception of one insurer that insures only sole practitioners in practice four years or less) to $20,000,000 per claim and per policy period. ALAS, which did not fully participate in the survey, nevertheless reported that its policy limits are significantly higher: $75,000,000/claim and $125,000,000/policy period. *See* LONG & LEVIT, *supra* note 21, at 46. Liability caps essentially make lawyers self-insurers of any malpractice liability over the cap, unless the lawyers buy excess insurance. *See* Schwartz, *supra* note 4, at 316. Caps are less likely to encourage self-insurance to the extent that malpractice plaintiffs are reluctant to seek greater damages than the caps. *See* Ramos, *Reforming Lawyers and Law Professors*, *supra* note 1, at 2602; Syverud, *supra* note 4, at 1635, n.19.

101. *See* Davis, *supra* note 3, at 202-20; *but see* Silver, *supra* note 3, at 234. The most significant exclusion that has developed among legal malpractice insurers is for liability arising out of a lawyer's serving as a director or officer of a client. *See* Robert E. O'Malley, *Preventing Legal Malpractice in Large Law Firms*, 20 TOLEDO L. REV. 325, 332 (1989). ALAS has gone even further and excluded all malpractice claims by lawyers who hold an executive porition in a publicly-held client, which effectively prohibits lawyers from holding such positions. *Id.* at 333-34.

102. *See* LONG & LEVIT, *supra* note 21, at 39 ("Experience rating . . . is a standard underwriting practice."). The Reliance National Insurance Company and the Meadowbrook Insurance Company (Michigan Lawyers Mutual Insurance Company) offer premium credits for participating in loss control seminars, and the Clarendon National Insurance Company offers premium credits for using their loss control consultant. *See id.* In addition, a recent survey by a publisher of legal software identified 14 insurance carriers, including the National Casualty Company and Attorneys Liability Protection Society, that commonly offer premium reductions of about 5% to firms using docketing software, with one carrier, Commercial Bankruptcy Lawyers Purchasing Group, granting 25% reductions. *See* Gary Blane Crouse, *Profession Watch* 12 OF COUNS., Mar. 1, 1993, at 19. Professor Schwartz's contrary assertion that "professional malpractice insurance . . . make[s] no effort to reflect the individual's accident potential," Schwartz, *supra* note 4, at 319, may be limited to medical malpractice, if true at all.

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lawyers do. Although it might seem that lawyers should have better information than their malpractice insurers about how to avoid malpractice, in fact this is not necessarily true. As Professor Abraham argues:

> [I]n its capacity as a risk pooler the insurer may acquire useful information more efficiently than individual insureds. Insurance prices or risk classifications can provide information about the riskiness of an insured's activities that the insured himself would have ignored or figured inaccurately. The insured may then be able to make more efficient decisions concerning the optimal combinations of risk, insurance, and loss prevention to adopt in conducting his or her activities. Further, since the insurer pools a large number of similar risks, it will sometimes be better equipped than any individual insured—because of its superior access to loss experience statistics or greater ability to finance research into loss prevention methods—to discover more efficient courses of conduct than those its insureds currently follow. When this is so, and the insurer is able to have its suggestions for changes in behavior implemented, efficiency is enhanced.[103]

The relevant legal regime may also affect who is better able to acquire loss prevention information. The more liability is based on custom, as negligence usually—but not always[104]—is, the more likely the insured will have superior

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103. *See* ABRAHAM, *supra* note 27, at 16. *See also* ARROW, *supra* note 60, at 74 ("In an organization of any complexity, an individual or small group simply cannot be aware of all that is relevant. Even if formal provision is made for the acquisition of information, as in the massive provision of statistical services in the modern advanced state, no small group of individuals can assimilate the data needed."). Although Professor Shavell contends that insureds should be willing simply to pay insurers to develop information about risk, *see* SHAVELL, *supra* note 26 at 197, in fact insureds may not cooperate fully in the insurer's efforts to acquire this information. The more the insured believes that the information he supplies will disadvantage him, the less likely he will be to supply it.

104. *See* Gleason v. Title Guar. Co., 300 F.2d 813 (5th Cir. 1962) (relying on Judge Hand's decision in In re Eastern Transp. Co. v. Northern Barge Corp., 60 F.2d 737 (2d Cir. 1932), to rule that relying on telephone conversations with a title company, which was the customary practice, rather than checking titles, was malpractice); *but see* Gleason v. Title Guar. Co., 317 F.2d 56, 60 (5th Cir. 1963) (on petition for rehearing, noting that the court "had no quarrel with the law" that the lawyer's duty to the client "must be measured by community standards," but finding that there was "no evidence whatsoever that the community condoned" the lawyer's failure to tell the client he was relying entirely on the title company's representation and the inherent risks of that action).

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information.[105] But when custom is rejected as a standard of liability, as in a strict liability system, the insurer may be in a better position to acquire information about cost-effective loss prevention techniques.[106] Liability not based on custom may be becoming more common in legal malpractice cases, as many involve duties to nonclients, conflicts of interest, or other breaches of fiduciary duties.[107] Market insurers may also have an informational advantage when liability rules are simply changing or new cases are rapidly accumulating.[108]

Finally, apart from economies of scale and changes in legal regime, there may simply be psychological reasons associated with cognitive dissonance that may make it difficult for a lawyer to process and assimilate, rather than

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105. Even under a custom based standard, the insured may not have superior information. In fact, Professor Leubsdorf has recently advocated a non-custom-based malpractice standard precisely because lawyers often lack sufficient information about what the custom is. He argues:

> Whatever its merits in medical malpractice cases, a professional practice test simply will not work for legal malpractice except in a few areas where procedures are standardized as in real estate closings. Otherwise, we have no information about how most lawyers deal with most of the problems that arise in malpractice cases. A lawyer called as an expert witness will know of the practice in his or her firm and possibly also that of a few other firms. He or she cannot possibly know how most of the thousands of lawyers who practice in a typical jurisdiction handle a problem. Even were such knowledge available, it is unclear whose practice would set the standard.

Leubsdorf, *supra* note 1, at 110-11. Interestingly, Professor Leubsdorf does not consider the possibility of malpractice insurers serving as expert witnesses in malpractice cases, *see id.* at 120-23 (arguing for replacing much of the role of malpractice experts with more detailed court instructions and treating lawyers' duties as issues of law), though that would not solve all of his concerns and might pose too many conflict of interest problems to be feasible.

106. Interestingly, two areas of law in which insurers have long offered loss prevention services, title insurance and workers compensation, *see* Schlesinger & Venezian, *supra* note 88, at 228, are strict liability systems. In a strict liability system, courts have less opportunity to collect and publicize in opinions information about loss prevention. Thus, insurers are likely to have much better information about loss prevention than insureds under such a regime.

107. *See, e.g.*, *Legal Malpractice Claims*, *supra* note 36, at 21-22 (noting anecdotal evidence from insurers of an increase in claims involving conflicts of interest, breaches of fiduciary duty, and non-client third parties).

108. Professor Hyman in his comments seems to suggest that uncertainty and change could lead to *less* loss prevention because its value would be uncertain. *See* David A. Hyman, *Professional Responsibility, Legal Malpractice, and the Eternal Triangle: Will Lawyers or Insurers Call the Shots?*, 4 CONN. INS. L.J. 353 (1997). That would be true if the changes were truly random and the value of precautions varied greatly from one type of malpractice to another. I am not convinced that either is true.

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discount and discard, information that suggests he should change his established method of practice.[109]

c. Free Rider Problems

Even if the market insurer has better information about loss prevention, free rider problems may discourage the insurer from providing this information to its insureds. These problems come in two forms. First, because of the public good nature of general loss prevention information—that is, the inability to exclude others from using the information and the ability of numerous people to consume the information at no additional cost—competitor insurance companies have an incentive to let some other insurance company offer the loss prevention information. They can then benefit from the lower risk of their insureds without having incurred the investment in loss prevention information.[110] Second, the insurer may provide loss prevention information specific to a particular insured, who may then turn around and switch (or threaten to switch) to an insurer willing to offer a lower premium because of his now lower risk profile.

It is important not to exaggerate the extent of free rider problems in the context of legal malpractice insurance, however. As for general information, many lawyers make a good living providing loss prevention advice that is to a large extent publicly available. The reason is that the information is costly to collect, organize, and digest in a useful way. Moreover, although insurance companies often do not broadly circulate their loss prevention materials, legal malpractice insurers may find it worthwhile to publicize loss prevention information, rather than hoard it, to encourage other institutions, such as law schools, law firms, or bar associations to do the loss prevention work in the future.[111]

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109. *See* ARROW, *supra* note 60, at 75 ("The efficiency loss due to informational overload is increased by the tendency . . . to filter information in accordance with one's preconceptions.").

110. *See* Schlesinger & Venezian, *supra* note 88, at 234; Hansmann, *supra* note 93, at 147.

111. ALAS, for example, makes available a fair amount of general loss prevention information. An example is the charts found in most Professional Responsibility supplements noting state variations in the ethics rules on client fraud and imputed disqualification. Moreover, Robert O'Malley, ALAS's chief loss prevention counsel, has written several publicly available articles on loss prevention. *See* O'Malley, *supra* note 80; O'Malley, *supra* note 101. A more ambiguous example is the fact that the St. Paul Fire and Marine Insurance Company, one of the largest legal malpractice insurers in the country, published the Legal Malpractice Review from 1977 until 1984. The insurer's explanation for stopping publication was:

> Much has changed since [the Review was started] over six years ago. The legal community has become much more aware of legal malpractice

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As for specific information, insureds may have sunk their own specific investments in their relationship with the insurance company that provided them the loss prevention services. The original insurance company might, for example, have succeeded in subtly modifying a law firm's culture in a way that is not easy to communicate to a new insurance company. Moreover, insurance companies view frequent carrier changes by insureds quite suspiciously because of the possible malign explanations.[112] Finally, as long as the first insurance company charged (through a higher premium) for the loss prevention services, it gets some benefit even if the insured jumps ship.

d. The Nature of Precautions

Information is not all there is to loss prevention. Loss prevention involves taking precautions. The nature of these precautions will also influence whether insurance companies are better situated than alternative institutions to provide loss prevention services. In particular, loss prevention may be less useful when malpractice is caused by inattention rather than a failure to invest in some durable precautionary device or structure.[113] It will be easier for the insurer to monitor durable precautions than attentiveness.[114] This distinction may explain why loss prevention is not an important part of homeowner and car insurance,[115] which cover many accidents caused by momentary inattentiveness. Although some legal malpractice certainly results from

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> exposure and the adverse professional liability climate; new publications have appeared addressing the subject of legal malpractice; and a large number of lawyer associations across the country have formed task forces or added standing committees to research and keep abreast of issues and trends relating to professional liability.

LEGAL MALPRACTICE REV., Winter 1984, at 1. Putting aside the delicious irony of this explanation coming in the midst of the largest liability insurance crisis in history, one might surmise that St. Paul was tired of having others free ride and anxious to free ride itself. The journal might also have simply been a form of advertising, *see* Schlesinger & Venezian, *supra* note 88, at 228, whose useful life had expired.

112. *See* LONG & LEVIT, *supra* note 21, at 29 ("The importance of continuity in the insured-insurer relationship should not be underestimated. . . . Underwriters may construe frequent changes in insurers as opportunistic, or potential evidence of instability.").

113. *See generally* Mark F. Grady, *Why Are People Negligent? Technology, Nondurable Precautions, and the Medical Malpractice Explosion*, 82 NW. U. L. REV. 293, 299 (1988); *see also* Schwartz, *supra* note 4, at 346-48.

114. *See* SHAVELL, *supra* note 26, at 197. That does not mean, of course, that loss prevention could not be used at all to reduce the incidents of malpractice associated with momentary inattentiveness. Momentary inattentiveness could be caused, or at least exacerbated, by excess hours worked or some drug or mental health problem. Loss prevention could be used to mitigate some of these "root causes" of inattentiveness.

115. *See* Schwartz, *supra* note 4, at 357.

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momentary inattentiveness, such as a calculation error made in the last-minute rush before a transactional deadline,[116] or a missed objection opportunity in the heat of trial, much malpractice can be prevented by some durable precaution.[117] Examples include improved systems for checking conflicts, calendaring, preserving confidentiality, staffing, maintaining accurate billing records, and evaluating client riskiness. Standardized procedures in all these areas could make even malpractice due to inattentiveness less likely.

Loss prevention may also be difficult when malpractice results from poorly exercised discretion in a particular situation, both because it will be difficult to put in place a corrective mechanism that solves the problem and because it will be difficult to monitor such behavior.[118] But difficult does not necessarily mean impossible. Ex ante, practice manuals could provide guidance, at the time of decision, an ethics hotline could backstop discretionary judgments or random audits could regulate others, and ex post, a review and critique of prior decisions could improve future performance. Obviously, not all malpractice will be prevented using these techniques, and not all such techniques are cost-justified. But the question is whether market insurance, as compared to other institutions, could lead to the adoption of more techniques that reduce the risk of malpractice by more than their cost.[119]

e. Monitoring by Insureds: Mutual Insurance Companies

As the above examples of durable precautions demonstrate, loss prevention often involves establishing better procedures for evaluating malpractice risks.

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116. *See, e.g.*, Prudential Ins. Co. v. Dewey, Ballantine, Bushby, Palmer & Wood, 573 N.Y.S.2d 981 (N.Y. App. Div. 1991) ($93 million typographical error in loan document). Professor Hyman views this case as an example of how much little marginal benefit loss prevention might provide, because it shows that even heavily lawyered transactions can result in mistakes. *See* Hyman, *supra* note 108, at 368. Another lesson that could be drawn, however, is that too many lawyers were relying on their assumption that *others* would be checking rather than checking themselves.

117. According to one insurer in a recent survey, "most of its claims could have been avoided through (1) a clear retainer agreement with the client, (2) a clear understanding with the client concerning the scope of services to be provided, and (3) better and more complete communication with the client during the representation." *See e.g. Legal Malpractice Claims*, *supra* note 36, at 23. Routinized procedures could help in all three areas.

118. *See* Kevin Lang & Peter-John Gordon, *Partnerships as Insurance Devices: Theory and Evidence*, 26 RAND J. ECON. 614, 615 (1995) ("Creative and/or intellectual pursuits are more difficult to monitor than mechanical, repetitive tasks.").

119. Professor Hyman suggests that it is "unlikely that more than a handful of such procedures can be instituted, because of the attendant cost and controversy." *see* Hyman, *supra* note 108, at 363. His empirical intuitions about the cost-effectiveness of various loss prevention techniques—that is, how much current malpractice is economically "preventable"—may be different than mine.

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One way to mitigate many of the problems already discussed is to have insureds monitor each other. That is essentially what mutual insurance companies, which are owned by their policyholders, do. In fact, many, though not all, legal malpractice insurers that offer loss prevention services are mutuals. Mutuals trade off the costs of reduced diversification against the benefits of improved loss prevention.[120] Mutuals can reduce moral hazard and adverse selection problems, and enhance compliance with loss prevention measures by having their members monitor each other.[121] For example, Robert O'Malley, chief loss prevention counsel for ALAS, the largest mutual legal malpractice insurer, recommends that "[w]hen possible, seminars should be held at the [insurance] company's Annual Meeting."[122] The reason is obvious. It would be hard to think of a more effective informal enforcement mechanism than having representatives from an insurer's member law firms present to discuss the claims from the prior year. Having a legal autopsy done on one of your malpractice cases by top lawyers in your field who have a financial stake in your future behavior is probably a very sobering experience.[123] Such a meeting would also serve to establish a kind of group solidarity that would

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120. *See* Hansmann, *supra* note 93, at 149-50.

121. *See id.* at 148

122. O'Malley, *supra* note 80, at 119.

123. For a fascinating discussion of the goings-on at one such annual meeting of ALAS in Bermuda, see Rita Henley Jensen, *Malpractice Rates May Level Off: ALAS Confab Looked at Future Costs, Past Law Firm Mistakes*, NAT'L L.J., July 19, 1993, at 1. Jensen reports that "the most well-attended seminars, to the surprise of some ALAS officials, were the "Monday morning quarterbacking-confessionals' of six firms hit recently by sizable malpractice verdicts or settlements, and a workshop on conflicts." She describes these sessions further:

> Some ALAS law firms that are involved in litigation must each year face their toughest audience available: their colleagues who help pick up the tab. For each case, a presenter summarized the facts and the legal arguments, and noted what lessons might be learned from both.
>
> This year the crowd seemed to pay little heed to the arguments made on behalf of two firms caught in highly publicized and controversial malpractice cases. Many who had sat through the presentations said later they thought the firms had made serious mistakes, despite the opinions of the panelists.

Id.

Finally, she quotes one law firm partner-participant, who noted that "it is this very absorption in the day-to-day problems of attorneys that makes this gathering so much more enjoyable than other professional meetings because colleagues here are not networking or marketing, but genuinely searching for guidance in an increasingly complex legal landscape." *Id.*

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deter free rider problems, and would improve information by fostering the sharing of relevant experiences among insured members.

f. The Problem of Solvency Risk

Not all roads lead to loss prevention. There is a class of lawyers who have a strong incentive to resist loss prevention by insurers. These are lawyers who would face a severe risk of insolvency in the absence of insurance. We have already seen that the moral hazard problem is strong in the absence of insurance for such lawyers. The problem is that insurance for these lawyers might exacerbate, rather than alleviate, the moral hazard problem.[124] The insurance company could address this problem by screening for insolvency risk, but that does not seem to be a risk they consider in the underwriting process. Although malpractice insurers do consider claims history, a judgment proof lawyer may escape detection on this radar even though he committed many acts of malpractice if he incurred few claims precisely because of insolvency, or if he was able to hide the claims made against him because he settled them quietly with no insurance company involvement.[125] Clients might also address this problem by insisting not only that the lawyer get insurance, but that he get insurance that requires claim prevention. That seems to demand a fairly high degree of monitoring and sophistication by the client, however. Thus, we should not be surprised if insolvent lawyers purchase a disproportionate amount of malpractice insurance that does not offer loss prevention services. If the insolvency problem is serious enough, and if the other factors discussed in this section suggest that loss prevention by insurers would be effective, then legislatively mandated legal malpractice insurance that includes a mandatory loss prevention component and an opt-out provision for those who can demonstrate sufficient asset reserves may be the best solution.[126]

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124. *See* SHAVELL, *supra* note 26, at 241-42.

125. According to Long & Levit:

> A recurring question is whether to report a claim that will not exceed the attorney's deductible or self-insured retention. Such claims fall within most policy definitions of the term "claim." As a practical matter, however, *there is little downside to omitting reference to such claims*, although a carrier could conceivably argue that such claims would have alerted it to an undesirable risk.

LONG & LEVIT, *supra* note 21, at 23 (emphasis added).

126. *See* SHAVELL, *supra* note 26, at 242. Oregon, the only state in the country that makes legal malpractice insurance mandatory, has a bar-sponsored insurance company that does in fact engage in significant loss prevention activity.

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5. The Bundling of Loss Prevention with Diversification

So far, I have established that lawyers might demand both diversification services and loss prevention services from market insurers. I have not yet explained, however, why the same institution needs to do both. In particular, lawyers could keep an outside law firm on retainer for long-term and emergency advice. To date, however, this option is rarely exercised. Nor do malpractice insurers tend to sell their loss prevention services separately from their diversification services.

Explanations of bundling seem to fall into three general categories. One is that bundling facilitates price discrimination and profit maximization by a monopolist insurer.[127] This theory does not seem to fit the known facts about legal malpractice insurance. For example, it does not seem to explain the rise of legal malpractice mutuals, which seem to have increased competition while offering more loss prevention services.[128]

A second explanation of bundling is based on economies of scope: "transaction costs are reduced if the insured relies on that insurer for its safety information rather than arranging a contract with an outside consultant, for the insured already stands in a contractual relationship with its liability insurer."[129] A long-term contractual relationship between insurer and insured could facilitate monitoring necessary for loss prevention, for example. One institution is generally cheaper than two, and perhaps more than two since the outside ethics counsel would presumably also have to get malpractice insurance. But that explanation can be only partial, because hiring outside ethics counsel might also lead to economies of scope, and because insurers could bundle other services that they do not. A variation on this theme is that the market insurer may have advantages in the ability to coordinate information from and disseminate information to its insureds. Lawyers owe their clients duties of confidentiality and loyalty that go beyond any such duties of insurers;

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127. *See* Schlesinger & Venezian, *supra* note 88, at 233-34. The basic idea is that a monopolist insurer wants its insureds to be as risk averse as possible, so it can extract the maximum risk premium from them. It can achieve this goal by manipulating the likelihood of loss. In some circumstances, lowering the probability of loss (loss prevention) can actually *increase* the risk premium (such as when the probability starts out close to 1). Thus, the monopolist insurer will engage in loss prevention to decrease risk, hence increase risk premiums and therefore monopoly profits. The monopolist will engage in loss prevention even if it cannot prevent insureds from free riding by not buying the insurance, but will do better if it can bundle the insurance and risk prevention and prevent free riding.

128. *See* Hansmann, *supra* note 93, at 146-47.

129. Schwartz, *supra* note 4, at 556; *see also* ARROW, *supra* note 60, at 68-69 (discussing value of centralized decisionmaking in terms of saving information costs).

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in fact, a lawyer seeking to play loss prevention counsel for numerous other lawyers could run up against conflict of interest problems before reaching the scale and scope efficiencies of insurers, though this problem might be mitigated somewhat by waivers.[130] Insurers (especially mutuals), by contrast, can justify using the information as part of a coordinated effort designed to benefit all of their insureds.

A third reason bundling of diversification and loss prevention may make sense is that the insurance company's size and clout make it better able than an outside law firm to exercise the authority necessary to make loss prevention effective. A purveyor of loss prevention services must be able to say no to his client, which requires some degree of independence from the client. A consultant too dependent on his client's business will be susceptible to bribery, or co-opting by the client.[131] Moreover, authority is enhanced when the parties subject to it are convinced that everyone else is obeying it.[132] An insurance company may be better able to convince its insureds of cooperation by other insureds than an outside lawyer would be able to convince his lawyer-clients. Finally, loss prevention services by an insurance company come with a stronger guarantee than loss prevention services by lawyers. The insurance company bonds its appraisal by agreeing to indemnify the insured for losses that occur;[133] lawyers guarantee only nonnegligent appraisals. And competition among insurers keeps them from overprescribing or

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130. *See, e.g.*, Maritrans G.P. Inc. v. Pepper, Hamilton & Scheetz, 602 A.2d 1277 (Pa. 1992) (finding that law firm violated common law fiduciary duties by representing competing companies where there was a danger that confidential information acquired in one representation could be used in others). It is important to note that the Maritrans case was one discussed by ALAS members at its 1993 annual meeting and one thought correctly decided by many present.

131. Mayers & Smith, in their pathbreaking article on corporate insurance, explained the problem as follows:

> [T]here are incentives to bribe the consultant to allow the firm to engage in actions which would result in wealth transfers. Therefore prior to entering these contracts it is in the firm's interest to choose an agent who is expensive to bribe because the reservation prices of the claimholders will reflect the probability of enforcement. Bribing an insurance firm is expensive; a large fraction of an insurance company's revenues is related to the sale of long-term financial contracts. These revenues will be reduced if the insurance company is discovered accepting bribes; further, the costs of accepting a bribe must be discounted over an infinite horizon.

Mayers & Smith, *supra* note 62, at 288-89.

132. *See* ARROW, *supra* note 60, at 71-73.

133. *See* Mayers & Smith, *supra* note 62, at 288-89.

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underprescribing loss prevention.[134] None of these considerations, of course, means that lawyers will or should never use other lawyers to advise them on matters relating to malpractice; rather it simply suggests why the insurance company may have an advantage in providing bundled services.

6. Is More Liability Insurance Good?

The preceding discussion can help inform the recent debate that has occurred over whether liability insurance is socially desirable.[135] Although economists generally argue that if parties voluntarily contract for something, the thing contracted for is efficient,[136] they recognize an exception if the contract imposes external costs on third parties. The argument against liability insurance is essentially that liability insurance imposes such costs on victims, in our case malpractice victims. Under what might be termed the diversification externality, insureds might inefficiently substitute more diversification for less expected loss reduction (the classic moral hazard problem). This makes insurers and insureds better off at the expense of victims, with the result that there will be too much liability insurance.[137]

But as I have discussed, several features of the insurance market tend to mitigate the diversification externality. First, market insurers will not offer insurance if the moral hazard problem (the absence of loss reduction activity) is too severe; the price of market insurance will be so high that insureds will turn to substitutes, as they did during the liability insurance crisis. Second, when tort victims are in contractual relationships with tortfeasors, as clients are with their lawyers, the potential for the lawyer and insurer to combine to impose "external" costs on the client is reduced, at least for sophisticated, repeat clients. Third, clients might rationally decide that having their lawyers buy malpractice insurance is better than extra deterrence; thus, the diversification externality story seems especially implausible when clients demand malpractice insurance. The reason clients might be willing to trade off insurance for loss prevention is that to the extent that the tort system undercompensates them, by for example denying attorneys' fees or damages for emotional harm, clients face a higher risk premium than they would if the tort system fully "insured" them. There may be some cases in which $1 spent

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134. *See id.*

135. *See* Schwartz, *supra* note 4, at 350; Syverud, *supra* note 4, at 1629. Schwartz argues that the efficiency of liability insurance is unclear and probably varies from market to market, but concludes that liability insurance is probably efficient. *See* Schwartz, *supra* note 4, at 358. Syverud argues that an inefficient amount of liability insurance is being purchased. *See* Syverud, *supra* note 4, at 1639.

136. Shavell makes just this argument in trying to justify the social desirability of liability insurance. *See* SHAVELL, *supra* note 26, at 212.

137. *See* Schwartz, *supra* note 4, at 349.

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on diversification may yield greater social benefit, by reducing the client's risk premium, than $1 spent on prevention, despite the fact that expected malpractice losses will be somewhat greater. This argument forms the basis for the support of no-fault insurance regimes; that is, there may be times when efforts to improve compensation may be more cost-effective than efforts to reduce expected losses. Fourth, and most important for our purposes, to the extent that the insurer provides loss prevention services, the diversification externality argument is weaker. The strongest case for the diversification externality is where otherwise judgment proof lawyers are able to obtain the insurance and neither the insurer nor the client is a good monitor of lawyer behavior.

A variant on the externality argument is that liability insurance leads to more lawsuits.[138] Although this is undoubtedly true, it is also true of any procedural reform that reduces the cost of bringing a suit. Yet no one argues that all such reforms are bad. The question is whether the extra lawsuits are more likely to be meritorious ones that would not be brought without liability insurance,[139] or frivolous ones that would not be brought without liability insurance (essentially client moral hazard).[140] This in turn depends on how effective insurers and lawyers are at deterring or resolving malpractice suits that lack merit. For example, as I discussed above, eroding policy limits tend to discourage plaintiffs from bringing malpractice suits whose value stems from threatening lengthy litigation, because if plaintiffs will not pursue damages beyond the policy limits, then lengthy litigation reduces their recovery. The extent of the externality problem might also depend on how effective courts are at policing the risk that insurance might lead insurers and insureds to collude to prevent meritorious claims from being brought.[141]

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138. *See* Syverud, *supra* note 4, at 1629.

139. For a suggestion that malpractice insurance might make more viable meritorious small claims that might not be brought in the absence of insurance, *see* Wilkins, *supra* note 24, at 831 n.132. The small claims Professor Wilkins has in mind would, of course, have to be claims that exceed the deductible.

140. According to one commentator, "the pervasiveness of insurance has led clients to mistakenly believe that lawyers do not pay when they lose malpractice suits. They think that because the attorney's insurance pays the claim, the attorney will be unscathed both financially and in reputation." Susan Korenvaes Robin, Note, *Attorney Malpractice and Preventive Lawyering: Are Attorneys Safer in Large Firms?* 40 U. MIAMI L. REV. 1101, 1105 (1986). As a result, some advise lawyers not to reveal to clients that they carry malpractice insurance, *id.* at 1107 n.10, despite the questionable ethical validity of such advice, *see* MODEL RULES, *supra* note 53, Rule 1.4.

141. For example, in Passanante v. Yormark, 350 A.2d 497 (N.J. Super. Ct. App. Div. 1975), the court held that fraudulent conduct by an insured in secreting prior misconduct that is covered by the policy does not act as a bar to coverage under the fraud exclusion. To hold

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III. CLIENTS AND LAWYERS AS ENTITIES

So far, I have considered three institutions that can provide insurance services to lawyers: self-insurance, client contract insurance, and market insurance. But in comparing the relative strengths and weaknesses of these insurance institutions, I have assumed that clients and lawyers are both monads. This part relaxes that assumption and explores some of the complications arising from client and lawyer entities. Interestingly, it turns out that these complications often strengthen the conclusions of the last part, namely that market insurance that offers loss prevention services may often be the best insurance institution.

A. Complex Clients as Insurers

When lawyers' clients are entities rather than individuals, one might think that market malpractice insurance should be less important. Entity clients are often "sophisticated" and so might be thought to be sufficiently able to take care of their own interests that they could provide contract insurance to their lawyers. In fact, however, market insurance that offers loss prevention may be more necessary rather than less necessary for these types of clients.

The problem is that entity clients have agency problems within themselves. As a result, the "client" faces the risk that he may have not one unfaithful agent—the lawyer, but two—the lawyer and management. To the extent that the lawyer is likely to side with the managing agent, even when that agent's action is not in the client's best interest, the client might be quite interested in having the lawyer monitored by an active insurer and quite reluctant to have the managing agent offer contract insurance to the lawyer.

This is not to say that client monitoring will be completely ineffective. When there is no conflict between the managing agent's interests and the client's interests, monitoring of the lawyer will probably be very effective, as the increased use of in-house counsel for this purpose shows. But this fact may also provide a further reason to think market insurance is likely to be effective, namely that the diversification externality discussed above will be less likely to occur with these clients.

B. Law Firm Insurance

An important insurance institution remains, namely the law firm. Traditionally, law firms have been organized as partnerships. Partners in general partnerships are subject to vicarious liability for torts and breaches of fiduciary obligation committed by fellow partners, as well as associate

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otherwise would invite collusion between the insurance company and the insured to cover up potential negligence.

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lawyers.[142] The combination of vicarious liability and the general failure to seek indemnity from the lawyer who commits malpractice means that the firm provides the equivalent of a malpractice insurance policy to its lawyers.[143]

Partnerships engage in all of the risk reduction methods that market insurers do, including diversification.[144] Although market insurers may provide more diversification, large law partnerships are close to, if not greater than, the size of some mutual malpractice insurers. Partnerships also engage in extensive underwriting and monitoring of their lawyers to minimize adverse selection and moral hazard problems. They have elaborate screening methods for hiring. They put their associate lawyers on lengthy and highly scrutinized "partnership tracks" before allowing admission to partnership. And they are more frequently creating "ethics committees" to supervise and ameliorate difficulties that arise in day-to-day practice.[145] In fact, a strong argument could be made that partnerships are better situated than market insurers to perform these tasks.[146] Partners have more continual contact with lawyers in their firm than an insurer with even an extensive loss prevention program probably has. Partners may also have better information about the strengths and weaknesses of the lawyers in the firm. Thus, one could make a plausible argument that at least large partnerships are superior insurers.

But if partnerships are superior insurers, then one might reasonably ask why they purchase as much market insurance as they do, and why they often favor malpractice insurance that offers loss prevention services. Law firms seem to be getting less enthusiastic about providing partnership malpractice insurance. The latest evidence of this fact is the current rush to pass Limited Liability Company (LLC) and Limited Liability Partnership (LLP) legislation

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142. The partnership is liable to non-partners for "any wrongful act or omission of any partner acting in the ordinary course of the business of the partnership or with the authority of his co-partners," UPA § 13, RUPA § 305(a), as well as for the "misapplication" of money or property received from a third person, UNIF. PARTNERSHIP ACT § 14, REV. UNIF. PARTNERSHIP ACT § 305(b). All partners are jointly and severally liable for these partnership obligations. UPA § 15; RUPA § 306(a).

143. *See* Lang & Gordon, *supra* note 118, at 615.

144. In fact, partnerships provide diversification against business risks associated with human capital investments, which is broader than the diversification service commercial malpractice insurers provide. *See* Lang & Gordon, *supra* note 118, at 614.

145. *See* Jonathan M. Epstein, *The In-House Ethics Advisor: Practical Benefits for the Modern Law Firm*, 7 GEO. J. LEGAL ETHICS 1011 (1994).

146. Note that if the firm is a better monitor than the insurance company, the traditional arguments about adverse selection and moral hazard apply. For example, if the law firm is a superior underwriter, then clients might view the fact that such a firm bought malpractice insurance as a signal of low quality. *See* Robert Puelz, Comment, *The Effectiveness of Debt Insurance as a Valid Signal of Bond Quality*, 59 J. RISK & INS. 499 (1992).

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and allow law firms to take advantage of these new organizational forms.[147] In general, vicarious liability of LLCs and LLPs for the torts of members or partners is limited to the assets of the firm and does not reach the assets of the individual members or partners. But individual members or partners are subject to personal liability for torts they commit, and for the torts of others over whom they had supervisory responsibility, or torts of which they have notice. Several LLC and LLP statutes require firms wishing to take advantage of these entities to maintain a minimum amount of liability insurance.[148] These statutes certainly encourage the substitution of market insurance for partnership insurance. Because active monitoring of one's colleagues exposes a member of an LLC or LLP to personal liability, such monitoring may well be discouraged, though how significant this effect will be remains to be seen.[149]

But these statutes may simply represent a legislative approval of a trend that was already taking place. One of the most striking features of the last two decades of lawyer regulation is the decline of the partnership as a regulatory institution. As law partnerships have approached mutual insurance companies in size, they have distanced themselves in spirit. Why?

Superior diversification of market insurers is probably part of the answer, because the costs of some types of monitoring have increased.[150] But it seems unlikely that the rise of mutuals such as ALAS can be fully explained by their superior diversification abilities compared to commercial insurers such as CNA or imperfections in the commercial insurance market. That leaves superior loss

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147. Robert R. Keatinge & George W. Coleman, *Practice of Law by Limited Liability Partnerships and Limited Liability Companies*, *in* THE PROFESSIONAL LAWYER (1995). According to Keatinge & Coleman, 21 state statutes currently allow professionals to organize as LLCs, and regulatory bodies in 8 states and the District of Columbia have explicitly allowed lawyers to organize as LLCs. Fifteen states and the District of Columbia have adopted LLP legislation; only D.C. has expressly allowed lawyers to form LLPs, but Keatinge & Coleman contend that specific regulatory authority for lawyers to form LLPs may not be required, because unlike LLCs, LLPs are general partnerships. *See id.*

148. *See, e.g.*, W. VA. CODE § 47B-10-5(a) (1996); TEX. REV. CIV. STAT. ANN. art. 6132b-45 (West Supp. 1997); DEL. CODE ANN. tit. 6, § 1546(a) (1997); CAL. CORP. CODE § 15052(a)(2) (West Supp. 1997); *see generally* Susan Saab Fortney, *Seeking Shelter in the Minefield of Unintended Consequences—The Traps of Limited Liability Law Firms*, 54 WASH. & LEE L. REV. 717, 729 (1997).

149. For a recent example of how monitoring activity can expose lawyers in limited liability entities to personal liability, *see* Sanders, Brain, Coll & Worley, P.A. v. McKay Oil Corp., 943 P.2d 104 (N.M. 1997) (holding that individual members of an incorporated law firm who voted to terminate the representation of a client in an allegedly negligent manner may be held personally liable).

150. For example, some firms have grown rapidly and opened satellite offices, making it harder to keep track of one's colleagues. *See, e.g.*, *Legal Malpractice Claims*, *supra* note 36, at 24. Others have downsized rapidly, leaving themselves potentially understaffed or unable to supervise associates or other employees properly. *See id.* at 23.

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prevention services. But why, given the partnership's apparent advantages in this area, should we ever expect market insurers ever to do better?

The theory developed above suggests several possible reasons. First, the character of law partnerships has changed, largely as a result of increased competition, in ways that may increase agency costs within the firm. A particularly important example of how large firms have changed is the fact that the locus of power in partnerships seems to have shifted away from centralized control to individual autonomy.[151] If central authority declines generally, that will increase the ability of individual lawyers to pursue their own agendas at the expense of the firm's welfare, and thereby hinder the firm's ability to monitor malpractice.[152] If the managing partner cannot control the rainmaker's salary, he probably cannot control the rainmaker's behavior either.[153] A mutual insurer may be able to exert leverage over firms that the firm's management cannot on its own.[154]

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151. *See, e.g.*, Anthony E. Davis, *The Long-Term Implications of the Kaye Scholer Case for Law Firm Management—Risk Management Comes of Age*, 35 S. TEX. L. REV. 677, 680 (1994).

152. Law partners are thus becoming more like corporate managers in the sense that conflicts of interest between them and the "owners" (other partners) may be increasing. And "firms whose managers have greater discretion over the choice of hazard-reducing projects will be more likely to purchase insurance." Mayers & Smith, *supra* note 62, at 286.

Professor Hyman in his comments on this article argues that lawyer resistance to loss prevention "strongly suggests that lawyers believe they are better at assessing risk than insurers are—or are willing to pay substantial malpractice premiums to maintain their preferred pattern of practice." David A. Hyman, *supra* note 108, at 360-61. But what may be good for individual lawyers may not be good for the firm as a whole, especially when the swashbucklers can impose some of the costs of their actions on others in the firm while reaping a greater percentage of the benefits. Thus, to the extent that law firms resist loss prevention, that may be the manifestation of an agency problem within the firm rather than a true reflection of the preferences of a majority of the partners. This certainly seems to be the view of Anthony Davis, whom Professor Hyman repeatedly cites. Davis views the weak central management of law firms as a "disease," Davis, *supra* note 151, at 679, for which the cure is in part providing the firm's management with "sufficient authority to control the practice of each member of the firm *without exception* and *regardless of seniority*." *Id.* at 683 (emphasis added).

153. In their recent empirical study of law partnership salaries, Lang & Gordon, *supra* note 118, find that in larger partnerships, partners keep a smaller share of the profits, which they conclude is more consistent with the partnership performing an insurance function than with the increased autonomy story commonly believed. The idea is that larger partnerships are better insurers, so risk averse lawyers will join large partnerships and pay for the insurance in smaller profit shares. They recognize, however, that their results are consistent with the autonomy story to the extent that partners seek power rather than salary. Another possibility is that partners get extra remuneration in ways that do not show up in salary data, such as business deals from clients. *See generally id.*

154. For example, Bob O'Malley of ALAS reports that it is a very common experience to hear lawyers say of some proposed policy, "I can't sell this to my firm, but if you tell us we have to do it, we'll do it." Interview with Robert E. O'Malley, Vice Chairman of the Board and

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Another feature of the changing character of law partnerships is increased mobility of lawyers between firms. The more mobile lawyers are, the harder they are to control because they can threaten to leave and take their clients with them. Insurers like ALAS may effectively reduce the mobility of lawyers by making it more likely that lawyers will face similar constraints on their behavior at their new firm, which may also be insured by ALAS or a similar market insurer.

Relatedly, the combination of competition for clients and increased third party liability may make it necessary for the partnership to have some "outside authority" to refer to as a way of maintaining independence from their clients. Third party liability means that malpractice is not only failing to do what your client wants when you should, but also doing what your client wants when you should not. A lawyer may not be able, however, to "just say no" to his client's desires, especially when the client can threaten to go elsewhere. But if the lawyer can rely on the authority of his malpractice insurer, he might be able to convince the client not to do something risky or wrong. Not only might the client be convinced that something more than an "ethics problem" might be going on, but the client also might realize that other lawyers (at least those insured by the same carrier) would not be able to act any differently. Thus may malpractice insurance bind lawyers to a code of conduct more effectively than does a partnership.

Finally, the law governing lawyers has undergone tremendous change over the last several decades. Not only have two sets of ethical rules been promulgated by the ABA, with numerous state variations, but the expansion of third party liability, fiduciary obligation, disqualification motions, and Rule 11, to name a few, have turned professional responsibility from a quaint sideline to a business necessity. Market insurers may be better able to collect information about these changes and the best responses to them. More important, to the extent that partnership culture has to change to adapt to what lawyers perceive—whether rightly or wrongly—as new legal circumstances, it may be difficult to effect such change from within the partnership.[155] That is how management consultants make their money.

Chief of Loss Prevention Counsel, Attorneys' Liability Assurance Society (ALAS) (April, 1997).

155. According to Professor Arrow:

> It may really be true that social agreements ultimately serve as obstacles to the achievement of desired values, even the values desired by all or by many. The problem is that agreements are typically harder to change than individual decisions. When you have committed not only yourself but many others to an enterprise, the difficulty of changing becomes considerable. If it is done on a conscious level, we have all the formalities

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CONCLUSION

I have sought in this paper to describe and explain an institutional response to an increase in liability. In particular, I have tried to argue that the current regulatory climate governing lawyering has spawned active market insurance that provides loss prevention services. More broadly, I have tried to show that legal malpractice insurance is an area worthy of further study. For example, this paper merely touches on questions of how legal malpractice insurance fits into the larger regulatory scheme, which includes professional discipline and court sanctions. In future research, I may try to address such questions as how legal malpractice insurance and professional ethics rules affect each other. For now, I will simply close with the somewhat whimsical thought that if we have not yet, we may soon reach the point where if a famous Supreme Court justice were to ask a famous French author what the most effective check on lawyer misconduct is, the response might very well be, "ALAS, Hugo."

> involved in persuading others to change their minds. What may be hardest of all to change are unconscious agreements, agreements whose very purpose is lost to our minds. Some commitments are to purposes which involve much sacrifice and very great depth of involvement. A commitment to a war or a revolution or to religion is typically one that is very hard to reverse, even if conditions have changed from the time when the thing started. Even if experience has shown the unexpectedly undesirable consequences of a commitment, the past may continue to rule the present.

ARROW, *supra* note 60, at 28.

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PROFESSIONAL RESPONSIBILITY, LEGAL MALPRACTICE, AND THE ETERNAL TRIANGLE: WILL LAWYERS OR INSURERS CALL THE SHOTS?

*David A. Hyman**

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INTRODUCTION

The past year has been an exciting one (at least by academic standards) for issues at the interface of professional responsibility and insurance law. Between the dispute over the American Law Institute's § 215 of The Restatement (Third) of the Law Governing Lawyers,[1] the issuance of ABA Formal Opinion 96-403,[2] the Kentucky Supreme Court opinion in *American Insurance Association v. Kentucky Bar Association*,[3] and the

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* Associate Professor, University of Maryland Law School. I appreciate the helpful comments of Robert Condlin, Oscar Gray, Deborah Hellman, and David Luban. Robert E. O'Malley, Vice-Chairman of the Attorney's Liability Assurance Society ("ALAS"), graciously gave permission to quote a passage from the ALAS Loss Prevention Manual, and the American Bar Association was kind enough to provide an advance copy of the 1996 ABA Nabrico National Legal Malpractice Data Study.

1. *See, e.g.*, Jonathan Aroner, *Insurance Lobby Aims at Normally Staid ALI*, LEGAL TIMES, June 10, 1996, at 1.

2. Formal Opinion 96-403 addresses the obligations of a lawyer representing an insured who objects to a proposed settlement within the policy limits. Formal Opinion 96-403 is excerpted in 82 ABA J. 83 (Dec. 1996). *See* James M. Fischer, Carrier-Policyholder Conflicts and Retained Defense Counsel's Proper Response, n.17 (1997) (unpublished manuscript).

3. 917 S.W.2d 568 (Ky. 1996).

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articles published in this volume,[4] this is now a hot area of scholarship. As the articles in this volume make clear, the disagreements among the authors in their formulation of the law of lawyering—particularly on the issue of whether the insurer counts as a client and the significance of that characterization—are both sharp and fundamental.[5] The magnitude of the disagreement and the stakes of the controversy are nicely captured by the title of the session at the American Association of Law Schools ("AALS") annual meeting at which the articles in this volume were originally presented: Lawyers and Insurers: The Struggle for Control and the Power to Regulate.[6]

Professor Cohen's article is in many respects the odd man out. Professor Cohen largely disregards the brouhaha about incipient conflicts of interest arising from providing legal services in the context of an insurance arrangement, and instead focuses on the significance of professional liability insurance in the regulation of lawyer behavior. Much of the article is devoted to providing a sophisticated economic model of legal malpractice insurance.[7] Professor Cohen's ultimate conclusion is that

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4. Thomas D. Morgan, *What Insurance Scholars Should Know About Professional Responsibility,* 4 CONN. INS. L.J. 1 (1997); Kent Syverud, *What Professional Responsibility Scholars Should Know About Insurance*, 4 CONN. INS. L.J. 17 (1997); Stephen L. Pepper, *Applying the Fundamentals of Lawyers' Ethics to Insurance Defense Practice,* 4 CONN. INS. L.J. 27 (1997); William T. Barker, *Insurance Defense Ethics and the Liability Insurance Bargain,* 4 CONN. INS. L.J. 75 (1997); Tom Baker, *Liability Insurance Conflicts and Defense Lawyers: From Triangles to Tetrahedrons*, 4 CONN. INS. L.J. 101 (1997); Robert H. Jerry II, *Consent, Contract, and the Responsibilities of Insurance Defense Counsel,* 4 CONN. INS. L.J. 153 (1997); Charles Silver, *Flat Fees and Staff Attorneys: Unnecessary Casualties in the Continuing Battle Over the Law Governing Insurance Defense Lawyers*, 4 CONN. INS. L.J. 205 (1997); Nancy J. Moore, *The Ethical Duties of Insurance Defense Lawyers: Are Special Solutions Required?*, 4 CONN. INS. L.J. 259 (1997); George M. Cohen, *Legal Malpractice Insurance and Loss Prevention: A Comparative Analysis of Economic Institutions*, 4 CONN. INS. L.J. 305 (1997).

5. *See, e.g.,* Pepper, *supra* note 4, at 28 ("Recently, able champions arguing for the two client view have come forward. From the point of view of one who teaches lawyers' ethics regularly, however, their position appears remarkably insensitive to underlying principles and basic rules of lawyers' professional ethics;" other authors demonstrate "a remarkable bias in favor of insurance companies.").

6. The session was jointly sponsored by the sections of Professional Responsibility and Insurance Law of the AALS and took place on January 7, 1997 in Washington, D.C.

7. Thankfully or regrettably—depending on one's point of view—Professor Cohen has written an article which is both formula and graph-challenged. The trade-off (and didn't you know there would be one in a paper written by someone with a Ph.D. in economics) is that the narrative is tough sledding in spots.

Professor Cohen's article consolidates the invasion of law and economics scholars into the field of professional responsibility. *See, e.g.*, Jonathan R. Macey & Geoffrey P. Miller,

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legal malpractice insurers (through their loss prevention efforts) are likely to become major regulators of attorney conduct.[8]

In his capacity as panel organizer, Professor Silver graciously invited commentators to direct their energy as they saw fit among the various papers which were presented. Accordingly, Section II of this article addresses the implications of Professor Cohen's article, including the "fit" between his model and the structure of American legal practice. Section III provides a cross-disciplinary perspective on the issues which arise at the interface of insurance law and professional responsibility, as addressed in the articles of Professors Silver, Syverud, Morgan, Pepper, and Baker, and the responding commentary by Professors Jerry and Moore and Mr. Barker. Section IV provides a narrative perspective on the issues raised in Section III. Section V offers a brief conclusion.

II. MALPRACTICE INSURERS AS ATTORNEY REGULATORS

A. Professor Cohen's Article

Although malpractice liability has attracted some attention as a regulator of attorney conduct, malpractice insurers have not.[9] Professor Cohen's article fills that gap, and provides a detailed exploration of the

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An Economic Analysis of Conflict of Interest Regulation (1997) (unpublished manuscript on file with *The Iowa Law Review*) [hereinafter Macey & Miller, *Conflict of Interest*]; Jonathan R. Macey & Geoffrey P. Miller, *Reflections on Professional Responsibility in a Regulatory State*, 63 GEO. WASH. L. REV. 1105 (1995) [hereinafter Macey & Miller, *Regulatory State*]; Richard A. Epstein, *The Legal Regulation of Lawyer's Conflicts of Interest*, 60 FORDHAM L. REV. 579 (1992).

8. *See* Cohen, *supra* note 4, at 307 ("In fact, because of their comparative institutional advantages, legal malpractice insurers are increasingly serving as regulators of lawyer behavior and may be beginning to substitute for the firm and the bar in this role.").

9. *See* Cohen, *supra* note 4, at 306. As Professor Cohen notes, two articles addressing this area recently appeared. Anthony E. Davis, *Professional Liability Insurers as Regulators of Law Practice*, 65 FORDHAM L. REV. 209 (1996) [hereinafter Davis, *Liability Insurers*]; Charles Silver, *Professional Liability Insurance as Insurance and as Lawyer Regulation: Response to Davis*, 65 FORDHAM L. REV. 233 (1996). Loss prevention is not a focus of either article, although Mr. Davis addresses it in passing, *see* Davis, *supra* at 220-22, and has published another article and a book which address professional liability insurance and risk management. *See* Anthony E. Davis, *The Long-Term Implications of the Kaye Scholer Case for Law Firm Management – Risk Management Comes of Age*, 35 S. TEX. L. REV. 677 (1994) [hereinafter Davis, *Kaye Scholer*]; RISK MANAGEMENT: SURVIVAL TOOLS FOR LAW FIRMS (1995). *See also* William H. Fortune & Dulaney O'Roark, *Risk Management for Lawyers*, 45 S.C. L. REV. 617, 634 (1994) ("Malpractice insurers, especially bar-related insurers, have an important role in risk management.").

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economics of various insurance arrangements, as well as a comparative institutional analysis. To briefly reprise Professor Cohen's argument, insurance is demanded by its purchasers because it provides risk diversification and loss prevention/reduction services.[10] Insurance takes a variety of forms, including market insurance, self-insurance, and client-provided (contractual) insurance.[11] The choice among these alternatives is driven by trade-offs between moral hazard, adverse selection, and transactional cost.[12] Market insurance is demanded when it can provide risk diversification and loss prevention/reduction at a lower cost than any of the alternative institutional possibilities.[13] Loss prevention has the significant societal benefit of potentially improving the behavior of the insured across the board.[14]

From a functional perspective, law firms also provide insurance.[15] Each partner's risk is diversified by the work of her partners—although this effect is considerably attenuated if all are practicing in the same area of law and representing similar clients.[16] Law firms also provide loss prevention by adopting systems and procedures which lower liability exposure.[17] Although the firm *qua* firm provides some quantum of insurance to both partners and customers, many firms also purchase market insurance.[18]

Professor Cohen suggests that law firms are inclined toward market insurance for several reasons. Partners can use the fact of market insurance to signal the quality of legal services to potential clients.[19] If an insurer is willing to stand behind the attorney, the client will accurately perceive that the chances of an adverse outcome attributable to legal malpractice are

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10. *See* Cohen, *supra* note 4, at 323-24. I suspect the benefits of risk diversification predominate, since a firm can readily purchase loss prevention advice—and once such advice is purchased, others cannot be excluded from adopting the same suggestions.

11. *See id.* at 324. Professor Cohen employs a broad definition of insurance to facilitate his comparative institutional analysis. *See id.* at 311, 313-14.

12. *See id.* at 314-27.

13. *See id.* at 323-27.

14. *See id.* at 326-27.

15. *See id.* at 346-48.

16. *See id.* at 316, 346.

17. *See id.* at 315, 347.

18. *See id.* at 347.

19. *See id.* at 330-31. As Professor Cohen notes, if clients are better at assessing the value of legal services than attorneys, market insurance can actually reflect that lower quality services are being provided. Although his point is analytically sound, it seems quite unlikely to occur in practice.

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lower than would otherwise be the case—and if something happens, the presence of the insurer enhances the possibility of recourse.[20]

Firms can also employ market insurance to resist the demands of clients and partners. Clients might demand certain services which are proscribed by both professional ethics and the malpractice insurance policy.[21] Clients who are told the firm can not comply with their demands because of the dictates of professional responsibility might well decide to shop for less scrupulous firms, unless they understand that every other firm with market insurance will behave the same way.[22] Firms can also use the same strategy to resist the demands of partners. Partners could threaten to defect to another firm unless their current firm undertakes representation it would prefer to avoid. The knowledge that any other firm would also refuse the (presumably risky) representation will strengthen the firm's position, and is likely to constrain partner opportunism in the first instance. Thus, market insurance helps constrain "firm-shopping" by both clients and partners.

Finally, partners use market insurance as a check on one another. One of the characteristics of a partnership is joint and several liability of all partners.[23] In the absence of market insurance, partners would have to spend a great deal of their otherwise billable time monitoring the conduct of their peers.[24] The time and effort required to monitor such conduct

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20. *See id.* at 330-31.

21. *See id.* at 349.

22. *See id.*

23. UNIF. PARTNERSHIP ACT, § 15 (1914). As such, the personal assets and malpractice coverage of each individual partner may be used to satisfy claims against the partnership, even though the individual partner was not involved in the transaction which gave rise to liability. *See id.* at §§ 13, 15.

The growth of limited liability arrangements reflects partners' desire to have the best of both worlds. *See* John Leubsdorf, *Legal Malpractice and Professional Responsibility*, 48 RUTGERS L. REV. 101, 141 (1995) ("The growth of law firms and the multiplication of malpractice suits against them has led to efforts to limit vicarious liability. Lawyers have persuaded state legislatures to allow them to create professional corporations (or limited liability partnerships or limited liability companies) in which the shareholder-lawyers are not liable for torts of their fellows in which they did not actually participate."); Susan Saab Fortney, *Am I My Partner's Keeper? Peer Review in Law Firms*, 66 U. COLO. L. REV. 329, 330 (1995) (firms have taken various steps to minimize malpractice liability, including restructuring).

24. Of course, partners already engage in routine monitoring of one another and of associates—although perhaps not as much as they should. *Compare* Fortney, *supra* note 23, at 339 ("Monitoring minimizes the risk of a partner taking a free-ride on the efforts of colleagues and protects the firm and its members from the acts or omissions of incompetent or malfeasant partners. Monitoring also helps maintain the value of human capital which is

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would also effectively limit the size and geographic dispersion of a firm.[25] Market insurance allows partners to monetize some of these monitoring costs, while simultaneously making possible a multi-office firm with scores or hundreds of partners—with all the gains that accrue from operations on such a large scale.[26] Thus, the availability of market insurance significantly moderates a dynamic that would otherwise constrain firm size.

B. Comments on Professor Cohen's Article

Professor Cohen's article is careful and comprehensive, and I agree with much of his analysis—although I will focus on our disagreements, in keeping with the role of commentator. Despite the theoretical appeal of Professor Cohen's transactional cost analysis, the model does not seem to correspond to current American legal practice—and certain demographic

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sensitive to the performance of agents. In order to avoid shirking by partners (agents), while controlling liability and protecting reputational capital, firms monitor the performance of firm attorneys.") *with* Dean Starkman, *Can A Law Firm Be Its Partner's Keeper?,* WALL ST. J., Jan. 7, 1996, at B1 (Morgan, Lewis & Bockius represented failed insurers controlled by partner; "a cautionary tale for law firms that, like Morgan, Lewis, have grown so large so fast that it's difficult to keep tabs on individual partners."); *and* Comments of Robert E. O'Malley, Judicial Conference - Federal Circuit, 133 F.R.D. 245, 288 (1990) ("All of these troubles that I've described in the nine points that I have discussed are attributable to and ultimately always traceable back to the poor judgment or misconduct or other questionable behavior or stupid decision by a partner who was not sufficiently monitored by his or her other partners in the firm."). However, the amount of monitoring which would be required in the absence of market insurance would be considerably higher.

25. *See, e.g.,* Michael Orey, *The Lessons of Kaye, Scholer: Am I My Partner's Keeper?,* AM. LAW., May 1992, at 3, 81, *reprinted in* Fortney, *supra* note 23, at 329 ("the actions of a partner you don't even know, working in an office on the other side of the country, could cost you your house and force your kids to go to public school."); Leubsdorf, *supra* note 23, at 142 ("Lawyers understandably shy away from liability for the negligence of hundreds of other lawyers, some of whom are scattered around the world and unknown to them."). The remedy for such difficulties is to know your partners, and make sure they don't work in an office further than a few steps away—a remedy which eliminates the possibility of a large firm.

26. *See generally* David B. Wilkins, *Making Context Count: Regulating Lawyers After Kaye, Scholer,* 66 S. CAL. L. REV. 1145, 1204-05 (1993) (Reviewing growth of large firms); Davis, *Kaye Scholer, supra* note 9, at 680 ("[t]he functions served by and benefits to be derived from the enlargement of that collective umbrella had to do with the economies of scale involved in representing large commercial clients and increased profitability.").

As the American Lawyer's annual survey of law firms makes plain, the most successful firms in the country (on a revenue per lawyer basis) have at least one hundred lawyers, and most have many more. AM. LAW., July/Aug., 1996, at 100.

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and structural features suggest it may never do so, at least for the overwhelming majority of lawyers.

One of the most striking features about Professor Cohen's analysis is the predictive implication of his transactional cost analysis—that attorneys will modify (for the better) their conduct as a general proposition in response to the loss prevention efforts of malpractice insurers.[27] If this prediction is accurate, it is quite remarkable; the insured are attorneys, whom one would presume to be quite knowledgeable about the law and the circumstances under which liability will be imposed—and to have arranged their affairs accordingly.[28] In addition, attorneys operate against a backdrop of extensive laws and guidelines—it is hard to believe that malpractice insurers will be much more effective than the authorities currently regulating lawyers.[29] Even Professor Cohen seems taken aback by this prediction; as he notes, the loss prevention feature of legal malpractice insurance is "akin to fire insurance purchased by fire safety manufacturers, whom we might not expect to seek loss prevention services."[30]

Professor Cohen's response to this difficulty is that "lawyers are not as expert in legal malpractice as many think they are."[31] That observation may well be true, but the more difficult question, on which Professor Cohen provides neither argument nor answer, is how (or even whether) attorneys can be persuaded that there are transactional cost advantages in looking to an insurer for loss prevention.[32] Indeed, one would expect that lawyers and firms will enthusiastically embrace the loss prevention suggestions of their insurers if Professor Cohen's transactional cost model has any predictive validity. In reality, firms and attorneys seem to view loss prevention

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27. *See* Cohen, *supra* note 4, at 338-39.

28. *See* Cohen, *supra* note 4, at 326-27.

29. *See generally* David Wilkins, *Who Should Regulate Lawyers?*, 105 HARV. L. REV. 799 (1992) (surveying possible regulators of legal conduct – and hardly noting insurers as a possibility).

30. *See* Cohen, *supra* note 4, at 327.

31. *See id.*

32. Loss prevention policies and procedures are already ubiquitous in most big firms, although there is considerable heterogeneity in the specific policies and procedures which are adopted. *See generally* Stephen R. Volk et al., *Law Firm Policies and Procedures in an Era of Increasing Responsibilities: Analysis of a Survey of Law Firms*, 48 BUS. LAW. 1567, 1568-81 (1993) (description of various policies and procedures employed by law firms, including restrictions on investments by firms, attorneys, and non-legal employees, directorships, new clients and matters, opinion and audit letters, audits, new lawyers, conflicts checks, and the like); DAVIS, RISK MANAGEMENT, *supra* note 9 (surveying risk management procedures); Fortune & O'Roark, *supra* note 9 (same).

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policies and procedures with considerable distaste: "Lawyers who are accustomed to billing by the hour bitterly resent any new procedure which 'wastes' billable time on apparently non-income-producing activities. They strongly fight the adoption of any such procedures as a result of that resentment."[33]

Attorney opposition to loss prevention is not based solely on the narrow issue of wasting billable time. For some lawyers, such policies and procedures abandon the cherished "one riot, one ranger" model of practice.[34] Others prefer to view the problem of legal malpractice as lawyer-specific, and not amenable to a systemic solution.[35] Indeed, resistance to such systems is sufficiently high that some firms do not implement such policies and procedures *even though liability has previously been imposed for failure to enforce such policies and procedures, or multi-million dollar claims arising out of such failures are pending against the firm.*[36] Such resistance strongly suggests that lawyers

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33. *See* Davis, *Kaye Scholer, supra* note 9, at 686.

34. Professor Fortney argues that this difficulty arises from a "confederation culture" at certain firms. *See* Fortney, *supra* note 23, at 340. ("In a confederation culture, each attorney practices independently as a 'master of his or her craft,' essentially functioning as an individual practitioner sharing offices with others. These attorneys perceive peer review as a threat to autonomy because they prefer to practice with little supervision or accountability."). *See also* Davis, *Kaye Scholer, supra* note 9, at 680 ("To the greatest extent feasible, every lawyer, or at least every partner, in these growing institutions continued jealously to guard his or her own individual independence from the control of the organization as a whole, and from the other partners individually. Therefore, the framework of firms comprising a collection of separate cottage industries was maintained. At the core of each practice group was a "rainmaker" responsible for that group's source of employment. Within this framework, individual lawyers sought to maintain the illusion of independence notwithstanding the largely institutional economic realities driving their activities. . . lawyers in firms of all sizes continued to prize and to protect their ability to control their individual professional lives. This maintenance of control was as true with respect to independence of judgment in lawyers' dealings with their clients, as it was in their dealings with their colleagues and their partners. Even within large firms, the practice remained essentially a series of little 'cottage industries' under a collective umbrella."); Robert E. O'Malley, *Preventing Legal Malpractice in Large Law Firms*, 20 U. TOL. L. REV. 325, 361 (1989) ("In many firms there is an overdone tradition of rugged individualism and a thoroughly undesirable 'each partner is a virtually autonomous' economic and sociological outlook."). Lawyers do not lose this outlook on life when they become judges. *See, e.g.*, Francis E. McGovern, *An Analysis of Mass Torts for Judges*, 73 TEX. L. REV. 1821, 1844 (1995).

35. *See* Davis, *Kaye Scholer, supra* note 9, at 686 ("The standard reaction is 'Don't bother me; I'm not your problem; go bother "Joe" down the hall—he had the last claim.'").

36. *See* Davis, *Kaye Scholer, supra* note 9, at 696 ("To me, the most extraordinary thing about the Kaye Scholer situation is that the firm had been in the same boat before.

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believe they are better at assessing liability risk than insurers are—or are willing to pay substantial malpractice premiums in order to maintain their preferred pattern of practice. Although the issue may simply be a transitional one, the near-uniform hostility of attorneys to loss prevention procedures significantly undercuts Professor Cohen's transactional cost model.[37]

When firms do invest in loss prevention, their efforts typically focus on the "bricks and mortar" of systems and procedures.[38] Although such systems and procedures can be tailored to address a variety of risk factors, it is difficult to monitor certain elements of legal practice. For example, lack of "attentiveness" may be a significant cause of malpractice, but the

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Kaye Scholer, as the successor counsel for O.P.M. Leasing Services, Inc., had intimate experience with the problems and issues which can arise when undertaking successor representation. And yet, despite all of the changes within the profession, the partners had apparently taken no effective steps to institutionalize the lessons of the earlier case. Having had the opportunity to benefit from hindsight, Kaye Scholer instead apparently failed to institute either meaningful central management of risk or thorough and effective new matter intake procedures."). *See also Pennsylvania Agency Sues Morgan Lewis Over Failed Insurers,* WALL ST. J., Feb. 28, 1997, at A3 (Pennsylvania insurance commissioner sues Morgan, Lewis & Bockius, accusing it of fraud, legal malpractice and civil racketeering for its role in the 1994 collapse of two insurance companies controlled by a former partner at the firm); Starkman, *supra* note 24, at B1 (Morgan, Lewis & Bockius continues to represent a handful of companies owned by its partners; "'You have to be able to have trust and confidence in your partners,' Mr. Meyers says, calling Mr. Stewart's alleged conduct 'aberrational and specific' to him."). *See also supra* note 32 (variable rate of adoption of loss prevention policies and procedures by large firms).

37. *See also* Davis, *Kaye Scholer, supra* note 9, at 697 ("enormous amount of denial still lingering in the air"). Although Mr. Davis' formulation implies that such denial will eventually be dissipated, the prevalence of the view that "lawyer knows best" undercuts that claim. *Cf.* Robert W. Hillman, *Law Firms and Their Partners: The Law and Ethics of Grabbing and Leaving,* 67 TEX. L. REV. 1, 59 (1988) (laws which regulate "taking" of clients when changing firms "ignored by many lawyers in their quest for better opportunities.").

But see Susan Saab Fortney, *Are Law Firm Partners Islands Unto Themselves? An Empirical Study of Law Firm Peer Review,* 10 GEO. J. LEGAL ETHICS 271, 309 (noting that "firms are, in fact engaging in some forms of peer review," although peer review still tends to focus on issues directly relating to firm finances; "successful implementation of peer review ultimately turns on attitudes and structures within law firms," and attorneys "who share an institutional perspective are more likely to implement peer review measures than attorneys who function as a confederation of individual practitioners.").

38. *See* Davis, *Kaye Scholer, supra* note 9, at 686; Leubsdorf, *supra* note 23, at 143 ("the measures that control malpractice are institutional measures such as data bases that track conflicts of interest, committees to screen new clients, computerized calendaring systems, proper accounting systems, supervisory arrangements, internal peer review of professional conduct, hiring and training procedures, and review of opinion letters.").

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nature of the conduct complicates preventative and remedial efforts.[39] Tailored loss prevention systems and procedures can indirectly address some forms of inattentiveness, such as that which results from the abuse of drugs and alcohol, or illness.[40] Unfortunately, such screening for inattentiveness is extremely underinclusive—and can also raise significant issues of unlawful discrimination. For obvious economic reasons, firms will also be reluctant to target what Professor Cohen believes is a potential cause of inattentiveness—excessive hours worked.[41]

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39. *See* Cohen, *supra* note 4, at 338-39. *See also* Manuel R. Ramos, *Legal and Law School Malpractice: Confessions of a Lawyer's Lawyer and Law Professor,* 57 OHIO ST. L.J. 863, 892-893 (1996) ("What types of mistakes created this huge economy based on legal malpractice? Usually they were fairly simple and administrative. Why did it happen? It was rarely because the lawyer was an idiot or grossly incompetent. It was usually due to obvious malignant situations: an associate who hurried and was unsupervised, a staff member who was inattentive, a lawyer who was swamped but could not say no to additional cases and potential revenue, or a lawyer who gave 'cocktail/curbstone' advice to someone a lawyer never thought was even a client.").

40. *See, e.g.,* O'Malley, *supra* note 34, at 360 ("Some firms require every lawyer to have an annual physical examination at the firm's expense. . . Similarly, a few firms have adopted a policy requiring every partner to prove or certify, or otherwise satisfy the firm, that the partner has timely filed federal and local income tax returns. The theory behind this requirement is that any partner who is having physical or mental or financial problems of such magnitude that he or she is disposed to neglect the duty of filing tax returns, will, at the moment of truth, not lie to or deceive the firm, but instead will seek help either within the firm or outside."); Fortney, *supra* note 23, at 346 ("Peer review also provides a mechanism for reexamining the competency of all attorneys on a continuing basis. . . Periodic peer review may empower firm management to detect and deal with senior partners who are incapacitated or incompetent.").

41. *See* Cohen, *supra* note 4, at 338 n.114. Although Professor Cohen's observation seems plausible, I am aware of no empirical evidence one way or another. If the relationship is even somewhat linear, it is truly ironic that one of the principal mechanisms by which associates win the tournament for partnership simultaneously increases the partnership's liability risk. *See generally* MARC GALANTER & THOMAS PALAY, A TOURNAMENT OF LAWYERS (1991); Manuel R. Ramos, *Legal Malpractice: The Profession's Dirty Little Secret,* 47 VAND. L. REV. 1657, 1719 (1994) ("Salary and partner status depend on the number of hours billed). *But see id.* (Rewarding high billable hours should reduce malpractice by encouraging attorney to "look under every rock.").

In the medical setting, public concern about the attentiveness issue led to restrictions in New York State on the number of hours that interns and residents could work consecutively and during a week. *See* N.Y. COMP. CODES R. & REGS. tit 10, § 405 (1998). Public attention was drawn to the issue after the death of a hospitalized 18 year old daughter of an attorney and writer for the New York Times, who was treated by an intern and resident in their eighteenth hour on call. *See generally* David A. Asch, M.D. & Ruth M. Parker, M.D., *The Libby Zion Case,* 318 NEW ENG. J. MED. 771 (1988); Timothy B. McCall, M.D., *The Impact of Long Working Hours on Resident Physicians,* 318 NEW ENG. J. MED. 775, 778

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Professor Cohen suggests that the performance of discretionary lawyering tasks can be monitored as well, although he concedes that such procedures will be difficult to design.[42] I think it unlikely that more than a handful of such procedures can be instituted, because of the attendant cost and controversy.[43] It is one thing to make sure a committee evaluates once-a-year audit letters and that conflicts checks are run through a database.[44] It is quite another for partners to review one another on a "real-time basis," by evaluating the structure of each financing vehicle, the opinion letters for each securities offering and bond issue, the due diligence conducted during each acquisition, the arguments presented in each brief, the reasons why alternative arguments were not presented and the like.[45] Even were the costs of such monitoring modest (which they are not), those being reviewed are unlikely to take it well.[46] Prospective monitoring of such conduct is time-consuming and exceedingly expensive; retrospective monitoring is likely to fall by the wayside when new (and billable) work awaits attention.[47] Ongoing peer review is difficult enough for lawyers to

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(1988) ("House officers are overworked, sleep-deprived and unduly stressed. The result is damage to their well being, to medical education, to patient care, and to the entire profession."). Similar concerns explain the longstanding restrictions on the number of consecutive hours that pilots and flight attendants on commercial carriers can work.

42. *See* Cohen, *supra* note 4, at 339.

43. *See* Davis, *Kaye Scholer, supra* note 9, at 691 (Subject of peer review of partners "arouses fear and loathing in many lawyers and many firms."). *See also* ALAS Loss Prevention Manual, Tab IIIG, 7 ("few subjects that a law firm's management deals with are likely to generate as much controversy as 'partner peer review.'"); Fortney, *supra* note 23, at 361-63 (rise and fall of bar initiatives promoting peer review).

44. *See supra* note 32. Of course, even computerized conflict checks are not perfect. Consider the effort required to keep track of the array of subsidiaries and names under which clients conduct business, the growth of law firms and branch offices, and the increasing mobility of attorneys. *Cf.* Murray Chass, *Conflict Deals Blow to Steinbrenner's Suit Against Baseball,* N.Y. TIMES, May 13, 1997 at D23 (Cravath, Swaine & Moore discovers that suing the Atlanta Braves on behalf of George Steinbrenner and Adidas can create difficulties when firm simultaneously represents Time Warner, the parent company of the Braves; managing partner describes the conflict as an "oversight.").

45. *But see* Fortney, *supra* note 23, at 365 (firm can institute "cold review" procedures for sanctions motions and securities offerings; firms can develop procedures for ensuring due diligence in securities offerings and checklists for filing and answering pleadings). At least two firms (White & Case and Kaye, Scholer) were required to adopt certain forms of peer review after government enforcement proceedings. *See id.* at 371.

46. *See supra* note 43. *See also* Fortney, *supra* note 23, at 364, n.174 ("attorneys in confederation firms enjoy a sense of independence and lack of accountability because each lawyer is viewed as a master of his or her craft"). Attorneys practicing in such a culture will be exceedingly reluctant to allow their partners to second-guess their mastery of their craft.

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accept under the best of circumstances.[48] It is likely to be impossible when even the organized bar is unwilling to back it.[49]

Associates can and do assist in monitoring discretionary conduct by partners, but the difficulties which result from this approach to loss prevention can not be overestimated.[50] If associates perceive that "whistle-blowing" effectively ends their career with a firm, they will be understandably reluctant to do so, even in the most egregious of cases.[51] These difficulties are magnified if the firm lacks a well-defined system to encourage such disclosure.[52] Thus, it is exceedingly difficult and costly to

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47. *Cf.* Fortney, *supra* note 37, at 295, n.133 ("As explained by one respondent, 'Good attorneys have barely got time to properly care for their own clients. . . The idea of routinely double-checking a competent attorney's work is stupid, cost-prohibitive and only effective as an appearance activity.'").

48. *See* Fortney, *supra* note 23, at 363, n.165 ("Predictably, a sentiment shared at the Williamsburg Conference suggested that peer review may work for other professionals, but law is an 'art not a science.' . . . This sentiment was articulated by one conference participant who cautioned against comparing the legal profession to other professions that have peer review. As stated, '[a]ccounting, medicine, engineering are much more sciences. . . . It will be infinitely more difficult for us to develop standards because we're more of an art than a science.'")

49. *See* Fortney, *supra* note 23, at 361-63.

50. *See generally* Leonard Gross, *Ethical Problems of Law Firm Associates*, 26 WM. & MARY L. REV. 259, 297-307 (1985); L. Harold Levinson, *Ethics Inside the Law Firm*, 36 VAND. L. REV. 847 (1983); Milton R. Wessel, *Institutional Responsibility: Professionalism and Ethics*, 60 NEB. L. REV. 504 (1981); Christie Newman Barrett, *Ethical Concerns for the New Associate*, FOR THE DEF., Jan. 1995, at 26.

51. *See* Deborah L. Rhode, *Institutionalizing Ethics,* 44 CASE W. RES. L. REV. 665, 702 (1994) ("Individuals working within organizations generally find little to gain and much to lose from exposing misconduct. Harassment, isolation, blacklisting, dismissals, and denials of promotion are common consequences.").

52. *See, e.g.,* Ted Schneyer, *Professional Discipline for Law Firms?*, 77 CORNELL L. REV. 1, 2 (1992) ("During the pretrial phase of a major antitrust suit against Kodak, the company's lawyer, a senior partner at Donovan, Leisure, Newton & Irvine, lied to opposing counsel and the judge when he told them that documents sought in discovery no longer existed. Though an associate who worked closely with the partner allegedly reminded him that the documents were still at the firm, the partner did not correct his previous statement. The associate kept the partner's lie to himself, but it later came disastrously to light. The law firm had no ethics committee to which the associate could have referred the problem."). Professor Schneyer is referring to Berkey Photo Inc. v. Eastman Kodak Co., 603 F.2d 263, 305-8 (2d Cir. 1979).

Firms have attempted to develop an in-house ethics capability, but encouraging associate whistle-blowing does not appear to be one of the goals of such initiatives, and the same structural and psychological features which make lawyers reluctant to accept loss prevention suggestions from insurers dog the in-house ethicist. *See* David Margolick, *What Price Ethics? $41 Million Settlement Has Lawyers Asking a Lot More Questions*, N.Y.

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design loss prevention systems and procedures for the discretionary aspects of lawyering.[53]

Even if a firm invests in loss prevention the memorialization of a "durable precaution" in an official firm manual of practices and procedures does not ensure the uniform enforcement of the same. Consider one telling example from a prominent consultant in the area of risk management for law firms:

> There are two elements for determining which practice management procedures are actually in place within a firm, and they are often in conflict. First is what the firm's management thinks is in place—based on policy manuals and procedures, firm 'culture,' specific directives, and so on. Second, and often quite distinct, is what the people actually practicing law within the firm actually do on a day-to-day basis.
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> To give the simplest of examples, the other day I was talking to the managing partner of the firm about the policy of maintaining and reviewing a complete chronological file of all correspondence leaving the firm

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TIMES, Mar. 13, 1992, at B16 (Size of firm, number of transactions, depth of adversarial culture, level of seniority of ethicist, and evolving standards of lawyer conduct make it difficult for in-house ethicist to know of more than "an infinitesimal fraction of the firm's activities"; Professor Gillers suggests that firms have not embraced in-house ethicists because of arrogance, self-deception, complacency, and distraction.).

Of course, even if a firm has a mechanism for encouraging disclosure it must still have a demonstrated commitment to getting to the bottom of matters once an associate comes forward. *See, e.g.*, Robert W. Gordon, *Lawyers, Scholars, and the "Middle Ground,"* 91 MICH. L. REV. 2075, 2110 (1993) ("We can advise the student about to become a law firm associate that, if a partner tells her to destroy a document, she should go up the hierarchy and consult the respected senior partner. But suppose the senior partner backs up the junior? The associate can refuse of course, at the risk of being fired, or quit. But what signal will these actions send to the other associates? Why, that sticking to your principles is naive and will do you in.").

53. To the extent liability exposure is weighted more toward ministerial issues than discretionary issues, this problem is not fatal—but at least one study of malpractice claims demonstrates that a substantial percentage of malpractice claims involve the more discretionary aspects of lawyering. *See, e.g., 1996 ABA-NABRICO National Legal Malpractice Data Study,* Table 5 (administrative errors accounted for 27% of alleged errors; substantive errors (*e.g.*, failure to know/apply law, planning errors, inadequate discovery) accounted for 40% of alleged errors)). *See also* O'Malley, *supra* note 24, at 285-86 ("the typical garden variety type of legal malpractice is not the problem—the stupid mistake. . . there is still some of this, but not too much of that in the relatively large law firms.").

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> on firm notepaper. While there are excellent reasons for such a system—including review of firm work product, accountability, and maintaining backup copies of materials these policies can only be met if the procedures are followed. The managing partner in question noted that a recent check had belatedly revealed that only half of the firm's professionals were actually contributing to the chronological file. In itself, this was not surprising. However, what was startling was the reason. Apparently, those whose secretaries had been with the firm since the policy was established four years earlier, were all religiously following the system. But almost all of those whose secretaries were hired subsequently were not contributing to the file because no one had ever told them of the procedure! This is not, in the scale of things, a weighty defalcation, but it illustrates neatly the problem of bifurcating theory and practice, even where there is an effort being made to practice good risk management.[54]

A more chilling example is provided by the Chair of the American Bar Association Standing Committee on Professionalism:

> A friend who is involved in the management of his firm recently told me that he had asked his partners for permission to check the firm's litigation docket control system. Their answer was predictable: "There's no need—our system is the most modern, up-to-date computerized system available. But," they said, "if you want to waste time and amuse yourself, go ahead." He discovered that fewer than 50 percent of all the thousands of litigated matters in the firm fully complied with the firm's docket control system. And in over a third, the only docket record was in the file and in the heads of the lawyer managing the case and her secretary![55]

Thus, a firm can easily invest considerable resources in creating such systems and procedures, but the result can be a Potemkin village of loss prevention: lovely in theory, and providing regular employment for

54. Davis, *Kaye Scholer, supra* note 9, at 685-86.

55. Seth Rosner, Prologue in DAVIS, RISK MANAGEMENT, *supra* note 9, at xiv.

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administrative personnel and the firm's ethics committee, but essentially irrelevant in practice.[56] The likelihood of these problems is worsened if practice areas or partners operate independently;[57] if the firm is geographically dispersed;[58] or if the firm does not have an iron-clad policy of enforcing the system or procedures against all partners—including the most senior.[59] Indeed, by several accounts, it is the most senior partners—against whom such precautions are ironically least likely to be enforced—who are most likely to get a firm in serious trouble.[60]

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56. *See* Davis, *Kaye Scholer, supra* note 9, at 686 ("having a beautifully crafted policy manual is meaningless if it is ignored by those who, by observing those policies, would insure the firm's well being"). *See also* Volk et al., *supra* note 32, at 1567 ("there is a great difference between policy-making and getting anyone to pay attention to the policy. Indeed, one must question whether there is any true policy decision in a sophisticated organization if there is not a plan to implement it."). Of course, additional difficulties are created by complacency about the risk of liability, message saturation, and outright ignorance. *See* O'Malley, *supra* note 24, at 286 ("It is a national scandal the extent to which partners in law firms over the age of 45 years old do not know, do not care what the ethics rules are and have never read or even considered reading the Code of Professional Responsibility. . . or the new form of the Model Rules of Professional Conduct.").

57. *See* Davis, *Kaye Scholer, supra* note 9 at 683 ("the firm's management must have sufficient authority to control the practice of each member of the firm without exception and regardless of seniority."); O'Malley, *supra* note 24, at 286 ("the large firm problem is one of institutional disarray and disorganization."); O'Malley, *supra* note 34, at 361 ("The foregoing discussion leads to the conclusion that large law firms need to know more about what their partners are doing, and need to exercise greater control over their partners' activities. The beginning point in responding to these needs is improvement in the internal management of large law firms.").

58. *See* O'Malley, *supra* note 24, at 287 ("The malpractice problems arising out of branch offices [and] mergers are far out of proportion to what they should be based on just the number of people that are involved in these things."); O'Malley, *supra* note 34, at 359 ("There is an obvious pattern of claims arising out of (a) inadequate control of branch offices, especially when there is considerable distance between the main office and the branch; (b) too much economic pressure on branch offices from the main office, causing too many low quality clients . . . .").

59. *See* Davis, *Kaye Scholer, supra* note 9, at 687 (procedures must apply "within the entire firm. In other words, no one is above the law. No matter how senior or venerated, or how large the billings of a partner or practice group, everyone is subject to the same procedures. . . . Unless the risk management system can accommodate that requirement, it is, by definition, inadequate and likely to fail in the very situations most dangerous to the firm.").

60. *See, e.g.*, Davis, *Kaye Scholer, supra* note 9, at 693 ("The fundamental failure [in *Kaye Scholer*] from which all the other failures flowed like a row of falling dominoes - was the failure of the firm to have in place independent management capable of enforcing 'the Rule of Law' over even its most prestigious, powerful and profitable partner. The Kaye Scholer case is the paradigm of the consequences to a firm for failing to manage its practice,

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Even if a firm has extensive systems and procedures in place, there will still be losses—a point neatly illustrated by the "case of the terrible typo."[61] In this famous case which Professor Cohen briefly alludes to, a typographical error resulted in the omission of "000" from a line in a mortgage document.[62] Although the mortgage was intended to provide Prudential Insurance Company with a security interest totalling approximately $93,000,000, the omission of "000" appeared to cap Prudential's claim at $93,000. After lengthy litigation, Prudential ultimately prevailed—and then brought malpractice claims against the three law firms involved in the transaction.[63]

As it turned out, the original omission was made by a secretary at one of the three firms. The error was ultimately replicated into approximately one hundred documents.[64] Based on the size of the transaction, it is likely that dozens of lawyers and several different proofreaders reviewed the documents in question—and all missed the repeated omission.[65] The most interesting element of the case is that the mistake was not unique to this one high-profile transaction; Prudential presented evidence of sixty other cases involving "typographical and other clerical mistakes made by

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at least as far as its most powerful member was concerned."); O'Malley, *supra* note 24, at 287 ("[P]artners are the problem. Not associates, not paralegals, not secretaries. In general, the people that are really fouling up badly are partners. I don't know of a single major claim of the 300 that I know about - by major claims I mean 300 claims that I've analyzed that are $1 million or more - in which an associate or a relatively inexperienced lawyer or for that matter even a relatively young partner was the problem. All of these various difficulties that I've summarized which lead in some way or another to liability - these problems are basically the senior partners of the law firms in question."). *But see* Manuel R. Ramos, *Legal Malpractice: No Lawyer or Client is Safe,* 47 FLA. L. REV. 1 (1995) (malpractice committed at same rate by attorneys with all levels of experience).

61. David Margolick, *How Three Missing Zeros Bought Red Faces and Cost Millions of Dollars,* N.Y. TIMES, Oct. 4, 1991, at B16.

62. *See id.;* Cohen, *supra* note 4, at 315 n.41.

63. *See* Margolick, *supra* note 61, at B16. Prudential estimated it cost them approximately $31,000,000 (between the amounts paid in settlement, attorneys fees, and costs)—or a third of the legal interest they had originally attempted to secure to resolve the matter. *Id.* Prudential's claims against Dewey, Ballantine and Haight, Gardner were settled, and the suit against Gilmartin, Poster was resolved on summary judgment. *Id.*; *see also* Gary Spencer, *Potential Liability Of Lawyers Widened; No Breach by Firm in Case of Missing Zeros,* N.Y. L.J. Nov. 20, 1992, at 1.

64. *See* Margolick, *supra* note 61, at B16.

65. *See* James Nolan, *USL Wins A Skirmish in Battle Over $93 Million Decimal Point,* J. COMM., July 31, 1987, at 1A (mistake overlooked by numerous supposedly crackerjack lawyers at several New York law firms).

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lawyers and banks."[66] If errors like these can occur when firms have already invested in proofreaders and teams of attorneys who check one another's work, one can only wonder about their incidence in less exalted circles of legal practice—and the extent to which additional loss prevention efforts will be cost-effective.[67]

If the standard of care is in flux, it becomes particularly difficult to decide how to allocate one's resources among the universe of loss prevention. In recent years, the incidence of legal malpractice claims and litigation has exploded.[68] Many of the biggest claims have arisen in areas of professional liability which were not recognized five years ago.[69] These trends make it difficult for firms and insurers to predict the optimal allocation of their loss prevention resources. Faced with this uncertainty, only firms with considerable resolve will devote substantial effort to loss prevention. After all, the payoff from such effort is both speculative and contingent, and immediately billable work beckons.

Although insurers will clearly play a role in regulating lawyers, four factors suggest it will not be a dominant (or even particularly significant) role. First, many lawyers do not purchase legal malpractice insurance. Although estimates vary somewhat, the conventional wisdom is that

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66. *See id.*

67. Macey & Miller, *Regulatory State, supra* note 7, at 1109 ("the prestigious law firm is able to monitor its young associates more effectively than smaller firms. Consequently, clients will value greatly the willingness of law firms to monitor their partners and associates. It is commonplace for small firm lawyers to complain about larger rivals chronically overstaffing cases by routinely assigning what appear to be a surfeit of partners and associates to handle cases. It is difficult to explain this practice as a simple matter of lawyer overbilling, because the practice is so easy for clients to detect, and because if large law firms truly had sufficient market power to overbill they could just do it. A better explanation may be that such "overstaffing" actually serves as an effective mechanism by which large firms can protect their clients and their own reputations by enabling their lawyers to monitor the work of their colleagues.").

68. *See* Ramos, *supra* note 41, at 1661 ("Since 1970, there has been an unprecedented growth in legal malpractice claims and lawsuits;" trends are just the tip of the malpractice iceberg.).

69. *See* Davis, *Kaye Scholer, supra* note 9, at 683-684 (list of principal classes and categories of risk "is probably not comprehensive, because new risks arising out of the practice of law are demonstrated with all too great a frequency"); O'Malley, *supra* note 24, at 283 ("[I]f I or anybody had talked to a group on the subject of legal malpractice or how lawyers get in trouble ten years ago, none of the points that are most important today would have been mentioned, probably not even five years ago...."); Ronald E. Mallen, *Duty to Nonclients: Exploring the Boundaries,* 37 S. TEX. L. REV. 1147 (1996) (reviewing growth of third party liability).

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between 25% - 55% of lawyers have chosen to "go bare."[70] These averages mask a distinct distributional skew: lawyers in solo practice and small firms are overwhelmingly uninsured.[71] Although reformers have frequently proposed that state bars should mandate the purchase of malpractice insurance, only Oregon has succeeded in imposing this requirement.[72]

In the absence of near-universal market insurance, it is hard to see how insurers can have a major impact on professional conduct. It is possible that malpractice insurance could have an effect on those who are uninsured, by setting a *de facto* standard of care for certain forms of conduct. However, this effect is likely to be considerably attenuated, since willingness to "go bare" clearly indicates a prior lack of concern about liability exposure—or an accurate assessment of the prospect of suit in the absence of insurance.[73]

Second, although the existence of firms may drive some of the demand for market insurance, this effect is likely to predominate among larger firms—especially those which are geographically dispersed. Forty five percent of lawyers in private practice are on their own, and 55% are in firms.[74] Of those who are in firms, 27% practice in firms of 2-5 lawyers;

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70. *See* Rhode, *supra* note 51, at 698, n.121 (collecting authority); Manuel R. Ramos, *Legal Malpractice: Reforming Lawyers and Law Professors,* 70 TUL. L. REV. 2583, 2587, n. 12 -13 (1996) (same; according to official records, 55% of lawyers in private practice in California are uninsured).

71. *See* Joseph Calve, *The Naked Truth About Going Bare,* TEX. LAW., Nov. 27, 1995, at 1, 15 ("[L]ooking at just solos and small-firm lawyers, the estimates [of lawyers without malpractice insurance] jump to 60 percent to 90 percent."); Roger C. Cramton, *Delivery of Legal Services to Ordinary Americans,* 44 CASE W. RES. L. REV. 531, 549-50 (1994) ("A significant number of lawyers, especially those struggling to make a living in handling small matters for individual clients, have neither malpractice coverage nor substantial personal assets that could be called upon to satisfy a malpractice judgment."); Ramos, *supra* note 70, at 2612-13 ("Even $2100 in annual premiums is too much for the average solo practitioner to pay. . . .").

72. *See* OR. REV. STAT § 9.080(2)(a) (1993).

73. *See* Ramos, *supra* note 70, at 2613 ("[S]olo practitioners, earning only $35,730 a year, who are probably supporting families, living from receivable to receivable, knowing enough about creditor and bankruptcy laws to shelter assets, quickly recognize that for the same reason that they would not sue an uninsured motorist, plaintiffs' legal malpractice lawyers will not sue them if they are uninsured."). The most positive spin one can put on these observations is that the lawyer is self-insuring because the risk of suit is sufficiently modest that market insurance is not cost-effective. *See infra* note 78.

74. *See* BARBARA A. CURRAN & CLARA N. CARSON, THE LAWYER STATISTICAL REPORT: THE U.S. LEGAL PROFESSION IN THE 1990S 7 (1994). Curran & Carson determined there are 805,872 lawyers in the United States, of which 587,289 (72%) were private practitioners. There is some indication that Curran & Carson's figures, which are based on Martindale-

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26% practice in firms of 6-20 lawyers; 24% practice in firms of 21-100 lawyers; and 23% practice in firms of 101 or more lawyers.[75] Expressed in terms of lawyers in private practice, 87% practice on their own or in firms of 100 or smaller, 74% of lawyers are on their own or in firms with 20 or fewer lawyers, and 60% are on their own or in firms with 5 or fewer lawyers.[76] In addition, 89% of firms maintain only one office, and 63% of firms had no associates.[77] Thus, the demographics of legal practice in the United States are overwhelmingly weighted toward solo and small firm one-office practice. As such, only a small section of the legal marketplace is likely to value market insurance for the reasons identified by Professor Cohen—an observation which explains the limited penetration of market insurance outside the big-firm setting.[78]

Third, since insurers care only about liability, they will focus on the subset of issues that give rise to such difficulties, rather than the more general field of attorney conduct—and their attention will be disproportionately directed at areas which give rise to substantial exposure. Obviously, this focus is not exhaustive of the field of professional misconduct. Indeed, some loss prevention efforts can ironically undercut the dictates of professional responsibility.[79]

Hubbell listings, undercount the number of solo practitioners. Ramos, *supra* note 70, at 2612, n.141.

75. *See* CURRAN & CARSON, *supra* note 74, at 8.

76. *See id.* at 16.

77. *See id.* at 19-20.

78. *See supra* note 71. Alternatively, the liability exposure associated with big-firm practice may simply dwarf that of small-firm and solo practice—meaning that small firms and solo practitioners are rationally deciding they do not need the risk diversification provided by market insurance.

79. For example, Model Rule of Professional Conduct 1.6(b)(1) authorizes but does not require disclosure to "prevent a client from committing a criminal act that the lawyer believes is likely to result in imminent death or substantial bodily harm." Although it is fairly implausible that a jury would award damages for such a breach of confidence, even a claim results in expense and inconvenience. An insurance company is likely to weigh the scales more conservatively than an individual lawyer, and might even decide to exclude coverage, to combat what could be termed the moral hazard faced by the insured—although the net result is likely to be an increase in the mortal hazard faced by third parties.

A less extreme example is the trend toward excluding coverage of malpractice claims which are brought as counterclaims to a fee suit initiated by the lawyer. *See* Davis, *Liability Insurers, supra* note 9, at 219-220. There is no ethical prohibition on bringing a suit for an unpaid fee, but exclusion of malpractice coverage will probably dramatically decrease the incidence of such suits.

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Fourth, insurers lack the market power to mandate the adoption of loss prevention measures.[80] Even if they could condition insurability on the adoption of such policies and procedures, insurers will find it difficult to monitor whether firms are only engaging in "paper" compliance.[81] Insurers can respond to this problem by limiting or excluding coverage, but the insured always retains the right not to purchase the policy—and the large number of attorneys who have chosen to "go bare" makes clear that malpractice coverage is important but not vital. Even outright exclusion of coverage only shifts the risk to self-insurance.[82]

If Professor Cohen is accurate in his prediction that malpractice insurance will become a major regulator of lawyer conduct, additional difficulty may result from "redlining" of certain areas of malpractice coverage by mutual insurers. Mutual insurers are controlled by the insured firms. If established firms determine that certain transactions are "too risky" for them to undertake, but are unwilling to allow upstart firms to reap the profits (and business contacts) resulting from such representation, what better way to accomplish these objectives than to have the mutual insurer exclude coverage?[83] There is certainly some evidence of historical

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80. *See, e.g.,* Ramos, *supra* note 70, at 2611 (legal malpractice insurance market is soft); Davis, *Liability Insurers*, *supra* note 9, at 220 ("with the exception of relatively short periods in the 1980s, the market for lawyers' professional liability insurance has been 'soft.'").

81. *See, e.g., supra* notes 54-55, where firms engaged in "paper compliance" with systems they adopted voluntarily. If this was the best that could be done with systems which the firm's senior partners genuinely believed were being complied with, imagine the range of options for circumvention when the system is forced down the throat of a reluctant firm by a malpractice insurer. *See also* Leubsdorf, *supra* note 23, at 143 ("Considering the propensity of lawyers to act independently and to bend rules, it is also important to ensure that measures, once instituted, will receive more than lip service.").

82. It is also possible that a risk may be excluded because it is covered by a different policy. *See* Silver, note 9, *supra*, at 234-41.

83. Stated less pejoratively, if a firm is unwilling to participate in a particular kind of transaction because of the risk of liability, it is unlikely to be enthusiastic about sharing that risk indirectly in its guise as mutual insurer. Regardless of how one formulates the motivation, it is clear that it is of considerable significance in a competitive market. *See* Anita Raghavan & Jacob M. Schlesinger, *Wall Street Concocts New Tax-Saving Ploy; Then It's Feds' Turn*, WALL ST. J., Nov. 6, 1997, at A1 (Bear Stearns, longtime "middle-of-the-pack" player in corporate finance develops and aggressively promotes innovative tax-savings transaction, but Treasury Department ultimately prohibits such deals after complaints from competitors; "competitors have a vested interest in seeing the government crack down on rivals' tax-advantaged deals – and they snitch. . . *Bear Stearns was especially vulnerable because it used such deals to pry clients away from competitors.*") (emphasis added).

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precedent for such conduct.[84] The risks of such behavior are elevated considerably if Professor Cohen is also correct in his prediction that mutual insurers will come to dominate the professional liability market.[85] Professor Cohen alludes to this issue in the closing pages of his article, but he takes the optimistic view that the refusal of the insurer to provide coverage will be a shield for the firm against the client, rather than a sword wielded by firms against one another.[86]

Finally, Professor Cohen suggests self-help as a loss prevention strategy.[87] Many of the tactics he describes are entirely beneficial, such as improved systems for checking conflicts and calendaring. However, his abbreviated discussion gives no hint of the implications of the simple suggestion that lawyers should "just say no" to high-risk clients.[88] To be fair, new business intake is a dangerous proposition—especially if individual partners are free to make their own decisions about such matters.[89] Not surprisingly, risk management experts emphasize that

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84. *See, e.g.*, Hartford Fire Ins. Co. v. California, 509 U.S. 764 (1993) (commercial insurers who did not want to offer certain forms of coverage, but were unable to persuade their competitors to eliminate such coverage, successfully pressured reinsurers to refuse to accept such risks).

85. *See* Cohen, *supra* note 4, at 339-40, 348. Professor Cohen predicts that mutual insurers will dominate the professional liability insurance market because their in-house expertise will allow them to offer a higher quality product at lower cost. However, some anecdotal evidence indicates that it is the mechanism of compensating defense counsel and the effectiveness of claims handling, rather than the organizational form of the insurer, that affects the efficacy of loss reduction. *See* Ramos, *supra* note 70, at 2605-07 (flat fee arrangements with defense counsel and effective claims handling procedure can dramatically decrease loading costs and speed resolution of cases). In addition, it is not so clear that the typical "make or buy" decision faced by insurers is quite so heavily weighted in favor of "make"—especially in light of the number of risk management consultants that are available for hire. *But see* Fortune & O'Roark, *supra* note 9, at 634 ("[B]ar-related companies are leading the way in loss prevention. . . . Prominent reinsurers have concluded that bar-related companies are the most effective way to underwrite malpractice insurance. They like the emphasis on one line of insurance, the depth of the underwriter's knowledge of the bar, and the innovative loss prevention programs provided by bar-related companies.").

86. *See* Cohen, *supra* note 4, at 349. This argument is somewhat of a departure for someone with an economic bent, since the standard economic model of professional ethics rules is that they are designed to protect the prerogatives of the enfranchised profession. *See infra* note 190.

87. *See* Cohen, *supra* note 4, at 338-39.

88. *See id.* at 315.

89. *See, e.g.*, O'Malley, *supra* note 24, at 284 ("in the large law firms by far the most serious problem is their new client selection process and their inadequate analysis of prospective new clients and their tendency to take anybody who comes in the door as long

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allowing individual partners to unilaterally accept new clients and matters is a path fraught with peril.[90]

Unfortunately, the standard remedy for a firm which is uneasy about a prospective client—refusal to deal—will in all likelihood only shift the liability risk from one firm to another.[91] From the perspective of the firm which declined to represent the prospective client this result is a gain, but the net effect is likely to be a wash from the societal perspective.[92] In some instances, refusal to deal could paradoxically increase the global risk of

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as the prospective new client evidently can pay the fee. . . The fundamental flaw in many of the large law firms is that they continue to follow the traditional rule that each individual partner is authorized to commit the firm to a new client without consulting anybody else in the firm if that partner believes that no consultation is necessary. And this has been disastrous in too many cases."); O'Malley, *supra* note 34, at 346-47 ("The new client/new matter intake process is by far the most serious flaw in most large law firms. . . . Some of the worst claims in the history of the legal profession are directly attributable to the bad judgment of an individual partner in accepting a new client.").

This difficulty is yet another variant of the principal-agent problem; the individual partner captures much of the gain if the client is accepted, and bears only a portion of the losses if things turn out poorly. The increased mobility of lawyers might even allow a partner to impose much of the costs of such conduct on a firm he has left, if his timing is good. *See, e.g.*, Mark Hansen, *Playing Against Hype: Computer Giant Claims Allegations in Pretrial Press Release are Libelous, Sues Plaintiff and Counsel*, 83 AM. BAR ASSOC. J. 36 (1997); Alan Cohen, *Bar Talk*, AM. LAW., Dec. 1996, at 13; Alan Cohen, *Hardball: It's Not Nice to Fool With Hewlett-Packard*, INFO L. ALERT, Sept. 27, 1996, at 15 (Plaintiff's counsel issued press release which defendant believed was libelous; Plaintiff's firm sued by defendant; partner responsible for case left firm after press release was issued but before suit was filed; former partner says he wouldn't do anything differently if given chance to water down press release, but chair of firm's executive committee "says he would prefer that nobody at the firm discuss pending litigation in the press."). Of course, the partner who left remains liable for obligations which arise from the partnership. UNIF. PARTNERSHIP ACT, § 36 (1914).

Interestingly, partner mobility can also result in opportunistic behavior in the opposite direction. Under some circumstances, plaintiffs can effectively "stack" the malpractice coverage at both old and new firms, even if the partner changed firms before the malpractice was committed. *See, e.g.*, Hillman, *supra* note 37, at 50-58.

90. *See* Davis, *Kaye Scholer*, *supra* note 9, at 693-94 ("But if Kaye Scholer had in place a central management with the accepted authority to review Mr. Fishbein's decisions at the intake level. . . the firm might have fared better"); O'Malley, *supra* note 34, at 347 (individual partners should not be allowed to accept new clients and new matters).

91. A firm can take steps short of an outright refusal to deal, such as limiting the scope of its representation. *See, e.g.*, Davis, *Kaye Scholer*, *supra* note 9, at 690.

92. Professor Cohen briefly addresses this problem in the rather different context of discussing why loss prevention by the insurance company (in engaging in underwriting to determine which lawyers to cover) might not result in loss prevention to society. *See* Cohen, *supra* note 4, at 327. His observations apply with equal force to individual clients.

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liability, since it is precisely such "marginal" clients and transactions which are most in need of high quality representation and counseling if the circumstances giving rise to liability are to be prevented.[93]

"Just say no" is also unhelpful because its distributional consequences are insensitive to the reasons why a client appears "marginal." The easiest case is when the client is using the lawyer to further a criminal scheme of one sort or another—but one should worry about a lawyer that needs to be told to avoid such clients.[94] More difficult problems are raised when the client is risky because he or she is promoting something innovative. Tried and true is certainly less risky, but Silicon Valley would be a ghost town—and much of the world would be at a subsistence level—if lawyers refused to represent start-up clients with innovative products.[95] Finally, those who have sued for malpractice previously or are seeking a lawyer to proceed with such a suit are likely to find it exceedingly difficult to obtain representation—hardly an optimal result from a system-wide perspective.

More generally, the incentives created by a focus on loss prevention results in vendors demanding a risk premium, refusing to deal with

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93. This point is nicely made in Charles Bosk's seminal book on surgical training and the recognition of error. CHARLES BOSK, FORGIVE AND REMEMBER (1979). The attending surgeons have just decided that a resident (Carter) should be dismissed from the program. In a remarkably insightful passage, Bosk notes "there is an irony in Carter's banishment from the medical elite. He was excluded for his inability to meet the expectations superordinates had for trustworthy subordinates. He had failed to properly internalize the norms of the doctor role while displaying great technical talent. *Demoting Carter to a training program where the attendings were less professionally imposing than those of Pacific made it even less likely that Carter would accept superordinate authority and hence less likely he would internalize these norms.* In addition, it was likely that his considerable technical talents would not develop to their fullest because of restricted clinical exposure. The attendings hoped that, all else having failed, Carter would learn a lesson from his exile from the elite. Given the available options, the punishment fit the crime; *however, it was the one most likely to perpetuate it.*" *Id.* at 163 (emphasis added).

But see Robert A. Kagan & Robert Eli Rosen, *On The Social Significance of Large Law Firm Practice*, 37 STAN. L. REV. 399, 421-22 (1985) ("Lawyer's work on disclosure statements rarely involves fundamental issues of preventing fraud. Their job is to draft opaque language that will help parry possible future lawsuits by sophisticated securities traders who discern the possibility of recouping losses through lawsuits alleging deception, inside trading and the like.")

94. *See also infra* note 99, for equally helpful advice on selecting clients.

95. *See, e.g.*, O'Malley, *supra* note 34, at 329 ("Because of the relatively high risk of a business failure, and the correspondingly high risk that the law firm will be sued, some firms, as a matter of policy, decline to act as counsel to the issuer in any securities offering where all three of the following high-risk factors are present: (a) a new client; (b) a start-up enterprise; and (c) the start-up enterprise is financing itself by means of an initial public offering.").

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purchasers who are unduly risky, or in the limiting case, market exit. Such self-help is wholly predictable, but likely to be controversial in the case of professional services. Consider a narrowly focused refusal to deal which may strike close to home. Since lawyers are widely perceived to be litigious, if a physician refused to provide medical services to a lawyer (or a lawyer's family member) in need, would that simply constitute an acceptable form of personal risk reduction?[96] What about the refusal to provide medical services to a woman in labor with high blood pressure and no prenatal care, simply because the physician did not want to assume the risk of a bad outcome?[97] Few lawyers would view these responses as salutary, but the logic of loss prevention leads inevitably in that direction.

In a voluntary market, the refusal of "reputable" firms to represent a client serves a useful signalling function.[98] Knowledgeable parties recognize the significance of the firms which are involved, and either refuse to participate or demand a risk premium. So long as the identity of the involved firm is disclosed, the terms of the transaction presumably reflect the potential hazards, and it would be inappropriate to impose liability *ex post*. Of course, unsophisticated third parties might have no knowledge as to the significance of the firms which were (and were not) involved, so the signalling function would not work perfectly—but brokers and other agents could serve their usual role in helping sort out this problem.

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96. *See* Hiser v. Randolph, 617 P.2d 774 (Ariz. 1980) (physician refused to treat semi-comatose patient with brittle diabetes; some evidence that refusal to treat was because patient's husband was a lawyer).

97. *See, e.g.*, Burditt v. United States Dep't of Health and Human Servs., 934 F.2d 1362, 1367 (5th Cir. 1991) ($20,000 fine upheld for violation of Emergency Medical Treatment and Active Labor Act (42 U.S.C. § 1395dd (1997)); doctor refused to provide care for woman in labor, commenting until "DeTar Hospital pays my malpractice insurance, I will pick and choose those patients I want to treat.")

98. This point is readily demonstrated by conduct at both ends of the spectrum. *See, e.g.*, Fortney, *supra* note 23, at 347 ("In the legal marketplace a prospective client's decision to retain a firm typically rests on the firm's reputation. For example, an issuer of securities may retain the services of a prestigious law firm so that the firm's national reputation is associated with the offering. Similarly, clients may pay higher fees for a tax opinion that bears the name of a reputable firm which presumably has quality controls."); Floyd Norris, *Psst! Have I Got a Tip For You*, N.Y. TIMES, Mar. 30, 1997, at 3:1 ("As a fraud, Comparator was easy to avoid. It traded on the Nasdaq small-cap market, with financial statements that were obviously a joke if you studied them. Brokers pushing it had bad reputations."); O'Malley, *supra* note 34, at 329 ("The presence of a small, undistinguished, and otherwise weak underwriting firm is often a signal to the lawyer that either the issuer of the securities, or the deal itself (or perhaps both), is of low quality.").

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At the most fundamental level, the liability risk from such transactions is only eliminated if the underlying transactions never go through. That might well be the correct outcome—but one must make the aggressive assumption that all or most would have resulted in liability in excess of the value generated by the transactions taken as a whole to conclude that society is better off as a result of non-completion. Distributional consequences aside, the picture from a societal perspective is more complex than would appear from the perspective of a single risk-averse firm.

Even if a firm is committed to aggressive screening of its prospective clients, figuring out *ex ante* which to accept and which to decline is a difficult task. Attempts to provide guidance on this delicate issue are usually unhelpful; how many lawyers need to be told that "low-quality clients" should be avoided?"[99] The default rules reflected in the literature

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99. *See, e.g.,* O'Malley, *supra* note 34, at 329 (firms should avoid "low quality clients"). Mr. O'Malley recognizes the difficulties raised by this formulation; "it is not possible to define a 'low quality client' because the type of client deficiencies that cause trouble are different from one context to the other." *Id.* His response is that firms should employ a common-sense businesslike procedures and a "smell test" to identify low-quality clients. *Id.* at 347. *See also* American Bar Association Standing Committee on Lawyer's Professional Liability, The Lawyer's Desk Guide to Legal Malpractice, 34-36 (steps to "qualify" or screen clients, including list of 11 "red flags." My favorite "red flag" is whether the client is "concerned or extremely unconcerned" with the costs of representation. *Id.* at 34. Fortune & Roark, *supra* note 9, at 642, 647-48, provide two checklists for screening potential clients, which are similarly unhelpful.

Finally, DPIC, a professional liability insurer, offers the following useful advice on its web site (at http://www.dpic.com.lplslp1) as part of its list of the Top 10 Ways for Law Firms to Manage Risk and Prevent Losses:

> 2. Select Client Carefully
>
> Certain clients are a higher risk than others. Check into the client's track record and finances before accepting any engagement. Don't accept clients who cannot provide adequate fees for your services, who restrict your scope of services to an unacceptable level, who insist on services that are outside of your firm's area(s) of expertise, or who present an ethical conflict.

The practical guidance to be gained from such advice is unclear at best. *See, e.g.,* Antonin Scalia, *Assorted Canards of Contemporary Legal Analysis*, 40 CASE W. RES. L. REV. 581, 592 (1990) ("But what guidance does such a principle provide for the lower courts, and what check is it against the personal preferences of future judges? 'Be reasonable and do not go too far' is hardly more informative than 'Do justice,' or 'Do good and avoid evil.'").

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(to the extent they are more than general prescriptions) are invariably both under- and over-inclusive.[100] Professor Cohen continues this pattern, quoting from an article by Professor Hazard to the effect that lawyers should not "take bad people as transaction clients" or "represent doctors in business deals."[101] Neither Professor Cohen nor Professor Hazard provide any help in sorting out who is a "bad" person. More fundamentally, if only "good" people can retain lawyers, there will be a lot of empty seats at most law schools in the coming years.[102]

Of course, default rules may still be helpful as a preliminary matter, especially if the default rule cost-effectively screens out ne'er-do-wells.[103] Professors Cohen and Hazard may also have not have been entirely off the mark, at least when it comes to representing doctors in business

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100. *See supra* note 99. *See also* O'Malley, *supra* note 34, at 347 (Some firms have developed new client/new matter screening process; "No one pretends the process is perfect. Some undesirable clients will slip through. Also the bureaucratic process with its conservative bias will tend to exclude a few clients (*e.g.*, a start-up enterprise proposing an initial public offering on a contingent fee basis) who miraculously turn out to be successful and honorable.").

101. Cohen, *supra* note 4, at 315 n.40.

102. Of course, if deviancy is defined downward, as happened with tax shelters, this problem corrects itself. *See, e.g.*, JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM 7-16 (1987) (description of growth of wide variety of tax preferences and shelters, resulting in widespread disenchantment with tax system and growth of tax protesters. Behavior previously limited to the well-to-do spread throughout the population: "By 1983, we even began to see people in the lower income levels, with incomes of only $18,000 and $20,000 a year, buying into phony tax shelters, private churches, master recordings, that sort of thing. They listened to this siren song and said, "Gee, everybody else is doing it. Why not me?").

103. A client who is switching firms offers both risks and rewards to the new firm. If the client refuses (as is his right) to allow the "new" firm to talk to the "old" firm, the risk/reward ratio is likely to be quite different than were that not the case. A default rule which automatically refused such representation, or allowed only limited representation would be an understandable (and probably an appropriate) response to a potential client who balked at such a basic precaution. *See, e.g.*, O'Malley, *supra* note 34, at 330 ("The client who is changing lawyers is a human red flag, or at least a yellow flag. If the prospective new client is changing lawyers, or merely seeking a firm as additional counsel, it is essential that the lawyer insist that the prospective new client authorize his or her former or existing lawyer to answer (on a confidential basis) all questions that the lawyer may want to ask about the prospective new client. If the prospective new client refuses to grant such authorization, the prospective new client is a low quality client and the lawyer should decline the engagement."); Davis, *Kaye Scholer, supra* note 9, at 690 (same); O'Malley, *supra* note 34, at 343 (collecting six commandments of loss prevention).

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transactions.[104] A friend in public accounting related to me the default rule that he developed after auditing hundreds of tax returns from the 1980s: "if a doctor is involved in a tax shelter, it's at least negligence, and possibly fraud."[105] Forbes Magazine came to a similar conclusion: "tax shelter economics were so bad that nineteen out of twenty investments could only be sold to groups of doctors. The twentieth scheme was awful beyond belief and could be sold only to dentists."[106] However, the number of physicians and dentists in this country is sufficiently modest that this default rule is woefully underinclusive—and some firms have done quite well representing doctors and dentists, which provides an indication of the overinclusiveness of this default rule.

In summary, Professor Cohen's model of professional liability insurance is elegantly crafted, internally consistent, and instructive about the comparative institutional trade-offs among different forms of insurance. However, in many important respects, it simply fails to describe the world in which we live—and the peculiarities and propensities of lawyers and the organizational forms in which they currently practice suggest it may never do so.[107]

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104. *See supra* note 101 and accompanying text.

105. *See, e.g.*, Stephenson v. Commissioner, 79 T.C. 995 (1982) (physician could not use self-styled "church" of which he had named himself minister as basis to not pay income taxes; fraud penalties imposed); Brannen v. Commissioner, 78 T.C. 471 (1982) (group of doctors invested in film distribution tax shelter; deductions denied); Zfass v. Commissioner, 71 T.C.M. 2670 (1996) (investment in tax shelter; negligence and valuation overstatement penalties). Of course, such behavior is not limited to physicians. *See, e.g.*, Zadan v. Commissioner, 65 T.C.M. (CCH) 2059 (1993) (fraud penalty upheld against lawyer); Scallen v. Commissioner, 877 F.2d 1364 (8th Cir. 1989) (fraud penalties imposed against professor who taught tax law at the University of Minnesota Law School).

106. *See* Martin D. Ginsburg, *Teaching Tax Law After Tax Reform*, 65 WASH. L. REV. 595 (1990).

107. Of course, Professor Cohen's model is valuable for reasons independent of its descriptive and predictive validity. *See* Ronald Coase, *How Should Economists Choose? in* ESSAYS ON ECONOMICS AND ECONOMISTS 16-17 (1994) ("The view that the worth of a theory is to be judged solely by the extent and accuracy of its predictions seems to me wrong. Of course, any theory has implications. It tells us that if something happens, something else will follow, and it is true that most of us would not value the theory if we did not think these implications corresponded to happenings in the real economic system. But a theory is not like an airline or bus timetable. We are not interested simply in the accuracy of its predictions. A theory also serves as a base for thinking. It helps us to understand what is going on by enabling us to organize our thoughts. Faced with a choice between a theory which predicts well but gives us little insight into how the system works and one which gives us this insight but predicts badly, I would choose the latter, and I am inclined to think that most economists would do the same.").

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III. A CROSS-DISCIPLINARY PERSPECTIVE ON THE ETERNAL TRIANGLE

The presence of an insurance company changes what would otherwise be an attorney-client dyad into a triad.[108] The reasons for (and implications of) this change, and how to handle the resulting interlocking and overlapping obligations and duties has given rise to an extensive literature.[109] The problem has surfaced in a variety of contexts, but the questions are always the same—and lawyers are always stuck in the middle.

The debate usually crystallizes around the issue of who is a client—and how many are there when an insurance company is paying the bills. Is there one client?[110] One-and-one-half clients?[111] Two clients?[112] Can the

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108. The triad is referred to under various names, including tripartite relationship, insurance triangle, and eternal triangle. *See* D.R. Richmond, *Lost in the Eternal Triangle of Insurance Defense Ethics*, 9 GEO. J. LEGAL ETHICS 475, 476 n.1 (1996) (collecting sources).

109. *See, e.g., id.;* Charles Silver & Kent Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 DUKE L. REV. 255 (1995); Charles Silver, *Does Insurance Defense Counsel Represent the Company or the Insured?*, 72 TEX. L. REV. 1583 (1994); Robert E. O'Malley, *Ethics Principles For the Insurer, the Insured, and Defense Counsel: The Eternal Triangle Reformed*, 66 TUL. L. REV. 511 (1991); Eric M. Holmes, *A Conflicts-of-Interest Roadmap for Insurance Defense Counsel: Walking an Ethical Tightrope Without a Net*, 26 WILLAMETTE L. REV. 1 (1989); Michael A. Berch & Rebecca White Berch, *Will the Real Counsel for the Insured Please Rise*, 19 ARIZ. ST. L.J. 27 (1987); Richard L. Neumeier, *Serving Two Masters: Problems Facing Insurance Defense Counsel and Some Proposed Solutions*, 77 MASS. L. REV. 66 (1992); John K. Morris, *Conflicts of Interest in Defending Under Liability Insurance Policies: A Proposed Solution*, 1981 UTAH L. REV. 457. Of course, the foregoing represents publications in the academic literature. There is a substantial additional list of articles in publications directed at practitioners.

110. *See* O'Malley, *supra* note 109, at 512 ("The dual-client doctrine is a confusing and increasingly useless anachronism. It is unsound as a matter of policy, law, and legal ethics. This Article argues that the insured should be deemed to be the only client of defense counsel in every case. . . [However], the insurer's contractual rights and financial interest in the matter [should] be considered and respected by defense counsel."); *But see* O'Malley, *supra* note 34, at 345 (distinguishing "insured (who is officially the lawyer's client, [and] primary insurance carrier (the 'real' client of the lawyer)"). *See also* Atlanta Int'l Ins. Co. v. Bell, 475 N.W.2d 294 (Mich. 1991) (no attorney-client relationship between company and lawyer). In the view of most of the authors, the tentative draft of the Restatement of the Law Governing Lawyers also endorsed a one-client view, although Professor Morgan disputes the point. *Compare* Silver, *supra* note 109, at 1588-89 *with* Barker, *supra* note 4, at 85 *and* Morgan, *supra* note 4, at 12.

111. *See, e.g.*, Charles Silver & Michael Sean Quinn, *Wrong Turns on the Three Way Street—Dispelling Nonsense about Insurance Defense Lawyers*, 5 COVERAGE 1 (Nov./Dec. 1995) (characterizing California Formal Op. 1995-139).

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question be answered without looking at the specifics of the arrangement?[113] If the insurer is not a client, why does it get to control the defense? If the insurer is a client, are its interests co-equal or subordinate?[114] And how should the retained lawyer be paid?[115] The

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112. *See* Silver, *supra* note 109, at 1587, n.17, 1590 ("Without denying that the insured may also be a client, I will argue that, with respect to both settlement and defense of claims, the company can always be a client to whom defense counsel owes a duty of care.").

113. *See* Silver & Syverud, *supra* note 109, at 271, 274 (1995) (Relationship between insurer, insured and lawyer is contractual, and "liability contract should 'bleed' into the retainer agreement"; "it is perilous and inappropriate to adhere to either the 'one client' or the 'two clients' view. . . Because it is up to lawyers and their principals to determine the nature of the relationships that exist between them, there is no reason to think that defense counsel must have one client or two clients in every case. . . a retainer agreement determines how many clients defense counsel represents."); Silver, *supra* note 109, at 1606 ("Bearing in mind the contractual nature of attorney-client relationships, it begins to seem extraordinary that judges, rule-makers, advisory committees, and commentators would presume to declare—for all times, places and purposes, whether an attorney-client relationship exists between defense counsel and a primary carrier. It seems arrogant to espouse either the one-client or two-clients view. What standing has an outsider to assert or to deny that a lawyer represents a company or an insured when the interested parties are free to decide the matter for themselves?").

114. *See, e.g.*, Silver, *supra* note 109, at 1587 ("the law of professional responsibility has never been entirely comfortable with the notion that defense counsel has two clients. Recognition of the company's status as a client is usually accompanied by the admonition that counsel must show special regard for the interests of the insured. For example, Oregon Formal Opinion 1991-121, quoted above in support of the two-clients view, states that "an attorney hired by the insurer to defend an insured must treat the insured as 'the primary client' whose protection must be the attorney's 'dominant' concern.'").

115. Although lawyers have historically been paid by insurers on a (usually significantly discounted) per-hour rate, there has been considerable movement toward alternative arrangements, including bundled flat fees, and the use of staff attorneys. *See* Silver, *supra* note 4, at 237-56. Insurers have also used guidelines (*e.g.*, restrictions on travel, limitations on billing for associates, paralegals, computerized research, telephones and faxes, reporting obligations) in an attempt to hold down the costs of representation. *See* Richmond, *supra* note 108, at 531-35 (cataloging guidelines). Insurance defense counsel have been less than pleased by these developments. *Id.* (noting unhappiness among defense bar; "the greatest problem posed by insurers' outside counsel guidelines is their threat to defense counsel's professional independence, a derivative effect on insureds' defense."). Professor Moore echoes this theme, noting that an absolute prohibition on bundled flat fees seems unduly harsh, but "arguably this is a situation where the unique aspects of insurance defense representation warrant taking additional precautions in order to protect the interests of the insured." Moore, *supra* note 4 at, 261. Despite these complaints, insurance defense firms have started to offer alternatives to hourly billing. *See* Thomas P. Grace & Peter J. Neeson, *Alternatives to Traditional Fee Arrangements*, FOR THE DEF., May, 1996, at 31.

The issue is not limited to insurance defense. Alternative billing arrangements and guidelines of various sorts have become popular in corporate settings as well. *See* Daniel B.

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answers to these questions have implications for the day-to-day practical issues of handling the defense (communication, control, and settlement), as well as the conflicts which can materialize.[116] Lurking under the surface is also the question of how strictly the rules of professional responsibility should be construed when an insurer is paying for the defense.[117]

The papers prepared by Mr. Barker and Professors Baker, Jerry, Morgan, Moore, Pepper, Silver, and Syverud reflect diverse views on these matters, and offer different analytical frameworks for assessing the issues. In part, the dispute is about turf: will insurance law or professional responsibility law dictate the nature of the arrangements between insurance companies and lawyers?[118] More subtly, the dispute is also a temporal one: are the terms of the arrangement between insurance company and lawyer determined at the time the insured enters into a contract with the insurer; at the time the lawyer is retained; or at the time an actual conflict develops?[119] At bottom, however, the issue is whether the rules of

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Mahoney, *When Pruning Is In Order: DuPont Takes a New Look at the Corporate—Outside Counsel Relationship*, BUS. L. TODAY, Aug. 1996, at 48-52 (DuPont entering into "partnering program" with outside firms by reducing number of firms; changing compensation to incentive system, and embracing technology; "In structuring alternative fee arrangements with our law firms, we stress that winning - through litigation or ADR - is still our principal goal, but that we want to win at the right price. We will no longer tolerate 24-carat solutions to 14-carat problems."); Dick Dahl, *Share the Pain, Share the Gain: Lawyers Are Finding It Pays To Tie Their Fortunes To Their Clients' Results*, 82 AM. BAR ASSOC. J., June, 1996, at 68 (incentive billing not yet embraced by the legal profession but the "writing on the wall is clear" for hourly billing.).

116. The other papers in this issue describe these matters in considerable detail. *See also* Richmond, *supra* note 108, at 483-508 (collecting common conflicts).

117. *See, e.g.*, Moore, *supra* note 4, at 276 ("Proponents of the 'one-client' view . . . conclude that since the disclosure required under Rule 1.7(b) cannot be met, it is (or should be deemed) unethical for lawyers to represent anyone other than the insured. But this is not the only possible solution, particularly if one is willing to be flexible and bend the rules a bit.").

118. Professors Baker and Jerry require the lawyer to treat the insured as at least a co-equal party to the insurer because of insurance law, rather than professional responsibility law. Professors Morgan, Moore, and Pepper argue for the same result because of professional responsibility law. Mr. Barker and Professors Silver and Syverund argue for a different result based on professional responsibility law and insurance law.

119. Professional responsibility law appears to require at least the intermediate, and possibly the latter response, since conflicts can only be waived knowingly and after consultation. *See, e.g.*, MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7(b)(2) (1983) [hereinafter MODEL RULES]. However, Professors Silver and Syverund and Mr. Barker would allow the deal struck at the time the insurance contract was entered into to decide the matter. The difference is significant, both in the impact on the individual insured, but also in the terms of contracts that will be entered into in the future insurance cycles.

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professional responsibility are simply default provisions, or constitute a mandatory minimum.[120]

It is unsettling that the issues which arise out of the eternal triangle remain unsettled.[121] Indeed, the lack of clear answers to the most preliminary of questions ("how many clients are there and who are they?") explains a great deal of the confusion about roles and responsibilities in cases where things have gone badly.[122] The mix-ups which arise from the eternal triangle would seem more appropriate for a "Who's on First" comedy routine than for the existence (or lack thereof) of professional relationships.[123]

Common consensus, whether one belongs to the one-client or two-client camp, is that the interests of the insurer are less important than that of the insured—although how much less is a disputed issue.[124] If significant conflict develops, counsel must usually withdraw, regardless of the content of the insurance contract.[125] Insured find much to appreciate about this solution *ex post*.[126] Matters look a little different *ex ante*.[127]

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120. Of course, the Model Rules of Professional Conduct specify that certain provisions are immutable, while other provisions may be waived if certain conditions are satisfied. *See e.g.*, MODEL RULES, *supra* note 119, Rule 1.1 (competence required); Rule 1.2 (limited representation allowable if client consents); Rule 1.3 (diligence and promptness required); MODEL RULE 1.4 (client must be informed of status); Rule 1.6 (client confidences can be revealed if client consents); Rule 1.7 (conflict of interest can be waived if client consents and lawyer reasonably believes representation won't be adversely affected); Rule 1.8 (duty runs to client, not third-party payor). *See also* Silver & Syverund, *supra* note 109, at 307-11. The time when one measures if these conditions are satisfied can make a difference. *See supra* note 119.

121. *See* Silver & Syverund, *supra* note 109, at 263 ("The rules [that govern the conduct of insurance defense lawyers] fail to provide clear and defensible answers to the most basic questions, such as whether an attorney-client relationship exists between the insurance company, and the lawyer retained to handle the lawsuit against the insured."); Richmond, *supra* note 108, at 536 ("If this rudimentary compass seems inadequate, that is because it is. The eternal triangle has vexed insurance defense practitioners for years and navigation is getting no easier.").

122. *See, e.g.*, Carrier Express Inc. v. Home Indem. Co., 860 F. Supp. 1465, 1482 (N.D. Ala. 1994) (attorney's testimony reflected he was unclear as to the number of clients he was representing, and the hierarchy of his responsibility to those clients).

123. *See* Martha Minow, *Who's the Patient?*, 53 MD. L. REV. 1173 (1994) (similar difficulties in another setting).

124. *See* Silver & Syverud, *supra* note 109, at 338, n.196 (primary client rule predominates). Professors Silver and Syverund favor a no-subordination rule. *Id.* at 341.

125. *See* Fischer, *supra* note 2, at 47 ("The 'withdrawal' approach has largely captured the academic and practitioner writing to date.").

126. *See, e.g.*, Pepper, *supra* note 4, at 34 (Joint representation does not serve client's interests; "The insured gains nothing directly from joint representation, and loses access to a

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Indeed, because the incidence of conflict *ex post* is affected by the insured's *ex ante* behavior, the view from an *ex post* perspective is necessarily distorted.[128] The bootstrap *ex post* creation of coverage and defense where the commensurate premium was not paid clearly favors the interests of the insured over the insurer.[129] However, the costs of such largesse end up somewhere—and the terms on which insurance contracts are entered into will quickly reflect that fact.

Despite the vigor with which this battle has been fought, the stakes of the controversy are actually rather modest. Indeed, the dispute essentially assumes the integrity (and necessity) of the larger framework of the rules of professional responsibility, and engages in a skirmish on whether insurance contracts can constitute an *ex ante* waiver under Model Rule 1.7 under certain limited circumstances. The "non-waiveable rules" of competence, diligence, and communication are not in issue, nor is the full reach of the conflict of interest, confidentiality, and limited representation

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lawyer serving only her interests and advising solely from her perspective. Imagine yourself in the insured's situation and it should not be too difficult to understand which option you would most likely choose.").

127. *See, e.g.*, Barker, *supra* note 4, at 77 ("For example, it may be in the interest of an insured, ex ante, to bond compliance by permitting placement of a spy in his camp, even if, ex post, the presence of the spy may prove unwelcome."). *See also* Fischer, *supra* note 2 at 47 ("withdrawal is not a realistic option when the conflict is inherent to the relationship, reflecting a recurring problem that affects a significant number of the total cases.").

128. *See e.g.*, Alan O. Sykes, *Judicial Limitations on the Discretion of Liability Insurers to Settle or Litigate: An Economic Critique*, 72 TEX. L. REV. 1345, 1346 (1994) ("Disputes over the rejection of settlement offers by insurers would not arise absent provisions in insurance contracts settling policy limits because and insured with unlimited coverage would face no exposure in the event of a large judgment."). Since the amount of coverage (and the incidence of such low-limits conflicts) is directly influenced by the *ex ante* willingness of the insured to pay a higher premium, it is a serious oversimplification to view matters solely from an *ex post* perspective. Although the insurer may certainly attempt to engage in strategic behavior at the back end, the insured may have behaved opportunistically at the front end, and can do so at the back end as well. *See generally* Ellen S. Pryor, *The Stories We Tell: Intentional Harm and the Quest for Insurance Funding*, 75 TEX. L. REV. 1721 (1997). Of course, as Professor Baker's paper reflects, there are many other forms of conflict besides the low-limits case, but most of the conflicts he outlines are subject to similar forms of *ex-post/ex ante* difficulty.

129. This result is most likely attributable to a sentiment noted by Randall R. Bovbjerg; "Something there is that doesn't love an insurer." Randall R. Bovbjerg, *Liability and Liability Insurance: Chicken and Egg, Destructive Spiral, or Risk and Reaction*, 72 TEX. L. REV. 1655, 1655 (1994).

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rules.[130] However, these sensible-sounding rules are by no means the only alternative—and there are no compelling reasons to treat them as such.[131]

Medicine provides a singularly apt area for evaluating this modest proposal. The medical profession is as well (or better) respected than the legal profession, and the stakes and informational asymmetries are at least as high in medicine as in law.[132] A short review of the evolution of medical ethics provides an effective antidote to the single-minded perspective offered by the Model Rules, and a contrast to the greater and lesser degrees of enthusiasm demonstrated by Professors Morgan, Pepper, Syverud, Baker, and Silver regarding a strict construction of Model Rule 1.7.

For much of its history, the medical profession operated as a classic cottage industry, and professional ethics focused on the "traditional rules prohibiting doctors' indulgence in the three A's: adultery, alcoholism, and worst of all advertising."[133] As the aphorism suggests, opposition to competition in its myriad forms was an early theme of medical ethics, although the objections were usually stated in more benign terms of

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130. *See supra* note 120.

131. Indeed, despite the invariant language of the Model Rules of Professional Conduct on certain issues (*see supra* note 120) there are certainly areas of the law in which the obligations are interpreted "flexibly." *See e.g.*, Steven B. Bright, *Casualties of the War on Crime: Fairness, Reliability, and the Credibility of Criminal Justice Systems*, 51 U. MIAMI L. REV. 413, 421 (1997) (Consistent evidence of poor quality of representation in capital cases; "The National Law Journal, after and extensive study of capital cases in the six southern states that account for the vast majority of executions, found that capital trials are 'more like a random flip of the coin that a delicate balancing of the scales' because defense lawyers are too often 'ill trained [and] unprepared' . . . . The American Bar Association concluded after an exhaustive study that 'the inadequacy . . . of counsel at trial 'was one of the 'principal failings of the capital punishment systems in the states today.'"); Susan Koniak, *Through the Looking Glass of Ethics and the Wrong with Rights We Find There*, 9 GEO. J. LEGAL ETHICS 1, 12 (1995) ("Some courts have argued that limits on a criminal defendant's right to bring a malpractice action are justified by the need to encourage lawyers to work for the low fees that are generally paid to counsel appointed to represent the indignant. In short, this argument boils down to nothing more than an admission that we do not pay these lawyers enough to demand that they be competent. . . . [The law] demands nothing of criminal defense lawyers, accepting almost all actual performance as adequate performance.").

132. *See* Cramton, *supra* note 71, at 553 ("The necessity-for-trust claim, I believe, is generally stronger in medicine that in law, partly because the information gap between doctor and patient is wider that it is in law and partly because patients are typically sick individuals who are less able to remedy their information deficiencies. In the practice of law, however, the strength of the necessity-for-trust claim is highly variable depending upon the context of practice.").

133. Stephen G. Potts, *Looking for the Exit Door, Killing and Caring in Modern Medicine*, 25 HOUS. L. REV. 493 (1988).

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ensuring patient welfare and the appropriate (high) level of quality. To this day, fully 75% of the opinions of the American Medical Association's Council on Ethical and Judicial Affairs involve such business-oriented matters as referrals, billing, advertising, recordkeeping, and the like.[134]

The American Medical Association's historical position on health matters was that all involved had to accept "the private physician's monopoly control of the medical market and complete authority over all aspects of medical institutions."[135] This fundamental precept was manifested in various ways. For example, beginning in 1927, the American Medical Association took the position that a contract to deliver medical services required a reasonable degree of free choice of physicians.[136] The position was repeatedly reaffirmed by the AMA over the following fifty years, until it was determined to constitute a restraint of trade.[137] Although the AMA's position appeared to be innocuous, it essentially prevented "a group of doctors from offering care to patients at any lower price than their colleagues. In the name of free choice, it effectively eliminated the possibility of competition and the right to patients to choose among competing physician groups."[138] By effectively precluding selective contracting, the ethical rule crippled insurers in their negotiations with providers, and helped maintain health care as a cottage industry built on a foundation of fee-for-service reimbursement.[139]

In like fashion, the American Medical Association and its local societies adopted ethical rules which prohibited salaried practice and prepaid medical care.[140] Physicians who entered into such arrangements and those who consulted with them were expelled—foreclosing access to local hospitals and cross-coverage. After "one of the bitterest battles in the history of modern American medicine," the Supreme Court held that the

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134. *See* David A. Hyman, *Professional Profiteering? The Ethics of Physician Entrepreneurship*, 35 PERSP. BIO. AND MED. 318, 319 (1992).

135. PAUL STARR, THE SOCIAL TRANSFORMATION OF AMERICAN MEDICINE 300 (1982).

136. *See* American Med. Ass'n, 94 F.T.C. 980, 1015 (1979), *enforced sub nom.* American Med. Ass'n v. F.T.C. 638 F.2d 443 (2d Cir. 1980), *aff'd by an equally divided court*, 445 U.S. 676 (1982).

137. *See id.*

138. Starr, *supra* note 135, at 300.

139. *See generally* Charles Weller, *"Free Choice" as a Restraint of Trade in American Health Care Delivery and Insurance*, 69 IOWA L. REV. 1351, 1364-67 (1984).

140. *See id.* at 1364-72.

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American Medical Association and a local medical society had violated the Sherman Act.[141]

Although organized medicine suffered defeats in these cases, the larger framework of laws and practices reflected medical dominance of institutional arrangements.[142] Although HMOs operated quite successfully in some parts of the country and developed their own institutional ethic, the paradigmatic doctor practiced alone or in a small group. Prohibitions on corporate practice remained on the books; compensation was based almost exclusively on piecework; all micro-allocation decisions were made by physicians, and tax-subsidized private insurance and public underwriting of care for the elderly (Medicare) and the poor (Medicaid) encouraged the near-complete insulation of patients from cost.[143] Not surprisingly, there were dramatic system-wide financial consequences, since all of the incentives pointed toward increased consumption—including the medical profession's ethic of fidelity to patients, which blossomed in the face of this artesian well of money.[144]

The unleashing of price competition in the medical marketplace changed the ground rules. The last decade has seen a sea change in the organizational structure and incentive arrangements under which doctors and other health care institutions operate.[145] Sixty-five million Americans receive their health care through HMOs, and the overwhelming majority of the population is in some form of managed care. These changes in the

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141. Thomas R. Mayer & Gloria Gilbert Mayer, *HMOs: Origins and Development*, 312 NEW ENG. J. MED. 590 (1985); American Medical Ass'n v. United States, 317 U.S. 519, 536 (1943) ("AMA represents physicians who desired that they and all others should practice independently on a fee for service basis, where whatever arrangement for payment each had was a matter that lay between him and his patient in each individual case of service or treatment.").

142. *See generally* Mark Hall, *Institutional Control of Physician Behavior: Legal Barriers to Health Care Cost Containment*, 137 U. PA. L. REV. 431 (1988).

143. *See id.*

144. *See* Arnold S. Relman & Uwe Reinhardt, *An Exchange on For-Profit Health Care, in* FOR PROFIT ENTERPRISE IN HEALTH CARE 209, 211-12 (1986) ("Surely you will agree that it has been one of American medicine's more hallowed tenets that piece-rate compensation is the sine qua non of high quality medical care. Think about this tenet. We have here a profession that openly professes that its members are unlikely to do their best unless they are rewarded in cold cash for every little ministration rendered their patients. If an economist made that assertion, one might write it off as one more of that profession's kooky beliefs. But physicians are saying it!").

145. *See* David Drake, *Managed Care: A Product of Market Dynamics*, 277 JAMA 560 (1997); Paul M. Ellwood, Jr. & George D. Lundberg, *Managed Care: A Work in Progress*, 276 JAMA 1083 (1996); John M. Eisenberg, *Economics; Managed Care* 273 JAMA 1670 (1995).

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organizational forms through which health care is delivered were reflected in changes in how physicians and ethicists thought about and handled conflicts of interest. The patient-centered ethic, which reached its zenith under fee-for-service practice, remains the centerpiece of professional self-definition, but it has been significantly tempered by considerations of the societal interests at stake—too much so for some tastes, and not enough for others.[146] Cost-effectiveness and cost-benefit analyses routinely appear in the medical literature. Bedside rationing is being seriously discussed.[147] Physicians and physician groups are entering into capitation contracts.[148] Even academic medical centers are starting to come around.[149] A distinctive managed care ethic has emerged—although the diversity of organizational forms which provide "managed care" certainly complicates matters.[150]

Indeed, things have moved so far and so fast that a backlash is brewing.[151] "Consumer protection" laws have been proposed and enacted

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146. *See* Warren Holleman et al., *Are Ethics and Managed Care Strange Bedfellows of a Marriage Made in Heaven?*, 349 LANCET 350 (1997); Marc A. Rodwin, *Conflicts in Managed Care*, 332 NEW ENG. J. MED. 604 (1995); Council on Ethical and Judicial Affairs, American Med. Assoc., *Ethical Issues in Managed Care*, 273 JAMA 330 (1995); Carolyn M. Clancy & Howard Brody, *Managed Care: Jekyll or Hyde?*, 273 JAMA 338 (1995); Ezekiel J. Emanuel & Nancy N. Dubler, *Preserving the Physician-Patient Relationship in the Era of Managed Care*, 273 JAMA 323 (1995).

147. *See* Mark Hall, *Rationing Health Care at the Bedside*, 69 N.Y.U. L. REV. 693, 758-76 (1994) (financial incentives to limit care should be deployed under certain circumstances).

148. *See* John M. Eisenberg, *Economics; Managed Care*, 273 JAMA 1670, 1671 (1995) (majority of physicians have entered into contracts with managed care organizations); Elisabeth Rosenthal, *Altered Medicine: Reduced H.M.O. Fees Cause Concern about Patient Care*, N.Y. TIMES, Nov. 25, 1996, at A1 (managed care plans switching from discounted fee-for-service to capitation).

149. *See, e.g.*, M. William Salganik, *UM Hospital, Doctors Team to Boost Scope; Medical School to Collaborate with Big Physicians Group; 'One-Stop Shopping'; 'Integrated System' Aims to Provide More for Less to Insurers*, BALT. SUN, Apr. 13, 1997, at D1 (academic medical center affiliates with physician "mega-group" to begin process of building integrated system); Diana K. Sugg, *Hopkins to Offer HMO for AIDS; Program, Among First in Nation, Aims to Pair Efficiency, Quality*, BALT. SUN, Jan. 17, 1997, at B1 (Johns Hopkins launching managed care plan for AIDS patients); M. Salganik, *Institutions Prepare for Managed Care; Providers Who Give Specialized Aid in Medicaid Scramble*, BALT. SUN, Nov. 17, 1996, at D1; David Blumenthal & Gregg S. Meyer, *Academic Health Centers in a Changing Environment*, 15 HEALTH AFF. 200 (1996) (listing strategies).

150. *See, e.g.*, *supra* note 146; Eisenberg, *supra* note 148, at 1670 ("[T]he wide variety of managed care organizations share mainly an attempt to control costs.").

151. *See* Thomas Bodenheimer, *The HMO Backlash - Righteous or Reactionary?*, 335 NEW ENG. J. MED. 1601 (1996); Matthew K Wynia, *The Oregon Capitation Initiative:*

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to address the perception that doctors are being forced by insurers to go too far in abandoning the patient-centered ethic.[152] Doctors are joining unions.[153] Unsuccessful referendums in California and Oregon sought to change the ground rules for managed care organizations.[154] Newspapers and politicians routinely editorialize about the need to enact legislative safeguards for managed care.[155] A Presidential Commission has been directed to develop of a "consumer bill of rights" for managed care.[156] Despite these reactionary efforts, physicians now practice in an environment that was inconceivable less than a decade ago. Simply stated, the cost-quality equilibrium has moved a long way from that which was the rule during the golden age of fee-for-service medicine.

Lessons and Warnings, From the Forefront of the Backlash, 276 JAMA 1441 (1996); John Merline, *The Backlash Against Managed Care*, 79 CONSUMER'S RES. 15 (1996).

152. *See* Robert Pear, *Congress Weighs More Regulation on Managed Care*, N.Y. TIMES, Mar. 10, 1997, at A1 ("Since Congress convened two months ago, lawmakers, often with encouragement from President Clinton, have rushed to introduce bills setting standards for health insurance plans, and H.M.O.'s in particular."); Fred J. Hellinger, *The Expanding Scope of State Legislation*, 276 JAMA 1065 (1996); Families USA, *HMO Consumers at Risk: States to the Rescue*, <http://epn.org.families/farisk.html>.

153. *See* Andrea Adelson, *Physician, Unionize Thyself*, N.Y. TIMES, Apr. 5, 1997, at 27, 28 ("growing number of doctors joining unions to improve their bargaining power with their new efficiency-obsessed bosses.").

154. *See Anti-Managed Care Measures Defeated, Supporters Vow to Press for Changes*, 5 BNA HEALTH L. REP. 1671 (1996) (Two California initiatives defeated); *Voters Defeat Two Ballot Initiatives Aimed at Managed Care Organizations*, 5 BNA HEALTH L. REP. 1672 (1996) (Two Oregon initiatives, including one which would have effectively outlawed capitation, defeated).

155. *See, e.g., Consumers and Managed Care*, N.Y. TIMES, Feb. 9, 1997, at E14 ("Lawmakers should be mindful of managed care's potential for innovation and cost control. But they should also move forward with reasonable protections for the millions who must live by managed care's rules."); Robert Pear, *Clinton Prohibits HMO Limit on Advice to Medicaid Patients*, N.Y. TIMES, Feb. 21, 1997, at A22 ("Surrounded by doctors and nurses in the Oval Office of the White House today, Mr. Clinton said: 'On the whole, the growth of managed care has been a good thing for our country. But we also know, we've seen enough to know, that we have to make absolutely sure that this rapid transformation does not lead to a decline in the quality of health care.'").

156. *See* Amy Goldstein, *Panel Outlines Protections for Health Care Consumers*, WASH. POST, Oct. 23, 1997, at A1 ("A presidential commission yesterday outlined a broad set of protections for consumers frustrated by a changing health care system, proposing that patients be guaranteed a choice of medical plans, more information to make smart decisions and new ways to protest when they become dissatisfied with their care."); Laurie McGinley, *Clinton Appoints Health-Care Panel and Orders Up 'Consumer Bill of Rights,'* WALL ST. J., Mar. 27, 1997, at A4 ("Their task will be focused and urgent: to find ways to ensure quality, and to ensure that the rights of consumers in health care are protected.").

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One could certainly argue that these changes in clinical medical ethics are a one-time event, or that the backlash indicates the societal assessment of a profession which has abandoned a wholehearted commitment to a patient-centered ethic. However, another example from the medical sphere—clinical research ethics—suggests that quite fundamental conflicts of interest can be handled so long as the ground rules are clear.

Clinical research is intended to answer a specific scientific question, but the demands of clinical research can readily conflict with the physician's patient-centered duties.[157] Despite this fundamental conflict, the gains from such research are sufficiently obvious that it is routinely performed in every teaching hospital in the country, and is underwritten by both public and private funding. The randomized controlled trial represents the "gold-standard" of clinical research.[158] Longstanding prophylactic rules help ensure the merit of such research and knowing participation by the research subjects.[159] However, even the most fundamental of prophylactic rules have been modified when they became inadequately reflective of the interests of current and future patients.

For example, informed consent is the touchstone for ethical research involving human subjects.[160] Emergencies, almost by definition, preclude informed consent, and often make it difficult to obtain any consent—meaning one must choose between unconsented research and no research

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157. *See* Samuel Hellman & Deborah S. Hellman, *Of Mice but not Men: Problems of the Randomized Clinical Trial,* 324 NEW ENG. J. MED. 1585, 1586 (1991) ("The randomized clinical trial requires doctors to act simultaneously as physicians and as scientists. This puts them in a difficult and sometimes untenable ethical position."); Philip J. Hilts, *Consensus on Ethics in Research is Elusive,* N.Y. TIMES, Jan. 15, 1995, at A24 ("'After all, there is an inherent conflict of interest in research. It is the investigators, who are directly invested in the study and cannot be objective, who are seeking consent from the patients.'"); ROY G. SPECE, JR. ET AL., CONFLICTS OF INTEREST IN CLINICAL PRACTICE AND RESEARCH (1996) (survey of such conflicts).

158. *See* Eugene Passamani, *Clinical Trials—Are They Ethical,* 324 NEW ENG. J. MED. 1589 (1991) ("randomized trials are in fact the most scientifically sound and ethically correct means of evaluating new therapies.").

159. *See id.* ("There is potential conflict between the roles of physician and physician-scientist, and for this reason society has created mechanisms to ensure that the interests of individual patients are served should they elect to participate in a clinical trial.").

160. *See* National Comm'n for the Protection of Human Subjects of Biomedical and Behavioral Research, *The Belmont Report: Ethical Principles and Guidelines for the Protection of Human Subjects of Research,* Washington D.C.; Office for Protection From Research Risks; 1979 OPRR publication 887-806; Office of Science and Technology Policy, *Federal Policy for the Protection of Human Subjects,* Federal Register, 56 Fed. Reg. 28,002-32 (June 18, 1991).

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whatsoever.[161] Unwilling to abandon research in emergency medicine entirely, a number of mechanisms have been suggested as a way of maintaining a middle ground between these two extremes.[162] The federal government was unwilling to entertain such possibilities, with predictable consequences on the amount of such research performed.[163] After a storm of controversy in the clinical research community, the government significantly modified its position.[164] Similar clouds seem to be gathering around another touchstone of clinical research ethics, the institutional review board.[165]

Two other touchstones of clinical research ethics are that all participants in a clinical trial should receive the "best proven diagnostic and therapeutic method,"[166] and one only conducts a randomized trial if there is no good reason to believe that one of the treatments is superior to

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161. *See* Michelle Biros et al., *Informed Consent in Emergency Research: Consensus Statement From the Coalition Conference of Acute Resuscitation and Critical Care Researchers*, 273 JAMA 1283, 1284 (1995).

162. *See id.;* Robert Levine, *Research in Emergency Situations,* 273 JAMA 1300, 1301-02 (1995); Paula Grim et al. *Informed Consent in Emergency Research: Prehospital Thrombolytic Therapy for Acute Myocardial Infarction*, 262 JAMA 252 (1989).

163. Charles R. McCarthy, *To Be or Not to Be: Waiving Informed Consent in Emergency Research*, 5 KENNEDY INSTITUTE OF ETHICS J. 155 (1995); Levine, *supra* note 162, at 1301; Carin M. Olson & Drummond Rennie, *Plungers and Polemics: Active Compression-Decompression CPR and Federal Policy*, 273 JAMA 1299 (1995) (trials of new form of CPR halted by FDA because subjects unable to provide informed consent); Charles Marwick, *Research in Emergency Circumstances*, 273 JAMA 687 (1995) (performance of clinical research in emergency conditions has come to a virtual halt due to NIH and FDA strict interpretation of regulations controlling such research); Carin M. Olson, *The Letter or the Spirit? Consent for Research in CPR*, 271 JAMA 1445 (1994).

164. *See* Richard S. Saver, *Critical Care Research and Informed Consent,* 75 N.C. L. REV. 205 (1996) (Reforms proposed by FDA address certain deficiencies, but lack breadth and scope necessary to advance critical care research in an ethical and sensible manner); Symposium, *In case of emergency: No need for consent*, HASTINGS CENT. REP. 7 (Jan. 1997) (differing views on necessity and appropriateness of reform; concerns about impact on minority populations).

165. *See* D.F. Phillips, *Institutional Review Boards Under Stress: Will They Explode or Change?* 276 JAMA 1623 (1996) (Institutional Review Boards ("IRBs") "find themselves under pressure from mounds of paperwork, regulatory fire from the federal bureaucracy, and economic constraints from the institutions they serve. Never before has such a pressure cooker atmosphere prevailed within the IRB system, leading government officials, university administrators, research sponsors, and IRB members to wonder whether the IRB system will crack or reform.").

166. Marcia Angell, *The Ethics of Clinical Research in the Third World,* 337 NEW ENG. J. MED. 847 (1997); Susan Okie, *Ethics and AIDS,* WASH. POST, Sept. 28, 1997, at C3.

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the other.[167] The combination of these principles means that placebo controlled trials are only proper when there is no known effective treatment.[168] The AIDS epidemic has put these principles to the test, and prompted additional revisions of the rules governing clinical research.

The "best proven" method for preventing the transmission of the HIV virus from infected mother to newborn infant is treatment with AZT.[169] Unfortunately, this "best proven" method was well beyond the health budget of most "Third World" countries—prompting the search for a treatment which was better than nothing, but cheaper than AZT.[170]

In order to test these new treatments, a number of randomized placebo controlled trials were implemented.[171] The New England Journal of Medicine published a Sounding Board decrying the research, and flatly labelling as unethical the use of placebo controls when an effective treatment was available.[172] An accompanying editorial analogized the research to the infamous Tuskeegee syphilis study, and lamented the research community's general "retreat from ethical principles."[173]

The New England Journal of Medicine printed a response by the heads of the National Institutes of Health and the Centers for Disease Control and

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167. *See* Benjamin Freedman, *Equipoise and the Ethics of Clinical Research,* 317 NEW ENG. J. MED. 141 (1987).

168. *See* Kenneth J. Rothman, *Placebo Mania: as Medical Knowledge Accumulates, the Number of Placebo Trials Should Fall,* 313 BRITISH MED. J. 3 (1996).

169. *See* E.M. Connor et. al., *Reduction of Maternal-Infant Transmission of Human Immunodeficiency Virus Type 1 with Zidovudine Treatment,* 331 NEW ENG. J. MED. 1173 (1994).

170. *See Making Hard Choices,* IND. STAR, Oct. 8, 1997, at A12 ("The minimum cost of AZT treatment for one pregnant woman is $ 1,000, which is 100 times what most Third World nations can afford to spend per capita for health care.")

Although these countries could almost certainly have afforded AZT as one arm of the clinical trial, they clearly could not have afforded routine treatment with AZT for the infected population, regardless of the results of the trial. As such, a placebo controlled trial provided a test of the realistically available alternatives, as well as more useful scientific results.

171. Randomized placebo controlled studies are being conducted in Cote d'Ivoire, Uganda, Tanzania, South Africa, Malawi, Thailand, Ethiopia, Burkina Faso, Zimbabwe, Kenya, and the Dominican Republic. Peter Lurie & Sidney M. Wolfe, *Unethical Trials of Interventions to Reduce Perinatal Transmission of the Human Immunodeficiency Virus in Developing Countries,* 337 NEW ENG. J. MED. 853 (1997).

172. *See id.* at 853, 855.

173. Angell, *supra* note 166, at 849. A few other commentators had also argued previously that the research was unethical. *See* Michael Lasalandra, *BU Staffers: U.S. funding unethical HIV studies,* BOST. HERALD, Apr. 23, 1997, at 16 ("experiments are in clear violation of all the major international ethical guidelines. . .we object to such trials if they deny women access to any intervention already proved effective.").

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Prevention which unflinchingly defended the merits and ethical integrity of the research.[174] One member of the New England Journal of Medicine editorial advisory board wrote a column in Newsweek criticizing the Sounding Board and editorial, and concluded with the observation that "insisting on the infeasible in the name of ethical purity is counterproductive in the struggle to stop this deadly virus."[175] The defenders of the research seem to have the support of most of the domestic and international scientific and public health communities—as well as the governments in the countries in which the research is actually being conducted.[176] There is also a good argument that the development of "cheap, but better than nothing" treatment regimens through the use of

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174. *See* Harold Varmus & David Satcher, *Ethical Complexities of Conducting Research in Developing Countries*, 337 NEW ENG. J. MED. 1003, 1005 (1997) ("To restate our main points: these studies address an urgent need in the countries in which they are being conducted, and have been developed with extensive in-country participation. The studies are being conducted according to widely accepted principles and guidelines in bioethics. And our decisions to support these trials rest heavily on local support and approval.").

175. David D. Ho, *It's AIDS, Not Tuskeegee*, TIME, Sept. 29, 1997, at 83. Shortly thereafter, Dr. Ho resigned from his position at the New England Journal of Medicine, along with another of the advisory board's experts on AIDS. *See* Lawrence K. Altman, *AIDS Experts Leave Journal After Studies are Criticized*, N.Y. TIMES, Oct. 15, 1997, at A10; Richard Saltus, *Journal Departures Reflect AIDS Dispute*, BOSTON GLOBE, Oct. 16, 1997, at A11.

176. *See* Varmus & Satcher, *supra* note 174, at 1003, 1005 ("There has been strong and consistent support and involvement of the scientific and public health communities in the host countries, with local as well as United States-based scientific and ethical reviews. . . the NIH- and CDC-supported trials have undergone a rigorous process of ethical review, including not only the participation of the public health and scientific communities in the developing countries where the trials are being performed but also the application of the U.S. rules for the protection of human research subjects by relevant institutional review boards in the United States and in the developing countries. Support from each local government has been obtained, and each active study has been and will continue to be reviewed by an independent data and safety monitoring board."). Thus, the research was approved by a series of institutional review boards charged with protecting the safety of those participating in the clinical trials, and informed consent was obtained from all participants.

But see Howard W. French, *AIDS Research in Africa: Juggling Risks and Hopes*, N.Y. TIMES, Oct. 9, 1997, at A1 (noting mixed evidence as to whether research participants had given meaningful informed consent, and degree of knowledge that such research could not be performed in U.S.).

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placebo controlled trials is more ethical than the "nothing but the best" approach taken by the United States.[177]

Thus, even the most fundamental clinical research ethics rules are subject to revision.[178] Of course, this is not to say that everything is up for grabs—each change in the standards is controversial, and subject to review on the merits.[179]

As this abbreviated history of medical ethics and clinical research ethics reflects, medicine currently incorporates default rules which are quite different than those embraced by the Model Rules. More importantly,

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177. Professor Uwe Reinhardt nicely described the dilemma as follows: "The champions of the poor, and the poor themselves must recognize that, in the political and budgetary climate of the 1980s [and 1990s!], pursuit of the maxim 'for the poor, nothing but the best' may leave the poor with nothing." Uwe E. Reinhardt, *Uncompensated Hospital Care*, *in* UNCOMPENSATED HOSPITAL CARE: RIGHTS AND RESPONSIBILITIES 1, 11 (Frank A. Sloan et al. eds., 1986). Given the choice between something and nothing, most people would have little difficulty choosing the former, but our legal system and ethical framework directly and intentionally precludes that option. *See infra* note 199.

178. The episode also provides additional evidence that some commentators are unable to understand that scarcity is not an artificial construct or a conspiracy against the less fortunate. *Cf.* Marcia Angell, *Cost Containment and the Physician*, 254 JAMA 1203, 1207 (1985) ("In a country that is this year spending about $300 billion on defense and $25 billion on tobacco, and in which $500,000 is spent for a 30 second advertisement during the Super Bowl, we should be prepared to argue for spending whatever is necessary for effective medical care.").

179. *See, e.g.*, Hilts, *supra* note 157, at A24 (conference on psychiatric research ethics resulted in disagreements "about what is ethical and what is not," but "surprising amount of agreement on useful things that can be done" so as "to help prevent ethical problems," such as inclusion of patient and consumer advocates on institutional review boards). Lawyers should find it disconcerting that the "strongest consensus" at the conference reflected considerable hostility toward the most shining achievement of legal reform efforts in health care law, the informed consent form. *Id.* ("Whatever else is done to solve the problem, the answer is not more or longer consent forms," said Leonard Rubenstein, a lawyer who specializes in issues of ethics and consent. "They are already like rental car contracts. These forms defeat their own purpose and make it almost certain that people won't read them.").

See also Philip J. Hilts, *New York Court Order Halts Some Research in Psychiatry*, N.Y. TIMES, Dec. 27, 1996 at A1 (referring to T.D. v. N.Y. State Office of Mental Health, 650 N.Y.S.2d 173 (N.Y. App. Div. 1996), *reh'g denied*, 1997 N.Y. App. Div. LEXIS 2007 (Feb. 4, 1997), *appeal dismissed*, 1997 N.Y. LEXIS 478 (April 1, 1997)) (regulations allowing for proxy consent for medical research involving children and mentally ill held violative of due process clause of U.S. Constitution; ten or fifteen ongoing experiments canceled; researchers complain that important and necessary research will not be conducted because stricter rules will take time and money to comply with; patient advocates argue that experiments should be carried out only on those who can give or withhold consent; "case is part of a trend across the United States to re-examine the relations between experimenters and their subjects.").

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the default rules in medical ethics and clinical research ethics have evolved over the years, whether in response to changes in the market for medical services, or other perceived inadequacies. Until recently, the fundamental principles of clinical medical ethics were quite analogous to those of the Model Rules—but clinical medical ethics has moved quite rapidly to a position on the patient-centered spectrum much closer to that long occupied by clinical research ethics.

The implications for the legal profession of this cross-disciplinary perspective are straightforward, albeit unwelcome. Simply stated, the positions reflected in the Model Rules (and the piecework-based model of compensation on which those positions are largely built) are by no means inevitable.[180] Professional responsibility rules may appear to provide useful "smart bombs" against insurance companies, but the stock of such ammunition is likely to be temporally limited.[181] More importantly, the purpose of the Model Rules is not the entrenchment of the profession or of individual professionals' preferred manner of doing business—and once the Model Rules are treated that way, the profession has gone astray from its avowed public purpose of patient/client protection. At least some members of the legal profession have figured this point out—and the recent move toward unbundling of legal services is a salutary step in the implementation of a more comprehensive and defensible understanding of true professional responsibility.[182]

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180. *See supra* note 115.

181. *See* Silver, *supra* note 4, at 244 (ethics rules as "smart bombs").

182. *See, e.g.*, Michael Millemann et al., *Limited-Service Representation and Access to Justice: An Experiment*, 11 AM. J. FAM. L. 1 (1997) ("The private bar's rigid adherence to the 'full-service' practice model unnecessarily denies many people who have moderate income effective access to justice. We argue that by providing more 'discrete task' or 'unbundled' legal services in domestic cases, lawyers can create new private practice opportunities that respond to the growing pro se litigation phenomenon in this country."); *See also* Deborah L. Rhode, *Professionalism in Perspective: Alternative Approaches to Nonlawyer Practice*, 22 N.Y.U. REV. L. & SOC. CHANGE 701 (1996) (unbundling serves client's interests); Geoffrey S. Yuda, *A Piece of Your Business: Competition from Nonlawyer 'Technicians': Cause for Alarm?* PA. LAW., May 1993, at 6. *But see* Mary Helen McNeal, *Redefining Attorney-Client Roles: Unbundling and Moderate-Income Elderly Clients*, 32 WAKE FOREST L. REV. 295 (1997) (ethical issues and quality concerns raised by unbundling).

Unfortunately, even if one is enthusiastic about unbundling, some of the "'malpractice traps' [reflected *supra* note 99,] include the basics of the unbundled relationship: clients concerned about fees; clients having little understanding of the legal system; clients having unrealistic expectations; and clients trying to tell the lawyer how to handle the case." Forrest S. Mosten, *Unbundling of Legal Services and the Family Lawyer*, 28 FAM. L.Q. 421, 434, n.65 (1994).

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IV. NARRATIVE SCHOLARSHIP PERSPECTIVE

I close with a fable, recognizing full well the difficulties which dog narrative scholarship.[183] Once upon a time, in a republic not very far away, there was a product known as FB.[184] The makers of FB were diligent and hardworking and proud of their product, since they were convinced that it enhanced the health and welfare of the population, was no more expensive than it needed to be given its excellent quality, and was better than the FB (or competing products) that were available in other republics and kingdoms. Indeed, people came from other lands to study FB and learn how to manufacture it the right way, so well known was its reputation. Centers of excellence grew up where the FB was perceived to be especially fine—and the costs correlated directly with perceived quality.

The makers of FB formed an organization (FB's Friends, or "FBF") to advance the public interest in having more and better FB available.[185] The first thing FBF did was encourage the government to license its members. Since licensing increased the cost of FB, FBF also persuaded the government to purchase lots of FB, and give it away to those that needed it, but could no longer afford it. FBF also created aggressive advertising and lobbying campaigns, which persuaded everyone that the makers of FB they were looking after the best interests of the public by providing high quality FB at a high price. The net result was that FB became identified as a basic part of every-day expectations about civilized life, even though its costs spiraled inexorably upward.

To be sure, there were some quality issues with FB. Even with a government enforced cartel, the makers of FB were geographically

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183. *See, e.g.*, David A. Hyman, *Lies, Damned Lies, and Narrative*, 73 IND. L.J. (forthcoming 1998); Daniel A. Farber & Suzanna Sherry, *Telling Stories Out of School: An Essay on Legal Narratives*, 45 STAN. L. REV 807, 832-40 (1993) (significant problems of truthfulness and typicality (selection bias) with narrative accounts); Richard A. Epstein, *Legal Education and the Politics of Exclusion*, 45 STAN. L. REV. 1607, 1619-20 (1993) (same). *But see* David Luban, *The Posner Variations (Twenty-Seven Variations on a Theme by Holmes)*, 48 STAN. L. REV. 1001, 1032-35 (1996) (narrative scholarship transcends facts and makes "subjectivity vivid"; only academic audiences would complain that such things are "too unempirical and subjective to pay any attention to"). Of course, if ignoring the subjectivity and selection bias of such narratives results in blind generalization from anecdotal evidence, that hardly seems like an optimal solution. *See infra* note 197. Those who doubt either the typicality or truthfulness of my fable should reexamine *infra* section III, n.187. It provides some additional support, for those who can wait.

184. Any similarity of FB to fee-based medicine (or fee-based lawyers operating under a strict reading of the Model Rules) is purely coincidental.

185. Any similarity of FBF to professional organizations having similar iterative initials (*e.g.*, the AMA and ABA) is entirely coincidental.

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dispersed, and it was difficult to enforce a uniform standard of quality. "Destructive competition" encouraged some makers of FB to cut corners. Blaming competition and a few "bad apples" in their own ranks, the makers of FB redoubled their efforts at insulating themselves from competitive pressures. Mandates and restrictive licensing made it exceedingly difficult to offer low-quality (but lower-priced) FB.

And lo, the makers of FB prospered mightily and made substantial campaign contributions to the elected representatives who had ensured them a quiet and lucrative lifestyle within a government-run cartel. The citizenry rejoiced, since they had been protected from knaves and profiteers. There was plenty of FB for those who had the money to buy it—and those who did not were reassured that uniformly high quality standards were being maintained—and if and when they could afford FB it would meet those standards. If they truly needed FB, a producer might take pity on them and provide charity FB, or they might qualify for an allocation of FB from the government.

All was well in the republic, until a cloud arose on the horizon. Some dangerous crackpot had developed a competing product called M.[186] M appeared to offer a similar product to FB, but at a far lower cost. The providers of FB insisted that M was not similar—it was far inferior—but the price difference was big enough that FB started to hemorrhage market share—especially when the biggest purchasers of FB decided that M was good enough for their purposes. This competition made clear that the citizens liked FB but they liked other things as well—and a cheaper product which appeared to offer a reasonable substitute for FB allowed them to spend the money they saved on things they wanted more than FB.

The makers of FB were devastated that they had lost their place in the hearts and minds of the citizenry—and decided that if they couldn't compete on price they would try and ensure that the market only competed on quality. The first thing they did was persuade the legislature to pass laws requiring standardized labelling, on the theory that people had been purchasing M out of the mistaken belief they were getting FB. The standardized labelling requirements also had the incidental benefit of making it harder to market M. Unfortunately for the makers of FB, the price differential was big enough that people didn't seem to care—or even if they did, they weren't willing to spend less on the other things they wanted to afford FB.

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186. Any similarity of M to managed care (or lawyers operating under a modified version of the Model Rules or those whose compensation is significantly different than fee-based) is purely coincidental.

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The next step was to target M with burdensome regulations, while FB was left unhindered. Those who made M had to put prominent labels on their product, which described the hazards associated with its consumption. The government prohibited the use of certain processes used by M's manufacturers to produce their product. Those who wished to sell M were forced to meet strict licensing standards as well. M's manufacturers fought these burdensome regulations and were successful in defeating many of them, except in the states where FB had a dominant position and the makers of FB were major employers. Yet even when burdened by regulations, the price differential was sufficient for many people to continue purchasing M.

Frustrated by their inability to get the market to run on quality rather than cost, the makers of FB decided that they could fix the problem by erasing the price difference. FB's manufacturers made no effort to sell their product at a lower price, but instead tried to tax M up to FB's level. The makers of FB were confident once the price spread was erased, people would return to FB. After all, everyone loved FB. They pushed through a tax on M which erased part but not all of the price difference. Remarkably, people still valued marginal dollars more than they valued the high quality FB—and bought M even at the tax-inflated price. Finally, the makers of FB decided to try and make M unappealing to its customers by forcing it to be sold in a manner that emphasized its differences from FB—and accentuated its less desirable features, without allowing those who made and sold M to comment on its salutary benefits.

Despite the similarity of the fable to the current medical and legal marketplaces, FB is fresh butter, and M is margarine—and the dairy farmers persuaded the federal and state government to do all of the things that were described.[187] The margarine wars started in 1870, and lasted at the federal level until 1950.[188] Wisconsin did not repeal its margarine statute until 1967.[189]

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187. An excellent review of the margarine wars is provided by Geoffrey P. Miller, *Public Choice at the Dawn of the Special Interest State: The Story of Butter and Margarine*, 77 CAL. L. REV. 83 (1989). Similar laws were enacted to limit competition from milkfat substitutes in the fluid milk and cheese markets. *See id.* at 84, n.3. Indeed, as my colleague David Bogen once told me, the history of the commerce clause and due process clause is written in dairy products. *See, e.g.*, H.P. Hood & Sons v. DuMond, 336 U.S. 525 (1949); Milk Control Bd. v. Eisenberg Farm Prod., 306 U.S. 346 (1939); United States v. Carolene Prod., 304 U.S. 144 (1938); Baldwin v. G.A.F. Seelig, Inc., 294 U.S. 511 (1935); Nebbia v. N.Y., 291 U.S. 502 (1934).

188. *See* Miller, *supra* note 187, at 83.

189. *See id.* at 84, n.3.

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All fables have a moral—and this fable has more than one. The most obvious moral is that providers prefer to take cost off the table and compete on quality. Indeed, most of the conduct of professional organizations (including restrictions on entry, prohibition of unlicensed practice, and ethical guidelines which serve proprietary interest) is readily explainable in light of that observation.[190] Second, consumer preferences are heterogenous, but cost is an important issue for many people. Although many people would prefer to think otherwise, this moral applies even to professional services.[191] Third, one should be cautious about generating a normative baseline for the cost/quality mix of professional services based solely or even largely on the assessment of the affected professionals. Given their track record, professional pronouncements on the appropriate and/or necessary level of quality should be viewed with a jaundiced eye.[192]

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190. *See, e.g.*, Macey & Miller, *Conflict of Interest*, *supra* note 7 (Professional responsibility law can help organized bar increase demand for services by arriving at efficient default terms, but can also be used by organized bar to "enhance its profits. . . by reducing the supply of legal services available in the marketplace."); Walter Gellhorn, *The Abuse of Occupational Licensing*, 44 U. CHI. L. REV. 6, 16-18 (1976) ("Of course many special interests perceive themselves as nurturers of the public interest rather than as self-seekers. The line between the common weal and one's own is not always easily drawn. But. . . . [o]nly the credulous can conclude that licensure in the main intended to protect the public rather than those who have been licensed or, perhaps in some instances, those who do the licensing.").

Professor Pepper suggests that professionalism can also protect helpless clients from exploitation and vulnerable professionals from powerful clients. *See* Pepper, *supra* note 4, at 41-47. However, the guild-based exploiter of clients explanation seems to be a more powerful predictor of conduct. *See* Gellhorn, *supra* at 17 (cataloguing misdeeds); Cramton, *supra* note 71, at 551-52 ("Much of the specific content of former and current professional self-regulation falls neatly within the economist's catalog of anticompetitive practices: entry restrictions that protect incumbents against new competition; market-division strategies that limit the competition of lawyers with one another, and restraints on price and service.").

191. *See* Martin Gottlieb, *Picking a Health Plan: A Shot in the Dark*, N.Y. TIMES, Jan. 14, 1996, at 3:1 ("Choosing a health plan is a personal matter, and personal needs vary. While quality, in terms of well-thought-of doctors and hospitals, might seem the primary consideration, it isn't always. Young people, who are less concerned about getting sick, usually cast a much harder eye on price. So do poorer people."); *See also* Ira Mark Ellman & Mark A. Hall, *Redefining the Terms of Health Insurance to Accommodate Varying Consumer Risk Preferences*, 20 AM. J.L. & MED. 187, 188 (1994) (widely differing preferences for coverage, health insurance should offer range of choices so consumers can pick Cadillac care, Buick care or Chevrolet care).

192. Professor Deborah Rhode made this point nicely: "No matter how well intentioned . . . no vocational group is well situated to pass judgment on matters that directly implicate its own economic interests, social status, and self image." Professor Deborah Rhode, *quoted in* Ramos, *supra* note 70, at 2598. *See also supra* note 190; Silver

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As the history of the margarine wars makes clear, although the citizenry and profession may embrace an existing product or service and view it as the appropriate baseline, it is by no means inevitable that it remain so. Indeed, persistent price differences can result in a paradigm shift toward a quite different cost/quality mix, even when there is stiff resistance from providers, and even for something as close to the emotional bread basket as our daily spread.[193]

The empirical evidence on butter and margarine is quite clear on this point. The process for manufacturing margarine was discovered in the late 1860s, while butter has been used for centuries.[194] Starting from a baseline of 0, margarine rapidly eclipsed butter in sales.[195] Margarine currently outsells butter by more than 2:1—including all the butter that is used for cooking, where margarine is not an effective substitute—and notwithstanding the fact the U.S. government is a major purchaser of butter.[196] At the more subtle level of consumer expectations, when I was growing up, I never heard the word margarine—and I thought butter was spreadable and came into large pastel shaped packages. To this day, I refer to margarine as butter—to the continual amusement of my children, who regularly correct me.

To be sure, professional services are not butter. The stakes and informational asymmetries in professional service contracts are considerably higher, as are the risks of exploitation and the consequences of choosing wrongly. Even if the client-and-a-half or two-client models advanced by some of the panelists works well for the mine run of cases, it provides little help for those unfortunate plaintiffs where conflict actually materializes.

Such bad outcomes are unfortunate, but it does not follow that my fable should be disregarded. Generalization from anecdotal evidence of

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& Syverud, *supra* note 109, at 363 ("When lawyers control the amount of legal services insureds must buy, it is predictable that there will be a tendency to set the requirements too high.").

193. Doesn't every law review article include a reference to Thomas Kuhn? *See, e.g.*, Arthur Austin, *The Reliability of Citation Counts in Judgments on Promotion, Tenure, and Status*, 35 ARIZ. L. REV. 829, 833 n. 43(1993) (Kuhn used as a "boilerplate cite"). This article has also done its part (*see supra* note 107,) to maintain the citation hierarchy. Fred R. Shapiro, *The Most Cited Law Review Articles Revisited*, 71 CHI.-KENT. L. REV. 751, 759 (1996) ("runaway citation champion is R. H. Coase").

194. *See* Miller, *supra* note 187, at 101.

195. *See id.* at 111-12.

196. *See. id. See also* INFORMATION PLEASE ALMANAC 71 (49th ed. 1996) (In 1993, per capita consumption of butter was 4.5 pounds; per capita consumption of margarine 10.8 pounds.).

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bad outcomes is an occupational weakness of lawyers, legislators, and judges, but that path is strewn with expensive and misguided policies.[197] One should not reason from the non-zero incidence of shipwrecks to the conclusion that only certain kinds of "extra-safe" boats will in the future be allowed to leave the harbor. The number of boats which make it safely home without such precautions and the cost of prevention must be factored into the equation as well. A single-minded focus on the shipwreck numerator, without regard to the total fleet denominator and the marginal cost/marginal benefit trade-off inevitably results in "reforms" which price transportation beyond the pocketbook of many on the shore—leaving them to swim at greatly increased risk, or stay on the beach and entirely forego the gains from (admittedly risky) trade. Those who sell and operate "extra-safe" boats do quite well under such a system, but the rest of the population must pay higher prices for a different mix of services than they would have purchased voluntarily.

Ex ante, if the choice is between a pricey but ethically unconflicted lawyer and a cheap one with a variety of potential conflicts which may ripen into true conflict, some (perhaps most, if managed care is any guide) people will prefer to save on their insurance premiums and take their chances at the back end.[198] If things work out well, so much the better. If not, after-the-fact regrets are irrelevant so long as the services were not marketed under false pretenses. It is hard to view the alternative approach—which prices people at the margin out of the market for legal services entirely—as a success for ethical lawyering.[199] The result of our

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197. *See, e.g.*, Bert Black et. al., *Science and the Law in the Wake of Daubert: A New Search for Scientific Knowledge*, 72 TEX. L. REV. 715, 716 n.1 (1994) (collecting authority that attorneys and judges know little or nothing about scientific and statistical evidence); Maurice Rosenberg, *Federal Rules of Civil Procedure in Action: Assessing Their Impact*, 137 U. PA. L. REV. 2197 (1989) ("The tendency of legally-trained minds to prefer thinking to counting is legendary. So is the lawyer's preference for learning by watching for the vivid case rather than tabulating the mine-run cases. The problem is not that watching this case or that is useless. A dramatic case or anecdote may be more informative and more memorable than a tubful of printouts. But the rub is that good anecdotes do not care if they are not representative; they can be badly misleading if generalized.").

198. *See supra* note 191. *See also* Silver & Syverud, *supra* note 109, at 362-63 ("In all other contexts, people are free to buy less than a 'gold-plated' attorney; ...insureds ... may prefer to pay for less expensive lawyering, just as consumers of health insurance increasingly choose cost savings over unlimited expensive medical care.").

199. *See, e.g.*, John Siliciano, *Wealth, Equity, and the Unitary Malpractice Standard*, 77 VA. L. REV. 439, 486-87 (1991) ("Tort law instructs health care providers to treat the poor the same as the rich, but then blithely ignores the fundamental impact that resource scarcity and the provider's freedom to refuse care to the poor have on the efficacy of its

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current understanding of the Model Rules is restricted choice at a higher cost. When regulation like the Model Rules wipes out the lower priced spread, those who "cannot afford to buy dairy butter must eat their bread unbuttered."[200] Once the Model Rules are actually brought to market, we will see if people actually value them—and whether they are prepared to put their money where the profession's mouth is.[201]

CONCLUSION

Professor Cohen provides a meticulous assessment of the prospect for decreasing bad lawyer behavior through voluntary liability insurance. Many attorneys refuse to behave as Professor Cohen's model indicates they should, and vigorously resist the adoption of policies and procedures that appear, from a marketing and transactional cost perspective, to be in their economic self-interest.[202] Although it is possible such behavior may simply be a transitional issue, I suspect that the structural and psychological factors identified in Section IIB (including the well-known hard-headedness of lawyers) will have a continuing impact—and

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command. . . . By embracing the chimera of equality between the rich and the poor [the tort law] effectively disables health care providers from offering reasonable, low-cost care to large numbers of the medically indigent. Thus, through its adherence to the unitary ideal, tort law may end up killing the poor with an unthinking and misguided kindness.").

200. People v. Marx, 2 N.E. 29, 34 (N.Y. 1885).

201. If clients are actually concerned about exploitation, they will buy insurance which offers them only ethically pristine lawyers and they will voluntarily patronize the same. If not, even modest savings should suffice to reset the baseline. In this regard, I differ significantly from Professor Pepper. *See* Pepper, *supra* note 4, at 65-66 ("It would take a substantial savings to the economy to justify turning upside down the ordinary understanding of the underlying professional ethic.") Although professional responsibility scholars may feel that way, it is not at all clear that the rest of the population does, if one judges by their behavior with respect to health insurance. *See supra* note 191.

See also Cramton, *supra* note 71, at 550-51 ("A serious question, infrequently discussed, is whether the required preparation and its cost [for becoming a lawyer] are essential in all areas of law practice. Some types of routine client service, such as sales of residences, simple wills, and uncontested divorces, may not require lawyers who are as thoroughly educated and as costly as lawyers are today. If these and other areas are opened to competition from other service providers, a market test of price and quality would be provided."). *See also supra* note 182.

202. *See* Fortney, *supra* note 23, at 372-73 ("[P]eer review and other quality control measures distinguish a firm from its competitors. Commercially aggressive firms can use peer review in marketing. . . . In voluntarily instituting a partner review program, firms recognize that the merger of ethics and management sells in the legal marketplace.").

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malpractice insurers will not become more than marginal players in the field of attorney regulation.

Although the other panelists frame the dispute as one arising solely at the intersection of insurance law and professional responsibility, the problem goes far deeper than that. Judge Windeyer of the High Court of Australia once ruefully observed that law marches "with medicine but in the rear and limping a little."[203] Maybe it is time for that insight to be applied across the board to all matters of professional responsibility. For all the sophistication and subtlety of reasoning that has been demonstrated by those who participated in the AALS panel and others who have written in this area, we should consider the possibility that our customers really want less than we are offering them—perhaps a lot less. Maybe we should try offering it to them.

203. Mount Isa Mines, Ltd. v. Pusey, 125 C.L.R. 383, 395 (1970).

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TAKING PROFESSIONAL RISKS

*Robert E. Keeton**

If ever an estimate of risk is accurate, it happens to be so by chance.

That statement is a commonsense observation, expressed in a commonsense way. It uses each word in its ordinary meaning. It is my observation, my statement of my observation, my choice of words to express it, and my choice of meaning for each of the words I used. Of course, even though I can use words with any meanings I wish, if I do not explain my meanings to you, almost certainly each of you within the sound of my voice will misunderstand me to some extent. For one or more of my words, you will have a different meaning in mind.

I have stated the observation in words that I used in a commonsense ordinary way and not as legal jargon, and not with a meaning defined in any special usage. Other professional groups, as surely as professionals in law, often choose to use words with special meanings. They may make the choice at one moment in time and quite deliberately. Or, instead, the choice may occur gradually over time, by a developing custom among them.

Any group may, if they wish, when expressing what they conceive to be a new insight into the human condition and human relations, choose to invent a new word to signify their new concept. More often, however, they choose to use some familiar word or phrase but with new meaning. Sometimes they choose a word from one of the world's many languages other than English, or, influenced by the Norman tradition, from Law French. At other times they choose a plain English word or set of words to mean something other than their most common plain English meaning.

You can use your words to mean anything you wish them to mean. But you can never force others to understand them that way. I believe it is distinctly better, to help us communicate with each other, that we do our best to steer clear of special usages, or, next best, explain candidly and openly any special usage we are adopting. But it is not my purpose to convert you to that view, if you do not already hold it. In short, I am less interested in persuading you to use words my way than in asking you to consider the substantive thought I am trying to express in saying, as I did at the outset:

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* United States District Judge, District of Massachusetts; co-author, ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW (1988).

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If ever an estimate of risk is accurate, it happens to be so by chance.

The term "risk," as ordinarily used and understood among non-specialists in our society, is a blend of what we think we know and what we know we do not know. It is a blend of human perception as fact and conception about uncertainties of the future. "Risk" in this commonsense meaning is an extraordinarily useful tool for planning and managing, if we use it wisely, with good judgment. If misunderstood or misused, however, it can lead to consequences more disastrous than if we had never intervened with our effort to think about "risk" and about "Taking Professional Risks."

The risk of disastrous consequences from unwise interventions has existed from the dawn of any relationship among human beings on planet Earth that might deserve the accolade of being called a "civilization," by which I mean a structure for getting along with each other by means other than the exercise of, or credible threat to exercise, raw power.

As populations have increased over the centuries, the complexities of social, cultural, political, and economic relationships have increased, and after some intervening times during which, as we look back, we may believe the lot of humanity as a whole was improving, we have come in the 20th century to a time when most observers agree that problems are outrunning solutions. In other words, the difficulties of working out social, cultural, political and economic plans and practices for living together in at least moderate harmony seem to be outrunning advances of science and social science toward producing enough more services and goods, tangible and intangible, on planet Earth to enable everybody to have a better life.

Perceived shortages of services and goods, tangible and intangible, produce conflicts of interest. Thus we have arrived at a time of deeper conflict of interest than ever before among geographically dispersed peoples, among all kinds of groupings within each nation, and in our distinctive American version of federalism, among national, state, and local interests. A wise assessment today of the risks we can rationally predict is that the development of new and more problematic conflicts of interests will continue as far ahead as we can predict, and indeed, the pace of change is likely to quicken.

We cannot have any confidence that we are prescribing wisely for the professional conflicts of interest that we perceive today without thinking about this larger context of new and more problematic conflicts of interests in our local communities, our state, our nation, and our world.

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Already, in the latter decades of the 20th century, we have come to something close to consensus that the ways we addressed, or chose just not to intervene to address, professional conflicts of interest we perceived in mid-century are not adequate today and will surely be farther short of adequate in the future. Someone, some privately organized or publicly organized group, or some governmental entity, or some combination of all of these, must take on more responsibility for doing something.

My belief is that our most promising prospects for managing and reducing the risks of adverse consequences from clashing interests lie in turning our energies to developing the *familiar* concept of *professionalism*, but in *new dimensions*. One of the lessons of our experience in the decades since mid-century is that whenever the public interest commitment of professionals wanes, the calls for governmental intrusions of various kinds increase. That point applies to all kinds of intrusions—legislative, administrative, and judicial, local, state, and national. Conversely, whenever public interest commitment of professionals becomes more manifest and genuine, governmental intrusions become less likely.

I suppose that what I have said up to this point is less difficult to sell to an audience such as this one than is any prescription for concrete action. What to do is the tough question, even if we can come close to consensus about the depth and nature of the problem.

In the remaining few minutes, I propose not a choice about details of a prescribed course of action, but only some preliminary and tentative guidelines about direction. I do so with the hope that if we could develop something closer to consensus on these more generalized statements of objective, and if we will focus energies on testing more specific proposals for action against guidelines such as these, we might come to some marked improvements in the actions we take.

The complex issues we are discussing today are, I believe, no more complex than those I have had to consider as a trial judge in recent years in litigation regarding application of federal and state legislation with respect to hazardous waste disposal.

Almost inevitably, though without resistance on my part, I bring to this set of problems today, as I was required to bring to that set of problems, the perspective of a federal trial judge. The constitutional structure allocating authority and responsibility among the branches of state and national governments in the United States places responsibility on courts to decide cases filed before them that present issues of law and fact within the scope of their jurisdiction. A court is not permitted the luxury of declining to decide because the material issues are so complex that any decision will

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be extraordinarily difficult and inevitably controversial. For controversies within the scope of their jurisdiction, courts are the place of last resort for persons or entities who have conflicts of interest that no other governmental institution can be moved to resolve by taking decisive action within the scope of its constitutional authority.

Increasingly, as economic, social, and personal relationships become more complex, clashes of interest produce controversies far more complex than paradigm tort, contract, and property controversies that constituted the regular fare of court dockets historically and well into the 20th century. A perceptive scholar, commenting recently on responses of various institutions and professionals to the reality of extreme complexity in a significant percentage of current controversies, remarked:

> Restricting one's attention to particular aspects of reality reduces complexity, making it possible to solve problems that otherwise would boggle the mind. The disadvantage in restricting one's attention, however, is that it often screens out important aspects and leads the analyst to the wrong conclusion.[1]

On the types of disputes and conflicts we are discussing today, no less than in relation to hazardous waste disposal or other complex litigation brought before federal trial judges in the 1990s, two points are worth noting. First, other decisionmakers, as well as commentators, may choose the course of adopting hypothetically simplifying assumptions as they discuss and write about present and future manifestations of any particularly complex problem. Second, to decide the cases that are before them, and are within the scope of their jurisdiction, courts are not permitted that choice. To decide cases, they must address the realities regardless of complexity, and declare outcomes despite conflicting positions, for each of which reasonable arguments can be advanced by professionals responsibly representing their clients.

Interests in clarity and candor about grounds for judicial decision of cases before the courts make a compelling case for acknowledging that thoughtful studies of various analytically separable parts of a complex problem can be very useful, but they are never enough to tell us how to decide what to do. Somewhere, somehow, sometime, somebody must focus on what to do beyond thinking seriously about the complex problem.

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1. Lynn M. LoPucki, *The Systems Approach to Law*, 82 CORNELL L. REV. 479, 480 (1997).

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It is not likely anyone should hope to be able to fashion alone a good answer about what to do. That is a task for teamwork, a task on which we must work together. The imagery of triangular relationships is helpful, but explains only part of the problem. The imagery of one client and two client models is helpful, but explains only part of the problem. The focus on flat fees and roles of a staff attorney is helpful, but captures only part of the problem. The focus on malpractice insurance and the adverse consequences that focus reveals is helpful, but captures only part of the problem.

I believe it is time to start doing something, together, about the problems of extraordinarily complex conflicts of interest arising out of liability insurance relationships, as they reach new dimensions of complexity and significance because of outside-the-law changes of this decade, which may be expected to continue with perhaps accelerated pace.

We need to develop a culture and practice of respect that fosters mutual cooperation. To help us work toward that goal, I propose that we try to develop, together, a unifying presumptive rule of mutual respect for the interests of all parties whose interests are likely to be affected by one's conduct in a context of multi-party conflicts of interest.

By a presumptive rule I mean one that is rebuttable, but imposes a burden of persuasion to rebut the applicability of the presumptive rule. If the burden of rebuttal is not satisfied by one of the persons (or entities) in the complex liability insurance defense relationship, then that party loses its effort to shift all responsibility to others and is legally responsible for any harm of which its acting in its own best interests is a cause in fact, under what I will call in shorthand, for convenience of communication, a tailored-multiple-cause-in-fact rule.

The objective of this proposal for a unifying presumptive rule of mutual responsibility is to create incentives for mutual respect in practice. We can accomplish more, I believe, by practical incentives, to behave, in the pursuit of self-interest, in the way we conceive to be in the public interest, than by threatening harmful consequences for not behaving that way.

A threat is no more effective than perceptions about its credibility make it. An offered benefit, on condition of engaging in the desired conduct, ordinarily is a more promising method of influencing human behavior than is a threat of harm. The aim, then, is to capitalize on the power of beneficial incentives instead of relying mostly on threats as incentives.

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I believe in the legal system's capacity to grow and adapt itself to meet society's needs for legal support for good solutions for society's most pressing problems. The legal system cannot do it all alone. But neither can other institutions without support in the legal system.

Ever the optimist, I believe in the legal system and in what we can accomplish, working together, under a government of law.

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PETER SEXTON*

Thanks for allowing me to comment on these papers. Reading this work and preparing for this Symposium was quite enlightening and informative.

I will comment on each one of the papers in order, starting with Professor Baker's piece. I found his paper quite interesting in that it provides a fuller understanding of what the various relationships are in the insurance defense context. Moreover, by adding the plaintiff into the analysis—which goes a long way to explain the dynamics of the insurance defense relationship—he is able to correctly point out that the dynamics can be quite complicated. Not only are plaintiffs involved, but also the plaintiff's lawyer. I think it is a good piece of work and it extends the thinking on the various relationships. I also agree with Professor Baker and Professor Silver on the debate over whether the defense counsel has one or two clients.

I think the dual client approach, for a lot of reasons, works better. Since I work for an insurance company, I may be able to provide some insight into the more practical aspects as to why the dual client approach is the better view. I think it serves all the stakeholders' purposes well, including the insureds. At the end of the day, if insurers are considered a client, they will be better able to manage the overall litigation, including defense costs. Insurers are in the business of managing litigation and legal

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expenses, and they have gotten very good at it. If insurers are allowed to be more of a partner—a client—I think that the overall litigation and defense costs will be managed more effectively.

This is flowing a little into commenting on Professor Pepper's work, but if I have any criticism of the general discussion around the insurance defense relationship, it is that there may not be enough of an appreciation for the amount of law that has developed around the tripartite relationship. This law goes a long way in protecting the insureds from the various bad deeds of the insurer. Moreover, there is a whole body of law on bad faith that addresses the concerns related to insurers acting in good faith, especially in instances involving coverage issues or coverage beyond policy limits. If insurers do not behave appropriately, they face the potential of a bad faith action. This provides insured with significant protections.

Getting back to Baker's paper, the process he goes through in the hypotheticals is helpful, and I mostly agree with his outcomes. With regard to the softball case Professor Baker diagramed on the board just now, it is probably the toughest situation for defense counsel. If I understand the hypothetical correctly, the defense counsel gets a piece of information, which if supplied to the insurer, could defeat coverage. I actually do not think this situation comes up very often, and I don't think it is a big concern in the grand scheme of insurance defense work. Nevertheless, there is way to address this situation. It is the claim adjuster's responsibility to uncover any information to defeat coverage. The defense lawyer does not necessarily have to comment on or forward such information. It does not go to the issue of liability. I agree that passing on such information could negatively impact the insured. If the defense attorney withdraws, that creates a problem and raises a red flag. It will be asked, "Why did you withdraw?" The lawyer is not going to answer that question and further investigation will then take place. So I believe that in this case, it may be better for the attorney to remain silent. When push comes to shove, the primary client concept should probably prevail—"do no harm to the insured."

My overall view of Professor Baker's work is that it does a lot to complete the picture of the various tensions back and forth between all of the parties.

I found Professor Pepper's article to be informative, especially since I am not an expert on legal ethics and professional responsibility rules. One observation I have, however, is Professor Pepper's statement that most insurers do not take the view that there is a dual client. Speaking for one insurer, I can tell you that is not the case. I also think I am speaking for many insurers. During the ongoing debate over Section 215 of the

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Restatement of the Law Governing Lawyers, I have had a number of discussions with other insurers, and I can confirm that there is consensus within the insurance industry around the dual client model. Though there may not be a consensus among insurance defense lawyers, I think that the insurance industry lawyers view the dual client model as the better approach. Again, this gets back to the practical reality that insurers are well equipped to manage litigation; control defense costs; and minimize indemnification payments. This ultimately keeps premiums down, and thus, ultimately serves the purposes of all insureds.

The other point I want to make, and again, I am not a professional responsibility expert, but my reading of [Model Rules of Professional Conduct] Rule 1.7b is that informed consent on all issues and all potential conflicts does not have to obtained prior to the creation of the lawyer/client relationship. There are plenty of opportunities along the road to deal with specific conflicts as they arise. The potential for conflicts, such as potential coverage issues or excess coverage, does not always require informed consent upon the creation of the relationship. Again, I do not think these conflicts come up that often, and when they do become a significant risk, there is an opportunity for the lawyer to step in and provide the necessary informed consent. The relationship can be created and the issue of informed consent can be dealt with appropriately when it ripens.

With regard to Professor Silver's paper, it is a fine piece and I fully agree with his view of the *AIA v. Kentucky State Bar* decision. Several years ago when I worked for Aetna, there were efforts to explore alternative fee arrangements, including flat fees. The thinking was that the hourly billing paradigm should not be the only arrangement that exists. In many instances hourly billing creates incentives for defense counsel that may not be aligned with the client's interests. If this is the case, then maybe there are ways to restructure the fee payment scheme to better align the interests of the parties. In general, I think it is simply determining how the lawyer is going to get paid. I do not understand why this alone should raise professional responsibility issues. Thus, I think the Kentucky Supreme Court was wrong.

Moreover, there are ways to make alternative fee arrangements that are a win-win for all parties. Fee arrangements can be structured in ways that allow defense counsel to do very well. Often, the defense counsel just needs to work smarter. For example, if they get a flat fee of $3,000 per auto case, they may be able to do much better than under a traditional hourly arrangement. However, they need to figure out ways to work efficiently and also get good results. If defense counsel does not get the results, they will not be retained for very long. Insurers closely monitor payout, so they have to provide quality results. However, if they deliver,

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they can do well—sometimes very well, especially when fee arrangements include bonuses.

I also do not understand or agree with the Court's decision on prohibiting staff counsel. I concur with Professor Silver that issues such as the inherent conflict can be handled and that such issues are similar to what faces panel counsel. Moreover, if the analysis of the issue of control over staff counsel is extended, it might also apply to all in-house counsel. Does this mean that there is inappropriate control over all in-house counsel? I am an in-house lawyer and I do not think so. I meet the same ethical restrictions and professional obligations that other lawyers must meet. Staff counsel is no different.

As an aside and following up on the comment on how long staff counsel has been around, I can tell you that Travelers had its 100th year anniversary of staff counsel in 1994.

The Kentucky Supreme Court's holding on unauthorized practice of law by staff counsel is unfounded. The insurer certainly has a financial stake in these cases. The insurer's indemnity dollars are at risk, along with the defense obligation. In the lion's share of the cases, the insurer has the entire interest at stake because it is paying everything—indemnity and defense. I suspect that many of the attacks on staff counsel are reactions from certain segments of the insurance defense bar to the significant shift of work from defense firms to staff counsel. Professor Silver is right when he points out that staff counsel is growing. Travelers now has 450 staff counsel lawyers and that number is growing. For a lot of the work, not all of it, there is a real financial advantage associated with staff counsel. I think we are seeing a reaction to this trend from some within the defense bar. I agree with Professor Silver's observation that "[P]rofessional ethics rules make perfect smart bombs. They apply only to lawyers. Consequently, disgruntled defense lawyers can use them against staff attorneys without seeming to be anti-insurer."

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PETER NOLIN*

I will try to bring some more practical grounding to the discussion of whether a defense attorney represents both the insurer and the insured. Having been in the trenches, I can say that I have never viewed myself as having two clients. I have always been told by insurers and have assumed myself, that I only had one client—the insured. The caveat everybody seems to overlook is that you take that one client relationship with an agreement, and I have always told my clients this, that the client and his defense counsel have a duty to tell the insurer everything. If you follow that model it all works and a lot of these perceived problems go away. The client accepts the representation on an agreement that defense counsel is going to share information with the insurer under the client's duty of cooperation with the insurer.

With this understanding, I am not really sure there is any conflict between the insurance law or the ethical rules. It all works—even the baseball example—in real practice. You have raised an issue where defense counsel knows that there are two witnesses who will say the harm was caused by an intentional act. Well, so what! If counsel tells the insurer and the insurer does not then put the insured on notice that there is a potential conflict, it remains a situation where the insurer and the insured go on together and defend the case.

If the insurance company puts the insured on notice that there might be a conflict, they also warn the insured of his right to get separate counsel. But that fact is not going to change the defense. The defense counsel that has been hired by the insurer is not going to defend the negligence claim by asserting that it was an intentional act because that defense would violate the insurer's duty of good faith. It is just never going to happen. Insurance defense counsel will continue to defend the insured as fully as possible as to all the claims. It all works for both sides. So, I think the modeling, while intellectually very interesting, does not reflect the real world. And frankly, I just do not know how a defense counsel is going to face judges saying he has two clients. Judges will pound on you, as it was pounded on me here at the University of Connecticut when I went to school a long time ago, that your client is the person for whom you are putting in your appearance, not the insurance company. That is the undertaking that the insured expects; that he is getting his own counsel from the insurance company.

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In terms of the notion of what defense counsel has been retained for, Professor Baker's onto it: you are only retained to defend against that claim. You are not there to defend against anything else and you are not there to represent the insured on bad faith claims. When the insured comes to you and says "Gee, what do I do? Do I have a claim against my insurer, do I need separate counsel?" I usually tell them to go talk to private counsel about whether they have those claims or need separate counsel. Defense counsel should not be advising the insured on his rights to sue the insurer. On most conflicting claims insurers will tell the insured the same thing—get private counsel. If the insurer has any doubt about a coverage issue, they have already given notice to the insured. The conflict issue raised by a coverage dispute is just as much on the insurer and they are usually much more aggressive about disclosing potential conflicts than is counsel.

You also have to remember that defense counsel may not know everything because most insurer's are scrupulous about *not* telling defense counsel about potential issues that will undermine coverage because that leads to bad faith claims down the road. If the insurer poisoned the well by telling the defense counsel that a particular fact might be a basis on which the insurer can get out of coverage on a claim of intentional tort, the insurer would be setting up the future bad faith claim. So, it really does not happen that way. Most insurers do not to tell the defense counsel of potential issues that will undermine coverage. Frankly, I do not see the problem of defense counsel having a conflict between the insurer and insured arising as often as people seem to be suggesting.

In terms of the issue of flat fees and staff counsel, I am going to stay away from that one because it is more of an internal insurer issue than an external issue for outside defense counsel. But, I will note that at least one plaintiff's counsel has remarked that from his point of view, he thinks it is curious that when insurance companies get sued in their own name, they go to New York and hire a lawyer for $500.00 per hour to defend them. But when the insurer is representing somebody in a third party situation such as on an auto accident case, they hire staff counsel on a flat fee or pay defense counsel $100.00 per hour. So, you may add to the list of potential attacks on the flat fee/staff counsel situation that somewhere down the road plaintiffs' attorneys are going to use it as a claim of bad faith or an appearance of impropriety. I only heard it in a joking setting, but there is no telling where the imagination of the plaintiffs' bar will lead when it comes to bad faith claims.

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DAVID HYMAN*

I want to start by thanking the organizers for inviting me to participate and Tom Baker for putting me where he did in the program. When we did this in Washington, I was the last presenter at the last session on the last day of the conference with some predictable consequences on the size and interest of the audience. Now, I guess I'm all that's between you and lunch, which isn't perfect, but it's still an improvement. Actually, on another note, when we did this in Washington, D.C., Charlie Silver started off by saying he felt kind of beleaguered because Steve Pepper, representing the forces of professional responsibility, beat up on him from one side and Bob Jerry and Tom Baker, representing insurance law, beat up on him from the other side. As if that wasn't enough, I was ungracious enough to shoot him in the back for not going far enough. I wrote him later and told him it was nothing personal—an old saying among the insurance mafia—it was because he was standing between me and the people I really wanted to hit. I'll spend a little time talking about that problem today.

To oversimplify grossly, the rules of professional responsibility start from a default position which is really a modification of the Texas Ranger rule: one riot, one ranger, one client, one lawyer. Now, the rules obviously accommodate considerably more than that, but the default position nonetheless casts a long shadow, especially when insurance companies are involved. Matters are complicated by the pluralization of both the lawyer side and client side, not to mention third parties. It's also important to note that insurers are present in and fund the overwhelming majority of civil litigation in this country.

The debate here has crystallized around "who is the client" and "how many clients are there" when the insurance company is paying the bills.

It's rather like the classic Abbott and Costello "Who's On First" routine, except here it's "Who's The Client"? and "How Many Clients Are There—one or two?" Can you actually answer those questions without looking at the insurance contract or other specifics of the retention agreement? If the insurer is not a client, why does he get to control the defense? If the insurer is a client, are its interests coequal or subordinate? How do you pay the retained lawyer is a subject of considerable interest to those of you on the defense bar side. The answers to all of these questions have implications, both for the day-to-day practical issues of handling the defense, such as communication, control and settlement, but also for handling any conflicts that materialize. We have focused here on conflicts,

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but I think it's important to acknowledge the communication, control and settlement issues need to be considered as well.

I divide this dispute up into three separate wars: 1) turf war, 2) temporal war, 3) war over immutability. The turf war is about whether professional responsibility law or insurance law is going to end up writing the rules in this area.

More subtly, I think it's also a temporal dispute because the question really is: "Are the terms decided when you enter into an insurance contract, are they decided when the insurance company retains the lawyer or are they decided at the time an actual conflict materializes?" At bottom though I think it's really an immutability question. Are the rules of professional responsibility and the particular ones we're speaking of today, simply default provisions or are they a mandatory minimum? Now a lot of trees have been killed during this battle but the battle is actually relatively minor. The battle essentially assumes the integrity and necessity of most of the rules of professional responsibility, and instead has a skirmish on whether or not insurance contracts can constitute an ex-ante waiver under Model Rule 1.7 for certain limited circumstances. There are lots of rules which are not placed in issue by that discussion including the nonwaivable rules of competence, diligence and communication as well as the broader scope of conflict of interest rules, confidentiality rules and the limited representation rules.

All of these rules are perfectly sensible sounding. There's nothing about them that strikes you odd. But, they're not the only alternative and in fact, there are no compelling reasons to treat them as such. As an empirical basis for that argument, I offer medicine in my article as a counter-example where these sensible rules of professional responsibility were accepted and widespread until quite recently. The article provides a review of the changes in the medical marketplace and corresponding modifications in the rules of medical ethics up to and including the attempts to deal with the move of the market to managed care—a subject I don't have to tell people about in Hartford. In brief, the changes in the last decade in the organizational forms through which health care is delivered have been reflected in changes in how physicians and ethicists thought about and handled conflicts of interest. The patient centered ethic which reached its zenith under fee-for-service practice still remains the centerpiece of professional self definition. But that ethic has been significantly tempered by considerations of the common pool and the societal interest at stake; too much for some people and not enough for others. Things have moved so far and fast that there's a backlash brewing, consisting largely of self-style consumer protection laws. Even with the backlash, physicians practice in an environment that was inconceivable as recently as a decade ago, and the

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cost/quality equilibrium has moved a long way from that which was the rule during the golden age of fee-for-service medicine. Doctors don't like that much. Some patients don't like that much either, and there are lots of bitter jokes and cartoons about managed care as a result. I've got about 50 slides I could show you of complaints about managed care and editorial pages but I'll offer just one joke to give you the flavor of the debate: "What's the difference between HMO's and terrorists? At least you can negotiate with terrorists."

Lest you think that the changes in clinical medical ethics are a one time event or that the backlash demonstrates what happens to a profession when it abandons a client-centered ethic, the paper offers a slightly different example, that of clinical research ethics. I'm going to spend a few minutes talking about that because it's a nice example. Clinical research can readily conflict with the physician's obligation to the patient. Despite the fundamental conflict, the value of such research is sufficiently recognized that it is performed routinely in every academic medical center, and is heavily subsidized. There are longstanding prophylactic rules which attempt to insure patient protection, but even the most fundamental prophylactic rules have been modified or for that matter, eliminated when they became inadequately reflective of the interest of current and future patients. The article describes the issue in the context of informed consent to emergency research but a more recent controversy, that blossomed in the last month issustrates the issue as well. The New England Journal of Medicine published a Sounding Board and an editorial about whether it was ethical to do placebo-controlled trials of drugs for the treatment of HIV-positive pregnant women in Africa. The reason why the use of placebos was controversial is because there's an accepted regimen for the treatment of HIV-positive pregnant women which is AZT. The problem with AZT is that it's very expensive. The placebo-controlled trials were to determine whether you could come up something that was better than nothing but still cheap. The editorial said flatly that the research was unethical, and violated a series of national and international codes and was essentially identical to the infamous Tuskeegee experiment. Two weeks later, the New England Journal of Medicine printed a response by the heads of the National Institute of Health and The Center for Disease Control, defending the research on the grounds that treatment with AZT was simply unaffordable for third world countries. Yesterday's New York Times reported that two of the three AIDS experts on the Board of The New England Journal of Medicine resigned to protest the editorial and the fact that they had not been consulted about it.

These events can be read at two levels: First, the basic inability of the editors of The New England Journal of Medicine to understand that

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scarcity acts as a constraint on the exercise of free will by all involved. It's a position the New England Journal of Medicine has effectively adhered to for a long time. In addition, the fact that the research got by a whole series of review boards and is government-funded, and everyone involved wanted to defend it, I think makes it clear that we're seeing a fairly explicit rewriting of the ethics rules to accommodate the economic realities. That's not to say that everything is up for grabs. Changes in the standards are controversial but changed they were.

What do I take from that? First, the default rules in medicine were different than they were in law and second, those default rules changed significantly, in the direction of, but well past the changes advocated by Professors Silver and Syverud. The implications for the legal profession are straightforward, albeit unwelcome. The positions of the Model Rules and the piece-work mechanism of compensation on which those positions are built, are not inevitable. Second, the purpose of the Model Rules is not the entrenchment of the profession or individual member of the profession's preferred manner of doing business. If you treat them that way, the profession has gone astray from its avowed public purpose. To its credit, I think the legal community is in the process of figuring that point out and the recent move toward the unbundling of legal services is a significant step in that direction.

Let me close with a fable. Narrative is very "in" these days. Admittedly, most of my co-panelists have heard the fable already, so I hope none of them will spoil the punch line or the moral.

Once upon a time in a Republic not far away, there was a product known as FB and any similarity of FB to fee-based medicine or law practiced under a strict version of the model rules is purely coincidental. The makers of FB were diligent and hard working and proud of their product, since they were convinced it enhanced the health and welfare of the population, was no more expensive that it needed to be (given its excellent quality), and was better than the FB available in the surrounding republics and kingdoms. People came from other lands to study FB and learn how to manufacture it the right way. Centers of excellence grew up where FB was perceived to be exceptionally fine—the costs correlating directly with perceived quality. The makers of FB formed an organization "FB's Friends" or "FBF" to advance the public interest in having more and better FB available. Again, any similarity of FBF to organizations with the acronym ABA and AMA is purely coincidental. The first thing FBF did was to encourage the government to license its members. Licensing increased the cost of FB so FBF had to persuade the government to purchase lots of FB and sometimes give it away free to those that needed it but could no longer afford it. FBF had aggressive advertising and lobbying

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campaigns which persuaded everybody that the makers of FB were looking after the best interests of the public by providing high quality of FB at a high price. The net result was that FB became identified as a basic part of every day expectations about civilized life, even as its costs spiraled upward.

To be sure, there were some quality issues with FB. Even in a government-enforced cartel it was hard to enforce uniform standards of quality. Mandates and restrictive licensing, however helped to make it exceedingly difficult to offer low quality, but also low-priced FB. The makers of FB prospered mightily and made substantial campaign contributions to the elected representatives—this is more relevant now than when I first told this—who had insured them a quiet and lucrative lifestyle in a government-run cartel. The citizenry rejoiced because they had been protected from from knaves and profiteers and there was plenty of high quality of FB for those who had the money to buy it.

Those who could no longer afford FB, were at least reassured that high quality standards were being maintained. If and when they could afford FB, they knew it would be high quality. All was well in the Republic until a cloud arose on the horizon. Some dangerous crackpot had developed a competing product called "M." "M" appeared to offer a similar product to FB but at a far lower cost. Any similarity of "M" to managed care or a loose interpretation of the rules of professional responsibility is purely coincidental. The providers of FB insisted that "M" was not similar, but far inferior.

But the price difference was big enough that FB started hemorrhaging market share, especially when the biggest purchasers of FB decided that M was good enough.

This competition made clear that the citizenry liked FB but they liked lots of other things as well and a cheaper product which offered a reasonable substitute allowed them to spend the money they saved by not buying FB on things they wanted more than FB. The makers of FB were devastated they had lost their place in the hearts and minds of the citizenry, and decided if they couldn't compete on price they would try to insure that the market competed only on quality. The first thing they did was to persuade the legislature to pass laws requiring standardized labeling, on the theory that people were being snookered by buying M when thinking they were getting FB. The labeling had the incidental benefit of making it harder to market M as well. Unfortunately for the makers of FB, the price differential was big enough that people, even in the face of such labeling, continued to buy M.

The next step was to target M with burdensome regulations, which left FB unhindered. Those who had made M had to put prominent labels on

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their product which described its hazards. The government also prohibited the use of certain processes used to make M. M's manufacturers fought these burdensome regulations and succeeded in defeating some, except in states where FB was dominant. Even burdened with these regulations, the price differential was so large that M continued to gain market share. Frustrated by their inability to get the market to run on quality rather than cost, the makers of FB decided to erase the price difference by taxing M up to the level of FB. They were confident once price equilibration was reached, people would start buying FB again. After all, everybody loved FB. They succeeded in erasing most, but not all, of the price differential. Remarkably enough, even a modest price difference was sufficient for people to continue to buy M.

Despite the similarity of the fable to the current medical and legal marketplace, FB is fresh butter and M is margarine. The dairy farmers persuaded the federal and state governments to do all the things I just described. The margarine wars started in 1870 and lasted at the federal level until 1950. Wisconsin did not repeal its margarine statute until 1967.

What's the moral? The obvious moral is that providers prefer to take costs off the table and compete on quality—and much of the conduct of professional organizations is understandable in light of that observation. Second, consumer preferences are heterogeneous but cost is an important issue, even for professional services. Third, one should be cautious about generating a normative baseline for the cost/quality mix of professional services based solely or largely on the assessment of the affected professionals. Given their track record, professional pronouncements on the necessary level of quality should be viewed with a jaundiced eye.

Obviously, professional services are not butter. The stakes and informational asymmetries are considerably higher. There are also risks of exploitation and the consequences of choosing wrongly are significantly more severe. Even if the one-client or two-client model works okay most of the time, it's not clear that it's a good solution when conflict actually materializes. As Professor Stephen Pepper has already pointed out, you end up with a lawyer who will stab you in the back when you need him the most.

Such outcomes are unfortunate but it doesn't follow that you should disregard my fable. Lawyers and judges love to generalize from anecdotal evidence but that's a bad strategy. You don't reason from the nonzero incidence of shipwrecks to the conclusion that only certain kinds of extra safe boats should be allowed to leave the harbor.

The number of boats which make it home safely without such preparations and the cost of prevention have to be factored in as well. A single-minded focus on a shipwreck numerator without regard to the total

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fleet denominator and the marginal cost benefit tradeoffs results in reforms which price protection beyond the reach of most of the market participants and leaves them on shore either to swim at greatly increased risk or stay on the beach and forego the gains from what is admittedly risky trade. Those who sell and operate extra safe boats do quite well under such a system but the rest of the population pays higher prices for a different mix of services than they would have purchased voluntarily.

As Steve observed, if this system is bad, what are you going to replace it with? Richard Epstein likes to say, "It takes a theory to beat a theory." Unlike Steve, I think the market works and does so quite ruthlessly. There are plenty of market imperfections, but the practical question is should we liberalize the rules of professional responsibility to reflect the fact that clients do not place quality of services on nearly the same elevated plateau that lawyers do. When regulation like the Model Rules wipes out the lower-priced spread, those who cannot afford dairy butter must eat their bread unbuttered. If we bring the Model Rules to market, we'll see if people actually value them and whether they're prepared to put their money where the profession's mouth is—and has been. For all the hard work that's been done in this area, we should consider the possibility that our customers actually want less than we are offering them—maybe a lot less. We should try offering it to them.

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JOHN TENER*

Good afternoon. Thank you very much. I'm here to present what is to me an important issue since I practice primarily in the first party insurance area. A whole new dimension of potential conflicts exist there, not in the context of the tripartite relationship, but as between the interests of an insurance company and I, as its agent, seeking to protect it on the one hand, and also fulfilling its and my duties to insureds under the obligations of good faith and fair dealing.

By way of some preliminary assumptions, I first want to emphasize this discussion is about first party insurance policies. Second, I'm assuming the insurer is a fiduciary; that is not necessarily an assumption that can go unchallenged, but for purposes of analysis and the effective role both of the insurer in a first party case as well as its counsel, it makes a much more timely and more prudent analysis. (That is not to say that in all or even most cases, the courts have yet concluded that in a first party context, an insurance company is a fiduciary.) Third, I will not deal with significant other ethical obligations of lawyers, particularly in the litigation context; in real life one cannot ignore these other obligations, especially a lawyer's obligations as an officer of the court and to the court and the judicial process.

Finally, and picking up as other speakers already have, and at the risk of running afoul of Judge Keeton's quite proper observation about oversimplification, there is a large risk of oversimplification here. I pose the dilemma in this way: the obligations of a lawyer both in zealously protecting the insurance company against the insured's claims while at the same time acting as an agent of an insurer-fiduciary, which requires placing the interest of the insured on the same or higher level as the insurer, in other words, wearing two hats, while acting as an attorney representing a first party insurer.

I begin with the Model Rules of Professional Conduct. I make no claim to having sought to include all the relevant rules and interpretations that may pertain in the various jurisdictions. The rule that is foremost for probably the majority of practitioners who fancy themselves as trial lawyers, is this: A lawyer shall represent a client zealously within the bounds of law. The comment to that rule includes this: "*Commitment and dedication to the interests of the client in zeal, in the advocacy on a client's behalf.*" These are standard rules one learns in law school and carries with oneself into the advocacy role. The comment to Rule 1.2 states that: "*A*

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lawyer is not required however to pursue objectives or employ means simply because a client may wish to do so."

Then the Rule becomes murkier. "*Where the client is a fiduciary, the lawyer may be charged with special obligations in dealing with a beneficiary.*" This, of course, presents fertile ground for further research, commentary, law review articles, seminars and symposiums. I will scratch the surface in this area; however, there is little reported authority beyond the already stated admonition that we lawyers may have special obligations. With reference to beneficiary, one could ask if it includes an insured under a first party insurance policy or merely the more traditional notion of a trust beneficiary. I submit that might be an unduly narrow approach to limit "beneficiary" to a trust beneficiary.

There are many pressures on insurance defense lawyers, as well as many temptations, not the least of which are economic pressures to zealously advocate for a client and to therefore maintain a client relationship. And it may be naïve for lawyers to speak of representing, in a third party context, insureds as "clients" when, in fact, if you asked them who their clients really are, they would acknowledge that it is "whoever pays my bill." Private lawyers might list the number of insurance companies they as lawyers typically represent, socialize with, send bills to and hope to nurture a relationship with that may last years. The point here is that it is a difficult concept for lawyers to divide one's obligations, especially in a first party context, when they so closely identify and work with the insurance company "client."

The following are some traditional and not-so-traditional interpretations of the duty of zealous advocacy in civil cases. (I distinguish these from those in criminal cases, which I believe involve a entirely different, though related, set of obligations for criminal defense lawyers. These include constitutional implications for lawyers' obligations.) In a civil context, one of the most revered notions holds that "*an advocate in the discharge of an advocate's duty knows but one person in all the world and that person is the advocate's client.*" This has a certain ring of Hollywood melodrama to it; it is what we probably as clients ourselves expect and indeed hope that our advocate/lawyer will serve our needs and *only* our needs, and certainly not with divided loyalties.

The next couple of quotes illustrating traditional notions of client advocacy require some context. These are quotes I drew out of *The Boston Globe* only three weeks ago as I was preparing this presentation. It involves a case that the *Globe* broke that alleges that lawyers in several prominent law firms in Boston had devised a scheme to tape record a former judge's young law clerk under the guise of interviewing him for a job. The lawyers suspected the judge of bias in a major, hotly contested

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fight over control of a high-profile Boston-area company. The taping took place, under the guise of a job interview, in two places—Nova Scotia and New York—places where, unlike Massachusetts, secret tape recordings are legal. These are some of the quotes from the lawyers or their advocates in defense of their tactics and legal ethics: *"There's no difference between a federal undercover operation and a private attorney's creating an undercover operation—no difference legally— no difference morally."*

Another quote, same article, same case: "*Nobody owns the truth. We lawyers are entitled to seek the truth. If a lawyer uses a ruse to get someone to put in a phony transmission, that's something the people feel is justified. A lawyer who is presented with evidence that a judge may be biased, is supposed to check that out.*" While these were not in an insurance context, they reflect, in part, what many lawyers view as their duty as a zealous advocate. Our adversarial system seems largely to presuppose that. The tension around ethical limitations, ethical restrictions and boundaries when representing a party that *itself* has restrictions, in part, is what this is all about.

The next example of sort of real life hurly-burly conflict involves an insurance company. Following is a partial transcript of the testimony of an insurance company claims representative in a first party case. (This was from the trial and came *after* the insurance company's trial counsel prepared this witness for testimony.) The questioning began:

> Is that your signature at the bottom of the letter?
> *I don't know—it might or might not be.*
> Does it resemble your signature?
> *Oh goodness, I write my name in a lot of different ways. I don't know if it can resemble it or not.*
> Can you read what it says in the cursive handwriting under the typed words Tony Hotsel?
> *I'm not sure.*
> Can you read what that says?
> *I don't know, it looks more like a hotel in the last word. I don't know.*
> Did you hear the female voice on the tape identify herself as Tony Hotsel?
> *Yes, I did.*
> Was that you?
> *I don't know.*
> Did you recognize your own voice?
> *No audible response.*
> On this tape?

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I don't know if it's my voice or not. I don't know how I sound to other people. I don't know.

This case involved an insurance company that, in the last six years, has had judgments against it for bad faith punitive damages in, among other amounts, $145 million, $100 million, and $20 million. One begins to wonder if there is not a company policy that suggests this is the way the company intends to conduct litigation; and if the company happens to pay a premium periodically, it's worth it because the company will still make plenty of profit. The real question however, for purposes of today, is: Where was the lawyer when this testimony was occurring? What ethical obligations does the lawyer have when that sort of testimony is occurring, and particularly if the lawyer believes it is going to occur? There are ethical obligations to the court, to be sure, but let's confine ourselves simply to the insurance company lawyer's obligations to counsel against this very sort of conduct.

I assume, as I presume you do too, that this is patently fraudulent testimony given to evade what clearly is a direct question about tape recordings as well as signatures.

Now shift the emphasis from the *lawyer's* ethical obligations in a first party context, to the *insurance company's* obligations of the duty of good faith and fair dealing. Most of us know it, and I assume most of the law students do too, but I will explain it quickly. Clearly an insurance company in a first party context must deal fairly with the insured.

I would highlight a distinction here between obligations of an insurance company in dealing with its insured with the obligation of a simple, if you will, commercial contractor in dealing with another commercial contractor in a commercial transaction.

First, it is not necessarily assumed that one is *required* to deal fairly in a commercial context. We learned in law school that one can always breach a contract if one is prepared to bear the consequences. Fairness therefore is not necessarily a relevant consideration in a commercial, non-insurance context. Many lawyers who practice in both insurance litigation and commercial litigation representing both insurance companies and non-insurance companies, have difficulty occasionally shifting their ethical roles and assuming the appropriate role accordingly.

Second, an insurance company must avoid coercive or abusive tactics, which seems obvious, but that is not so obvious if one is in non-insurance commercial litigation context.

Third, an insurance company must conduct an adequate investigation on behalf of the insured.

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Fourth, an insurance company must handle its claims in a timely manner; that is, it cannot footdrag. But can it footdrag once it is in court? Probably not. The point being, however, if it is not an insurance company, there may be a different set of rules.

Finally, and perhaps the most difficult point for a lawyer, an insurance company must provide accurate information and, while it is not so expressly stated, must be forthcoming on coverage information, even coverage information of the sort similar to that in a Brady Rule criminal context, which may indicate coverage when there is contest over coverage. And, insurance counsel has the same duty as an insurance company to provide that information to an adversary. That goes against the grain of many advocates, both instinctively and by our training. While we have long since passed the point of trial by ambush, there still remains some feeling, notwithstanding the recent Federal Rules adoption of early and full disclosure of one's case within an early timeframe. That is, full disclosure is not necessarily what lawyers are accustomed to as traditional advocates.

Also to be considered are some of the attributes of an insurance contract that implicate a lawyer's role in seeking to protect the insurance company in fulfilling its contractual obligations, *and* protecting the company at the same time when that contract makes it vulnerable to an insured's acts of bad faith.

First, the insured, in an insurance context, has an expectation of trust in and dependency on the insurer. That is not necessarily true or relevant in a strict, non-insurance commercial context.

Second, there is a public interest and a public oversight element to insurance contracts. Again, this is frequently absent in a non-insurance context.

Third, there is frequently an unequal bargaining power that comes into play in insurance, but not in all commercial cases, when a multi-national corporation has a commercial general liability policy for its worldwide operations. It typically can have vastly more assets than its insurer might.

Finally a fiduciary obligation on the part of the insurer exists which is absent in the context of strict commercial contracts.

So, what this presents for the lawyer representing an insurer fiduciary is the dilemma of knowing which role—frequently played at the same time—should the lawyer play? Is it the advocate protecting the insurance company or is it the agent of a fiduciary, putting the interests of the insured of the adversary equal to or even above those of the insurance company? As a trial lawyer, we are taught to seek solutions, resolve cases if it is an insurance matter, and even if not, seek a solution, have closure and move on.

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We wrestle with how one does that in the context of our dual roles. These very nice and interesting questions that have been raised of conflict and the dilemmas surrounding them do not admit to nice and easy solutions. We look to Tom Baker and the Insurance Law Center in the years to come, to develop some far reaching solutions by way of scholarly analysis (one of the reasons I applaud this wonderful opportunity to be here in the infancy of the insurance law emphasis at the Law School). This is a fertile area for much more critical, scholarly analysis.

Some guidelines the prudent lawyer might consider in dealing with these conflicts and dilemmas:

First, discuss the conflict with your insurer/client. Make sure the client is clear about what you deem to be your role. Do not assume it in my view. The insurer has to understand and should understand its own obligations of good faith but it also needs to understand the obligations a lawyer bears, both as an advocate and acting on behalf of the insurer.

Second, it is a good idea to regularly read and research the rules of professional responsibility. I am with a firm that has the whole panoply of inside loss control, including an active Ethics Committee, a sophisticated conflict checks system, and a loss prevention-oriented insurance company that audits much of how we practice law.

I think it is essential in matters of conflicts to talk to other lawyers. It is surprising to me, after all these years, that there are still ways of looking at these problems that I might not see, or misunderstand, or misinterpret. It truly is a matter, as Judge Keaton suggested, to treat as a matter for teamwork. This requires a collaborative, collective effort to work through these emerging problems.

Finally, I think one ought to follow what I call the Luke Skywalker rule. You will recall the last scene in the first movie Star Wars: Luke was flying directly at the death star. Missiles were coming at him. His computers were blinking madly, his shipmates were screaming at him and then the firm, convincing voice of Obi-Wan Kenobi came up and it said, "*Luke, trust your feelings. Use the force.*" I suggest to you that in matters of ethical complexity of the sort we have been discussing, it is well to trust your feelings. You might call it the smell test. One rule of thumb my partners often use is, "*How would it look on the front page of the* Hartford Courant *or* The Boston Globe?" Are you prepared to have this sort of conduct subjected to the bright light of day? A pet test for me over the years has been "*What would my kids think of me if I did this and they understood it?*" Now they are both in their 20's and wiser than I am; they are both a tremendous source for me of common wisdom and common sense.

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Each of us picks our own sage and own muse; eventually we hope the Law Center will be an additional source for more guidance.

Thank you very much.

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SUSAN LAWSHE*

My role this afternoon is really two-fold. First and foremost, I'm here to provide comments on George Cohen's article, which is an honor. Second, I'm here to give you my perspective as an underwriter of lawyer's professional liability insurance and hopefully open a window for you on the mind of insurance companies. I should explain that my observations are informed by my experience underwriting what I call large law firms—35 or more attorneys. In the insurance industry, that's a commonly accepted demarcation between large and small firms. In the market of large law firm professional liability insurance, real concern among firms and insurers is severity rather than frequency of claims, so that really what firms are worried about is not that they're going to be presented with six or eight or ten claims during the course of a year that will cost them $10,000-$15,000 to get rid of. The fear is that in the course of a year, when they least expect it, they're going to be hit with a $20,000,000 claim which bankrupts the firm. So, rather than worrying about marketing to new clients, they'll end up trying to sell the office furniture for the highest price. That type of fear is what drives the decision to buy professional liability insurance, and the severity issue is one that is particulary driving for large law firms because generally they have a highly sophisticated practice and sophisticated clients. They want to know that they're not out there all alone and in the event someone comes knocking on the door saying I want $20,000,000 right now, they've got someone they can pass that risk off to and they're not faced with figuring out how to close the doors.

I agree completely with George's point that loss prevention services are valuable in this particular market. Mutuals like ALAS believed that loss prevention had value and really started making those services available on a broad scale back in the late 70's or early 80's. ALAS began in 1979, so that is a demarcation point. The commercial market began following in their footsteps and firms apparently liked it and saw that it had value. But, the belief in the value of loss prevention really was an intuitive rather than scientific belief. Nobody actually knew if they were saving money, nor

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could they quantify how much money was being saved, but everybody figured loss prevention had to be a good thing so everybody should do it.

In an effort to find out what really works and what does or doesn't save money, Executive Risk recently commissioned a study by Louis Harris and Associates to examine exactly that question. We surveyed one third of the large law firms in the country, and we found a significant correlation between risk management techniques and reduced professional liability exposure. I think the most significant finding in terms of savings is that in law firms where there was a risk management partner or committee (an individual partner or committee responsible for reviewing every new matter that comes into the firm before any work is done), the firm saved an average of $1,000,000 on the firm's largest claim in the last 5 years. One million is a big number; we definitely like the thought that can save $1,000,000. But I think the key to this study and to this type of statistic is not the magnitude of the savings but the fact that for the first time we can have evidence that risk management directly correlates to a reduction in loss. There's a lot more work to be done in terms of detailing exactly what works and doesn't work, because we're at the beginning of this process. But in terms of being able to say overall, yes, risk management is valuable, I would definitely agree with George. I think that is a good explanation for why insurance companies are offering risk management services. If you can reduce the frequency of claims and the severity of claims, then you can hopefully reduce the cost of claims as well. That's a great motivator both for insurance companies and law firms.

I also agree with George that insurance companies are really best equipped to provide risk management services and there are a number of different reasons for that. As George mentioned, insurers definitely have a broader base of knowledge. We've got access to lots of different law firms in different parts of the country in different practice areas, so we can look at what everybody is doing and then analyze what does and doesn't work. In addition, we have the ability to disseminate that knowledge much more broadly than your average law firm would be able to do. We can share what we learn with all of our insureds and hopefully elevate the level at which the profession is monitoring itself and practicing. Moreover, as George mentions in his article, insurance companies have the money to fund studies by experts to examine various issues regarding claims trends, national risk management, technology—the Harris Study is a good example—and we have the resources to go outside the industry and look for additional expert help and hopefully spread that throughout the industry.

Finally, I think attorneys are often not as objective in analyzing their own risk profile as insurance companies can be. There are a lot of different

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factors and practical pressures that come to bear on a law firm which is trying to evaluate its risk profile and how best to protect itself. Within a law firm there may be problems with partners who have their own particular agenda and rainmakers who don't want to be bothered doing a conflicts check, they just want to put their name on the incoming client form and get their bonuses. These people can be hard to regulate. There may also be a significant expense involved with upgrading a firm's loss prevention system. It might be more tempting to say, "our conflict checking system is just fine and we don't really need to spend $1,500,000 to upgrade to the latest version of the software." That's an extreme example, but changing the way a firm functions internally can be expensive both emotionally and practically, so there are multiple levels of resistance. Firms also have a tendency to rely heavily on the value of their client relationships. A firm might say, "We've had this client for 20 years—all of our clients respect us. It's an excellent relationship. If anything went wrong, they would never sue us. We could work it out, it would be okay, honest, really." That's true as long as your client is getting the result they want and true as long as the economy is going well and everyone is making money. When a client doesn't get the result it wants, firms are sometimes very surprised to find themselves on the receiving end of a lawsuit. In addition, elements beyond the attorney/client relationship sometimes come to bear. In the regulatory environment, you could find yourself in a situation where you've been practicing in a certain accepted way for years and suddenly, the regulators or courts are telling you it's not okay. Finally, I think firms have a tendency to rely on the projective value of their claims history—perhaps more than they should. From an underwriting perspective, one of the questions that I always ask is, "Are they lucky or smart?" If you look at a firm and they haven't had a claim in the last 20 years, you could say, "Do they really know what they're doing? Are they careful? Do they have good risk management in place? Or, are they poorly run and incredibly lucky?" Lawyers in general have a tendency to think they're smart rather than lucky.

So, all of these pressures come to bear on firms that are trying to regulate themselves, to look at risk management and loss prevention techniques, and pick the best way to protect themselves. An insurance company has the ability to be much more objective. We don't have the same types of internal pressures and hopefully we are in a better position to analyze what works and what doesn't, and then to disseminate that information to firms across the country.

Finally, George stated that insurers act as regulators of attorney behavior, here I can't agree. I don't think insurance companies regulate attorney behavior. The element that is missing from George's analysis is

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market conditions. Now, it is possible for me to posit a situation—hypothetically—in which there might be a hard professional liability market. I'm told it existed in the 1980's—that precedes my tenure in the insurance industry—it's sort of a fable. I'm told there was a time when the market was hard, insurance was hard to come by, rates were very high, law firms were going bare, and nobody could get the coverage they actually needed.

In that situation, if we accept that it really existed, I can see how insurance companies might be able to use risk management techniques as a bludgeon on law firms. Insurers might be able to say "We're not going to insure you unless you adopt these particular systems. We are not going to give you a rate you can even possibly afford unless you do what we tell you to do regarding client intake."

We are not in a hard market right now, but a soft market, and that has been the case for awhile. This soft market affects not just lawyers' professional liability, but other types of errors and omissions coverage and directors and officers liability coverage as well. It's a buyers market. If you don't like the policy and/or pricing being offered by a particular insurance company, you can go down the street and get a better deal.

In this type of market, I don't think it's tenable to say that insurance companies have the ability to regulate attorney conduct, because if we attempted to impose requirements on firms, they go someplace else. So, we don't have the ability to enforce risk management techniques or particular loss prevention controls. I think that takes us out of the running as a regulator of attorney behavior.

Still, law firms often use their insurance carrier's opinions and recommendations to influence partner behavior. Certainly, the information that insurance companies can provide to the large law firm market is a tool that attorneys can use to regulate themselves. But, at the end of the day, those loss prevention techniques have to be adopted voluntarily by the lawyers, and I think the lawyers still bear the responsibility for regulating themselves.

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PETER KOCHENBURGER*

I have been asked to comment and further discuss Ellen's work and I would encourage you to read her summary and longer article. Both pieces provide nuances she was not able to address in the short time today. Her examples are also useful.

I would like to make one quick point first. It strikes me there is a counterbalance to a plaintiff's attorney's emphasize on negligence so as to obtain insurance proceeds. In order to attempt to inflame a jury and obtain a punitive damages verdict, the plaintiff must allege and compellingly demonstrate at trial the defendant's intentional, wrongful conduct. The attractiveness of punitive damages, or a high compensatory award, militates against concentrating solely on negligence.

I am grateful that Ellen sees a somewhat expanded role for declaratory judgments in insurance coverage conflicts. But, does even her conception go far enough and prevent much of the unnecessary economic damage to an insurance company (and its stockholders and policyholders) that occurs if coverage is not ultimately found or when there is no formal opportunity to even properly dispute coverage? We spent a good part of the day discussing the detriment to insureds when coverage is in dispute. However, there can also be significant harm to an insurance company (though that harm is almost exclusively economic), when coverage is not found or when there is no formal opportunity to litigate or properly decide coverage issues.

We have all read the standard "duty to defend" cases. It is striking how broad that duty is. For example, in a 24-count complaint there may only be one possibly covered allegation and that allegation may be completely secondary to the actual liability issues, but this count triggers a duty to defend the whole case. Significantly, only in rare circumstances is there an opportunity after the fact for the insurance company to recoup defense costs incurred in defending the other 23 uncovered counts. As a recent California Supreme Court case suggests, it is possible to recover such costs, though unlikely and only if carefully factoring out the cost in the covered versus uncovered count. But even that opinion, considered "ground breaking," makes it difficult to recoup defense cases associated with uncovered claims. So, if the duty to defend is so broad, and if the courts do not give insurance companies an adequate opportunity to contest coverage, is not the duty to *indemnify*, which we do not hear much about, really

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functionally equivalent to the broad duty to defend? When an insurance company believes there is no coverage for the majority of allegations against its insured, and believes that the covered count(s) exposes the insured to little or no ultimate liability versus the uncovered counts, and yet does not have the ability to adequately explore and, when appropriate, contest coverage, then in fact the insurer is buying the whole claim. While the insurer suffers largely economic damages from paying uncovered claims, as opposed to reputational or other damages possibly suffered by insureds, the payment of unnecessary claims by insurers (for exposure to which no premium was ever calculated or collected) results in higher premiums and economic inefficiencies.

In examining insurance coverage disputes we should recognize that an insurance contract is exactly that – a contract with dual and not sole obligations. Insurers clearly have contractual and regulatory obligations. So do insureds. In coverage cases at the outset of the opinion we often read the phrase, "What are the reasonable expectations of the parties," but in the analysis and at the conclusion the insurer's expectations are generally omitted and the focus is largely or solely on what the insured allegedly expected. Now, insurers do not bring coverage actions lightly. No one likes to sue insureds and putting it mildly, it makes account renewals difficult and insurance companies obviously depend on their ability to sell insurance. Nor, despite popular myth to the contrary, are insurers looking for hypertechnical loopholes in the contract so as to wriggle out of the duty to defend and indemnify. Good business practices and regulatory and judicial constraints compel carriers to consider coverage issues carefully. However, the mutual duties and obligations of the insurance contract are the core of the insurance agreement, and its terms and conditions are no more a "technicality" to be ignored than the courts should ignore the myriad technical search and seizure constraints imposed by the 4th Amendment in a criminal case.

Most of us would agree in theory that the definitions and exclusions in an insurance contract are not mere verbiage and that they deserve enforcement. Yet many coverage disputes are often examined from the perspective of the insurer trying to "slip out" of its obligations. This perspective, however incorrect, often occurs in the personal lines context (automobile and homeowners insurance). But most significant insurance disputes are between insurers and sometimes equally large or larger commercial entities that are fully able to negotiate the terms of the insurance contracts and also fully protect its interests in any coverage dispute.

In a typical suit, if there is no ability to file a declaratory judgment action immediately, then the consequences tend to come down to one of

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several options. For example, assume there is a five-count suit for racial discrimination in rental housings. Only one of the five counts is covered under a standard CGL policy– say an allegation regarding negligence in supervision and training. Now, this count brings in a defense. In fact, likely that count was put in there for no other reason than to hook in an insurance obligation. The problem is, what does the insurance carrier do other than issue a reservation of rights? It obviously sends out that immediately and says, in effect, "We do no know whether or not you intentionally discriminated. We hope you did not. Generally we do not defend and we certainly do not indemnify for it. But, we do defend and indemnify as to negligence." But how then does the carrier prove that? If they can simply file a D.J. using only the eight-corner rule, they will lose because there is a covered count. Indemnity obligations cannot be determined yet since there is no judgment against an insured to be parceled out between covered and uncovered claims. If the insurer files a D.J. and tries to use extrinsic evidence, then I agree with Ellen that this approach could damage the insured's defense, since the insurance company is on one hand providing a lawyer to defend the insured and on the other trying to prove intentional acts by the insureds so as to properly defeat the indemnification duty. Accordingly, using extrinsic evidence in a D.J., is not usually a feasible option either.

If the case goes to trial, an insured can request a special verdict apportioning damages to specific counts, so the insurer can understand its indemnity obligations, if any. The problem is that in many states it is completely discretionary with the judge to provide a special verdict form to the jury. It also puts the insurance defense lawyer in an awkward spot. She is hired to represent the insured and may decide not seek a special verdict when that request has no value to the insured but only to insurer. The insured could seek to intervene to request a special verdict – but that it also an awkward thing to do and does not help relationships with insured or the defense.

To go back to our earlier example, if the coverage issues are not resolved, then because of the "covered count" of negligent training and supervision, an insurer could wind up paying a multimillion-damage award even though liability was premised almost exclusively on findings of intentional racial discrimination by the insured. Yet, it is highly unlikely a jury would award significant damages based on this covered count. So, what does an insurance company do then? The answer is often nothing. What can they do? They can file a D.J., and then try to argue intentional acts and that requires relitigating the entire trial all over again, which is a waste of judicial resources. Certainly, on a practical level, it would be difficult to retry the case and you would need the original plaintiffs to

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cooperate and testify again. The people who have already testified in what may have been a very grueling trial the first time, will have no incentive to come back and testify again so the insurance company and insured can figure out who pays what. Overall it is a very difficult proposition.

Thankfully, what often resolves this very difficult problem is that 97%–98% of all cases settle. Often the insurance dispute resolves itself in informal agreements between the insured and the carrier, leaving a defense lawyer completely out of that loop. "The case can be settled for $1,000,000. We think your liability that is covered by insurance is $800,000 – you pay the rest." Probably, the majority of the time that it how it works. The industry does not have an overwhelming number of coverage suits given the number of claims the industry defends (in fact this would be an excellent area to research). However, problems arise when the insured claims it does not have the assets to pay the rest of the uncovered settlement, or simply disagrees with the insurer's indemnity position, leaving both parties engaged in a risky trial, and in some jurisdictions the insurer to a bad faith claim, however unjustly. Insurers are then left with defending, or possibly indemnifying suits where covered claims are an insignificant part of the lawsuit as a whole.

I would also like to address one of Dr. Pepper's points. He stated that the dichotomy between the duties an insurance defense lawyer owes to the insurer and insured might be acceptable if the insurer is willing to pay for any consequences or damages to the insured due to this conflict. I argue that the reverse is also true. The duty of good faith and fair dealing currently goes in one direction, insurer to insured. Often glossed over is the obligation (the duty of good faith and fair dealing?) the insured owes to the insurer, such as not to engage in collusive behavior (one of Ellen's concerns by not allowing declaratory judgment actions). Questionable practices occur where counts in suits suddenly appear, disappear and then reappear, for no other reason than to bring in insurance coverage – is that a violation of duty of good faith and fair dealing? Or the failure of an insured to fully disclose to the insurer facts of the case that affect coverage determinations. Insurers often face instances where a insured rolls over in a stipulated judgment and assigns its coverage and any bad faith claims to the plaintiff in exchange for covenant not to collect the judgment against the insured. Often the amount of the judgment is artificially high and collusive. In the commercial context, it is difficult to understand why the duty of good faith and fair dealing is not truly reciprocal.

The last thing I want to touch on is John's comment when he talks about the duty of a defense lawyer in first party claims where coverage is an issue. There is a similar context in worker's compensation claims where there is an ongoing claim to adjust and the injured worker is in separate

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extracontractual litigation with the insurance company over alleged bad faith claim handling. Company representatives will be working with outside counsel to defend the bad faith suit, while at the same time claim representatives will be working regularly with the injured worker to pay benefits and for medical treatments that are legitimately owed to the worker. It is difficult for the carrier to balance both claims appropriately and equally difficult for the injured worker should benefits be cut off.

Injured workers are vulnerable claimants and this may, in the court's view, heighten the duty owed. In the worker's compensation context, some courts have held that insureds and insurance carriers have a duty of good faith and fair dealings to injured workers despite the fact that the workers are not true insureds. But at the same time, carriers may also have contractual obligations and a duty of good faith and fair dealing to the employer/insured. In some instances these duties are competing and adverse, such as in disagreements over whether the contested injury was work-related, the extent of the injury, the relationship of the current injury to previous injuries, or the desire to get an employee back to work. Employers may incur a direct premium increase from the results of the claim handling, as the loss associated with the claim effects either the employer's experience rating (which could increase the premium for the new policy term), or the bottom line when employers have a self-insured retention or retrospectively rated plan. This tension between an insurance company, the employer/insured and the injured worker can be very difficult and provides complex issues for defense lawyers.

Thank you.

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BOB JERRY*

As the last speaker at the end of the day, I will be brief. My principal responsibility is to comment on John Tener's presentation. He makes three major points. First, referring to the lawyer's ethical obligations, he makes the interesting point that where a client is a fiduciary in the first-party setting, the lawyer has special duties in dealing with that fiduciary's beneficiaries. I look at that argument and see it as subtext to the special contractual duties that all insurance companies owe insureds, in what is at least a quasi-fiduciary relationship. The scope of some of these duties is arguable, but they include things like a duty to explain coverage when the policyholder does not understand it, a duty, perhaps, to point out coverage of which the policyholder is unaware, and certainly a more robust duty to give advice. The boundaries of all of these duties are uncertain, but, after all, this is a different type of relationship than you find in your garden variety, bilateral contractual relationship. John's message, with which I agree, is that the attorney as counsel for the insurer should be mindful of the special obligations that the insurer may have. John is absolutely correct on that point.

His second major point is on the role of good faith. He does a service to us by putting this important concept squarely on the table. In my comments, I would like to extend the analysis to the third-party context, which he did not reach, and explore what some of the messages might be. I see that Charlie Silver had to leave to catch his plane just a moment ago. When he and I traded some e-mail messages about 18 months ago, I said, what do you think about this? Let's imagine we have a victim who has sued the policyholder, the claim is very large, and the insurer in control of settlement works out an agreement with the plaintiff to settle the claim for $50,000. After all of this is wrapped up, and we have a within limits settlement, the plaintiff comes back and proposes to the insurer, "Let's reduce the settlement amount. I'll take less money. Give me $25,000 instead of $50,000. What I would like in exchange, however, is that we don't seal the settlement, and I want some admissions of culpability made on behalf of your policyholder." What underlies the proposal is that the plaintiff is a business competitor and wants some reputation-damaging concessions he could make use of.

The question is, could the insurer accept that reduction in the settlement? You might look at it and say, "Well, it reduces claims costs—that's pretty interesting to me—and it's within the judgment risk. We're

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just talking about the insured's reputation, which is not covered by the liability policy." Under what reasoning is it that we would say that the insurer cannot accept the proposal?—because I don't think the insurer could accept it. The reason has to come from the duty of good faith and fair dealing—whatever that duty means, that's where the answer is. Good faith is speaking to us in the third-party context. I would argue that that is analogous to the well-settled law in the situation where multiple plaintiffs face the policyholder with limited liability limits. Certainly the insurer can settle with one of the plaintiffs under the privilege to settle in the liability policy, even if it exhausts the policy limits and leaves the policyholder exposed to the claims of other plaintiffs. But we know that those settlements must be made in good faith. I think that's what's going on in the third-party area.

I would like to take that thinking and pour it into the duty to defend. Can the insurer disregard all reputational interests of the policyholder in undertaking the defense? And, I'll throw this wrinkle in at 3:55 PM, I'm inclined to think no, because of the good faith duty. I'm not sure where the boundary of that duty is. I'm not disagreeing with the point made earlier today that the liability policy does not cover reputation as a protected interest, but the good faith duty may speak to the attention the insurer needs to give to reputation in undertaking the defense of the client. When I say I am uncertain how much attention the insurer must give the reputational interest, I'm only saying that I'm uncertain about the boundary of the good faith duty. That's something we struggle with in contract law.

I might add that if we're worried about insureds coming to the liability policy thinking they're entitled to something more in this area, realize that there's nothing in the current forms that negates the expectation they might have. Although it would be fun to elaborate on this more, the policyholder in many situations, and Stephen Pepper got to this, simply expects to be taken care of in the broadest sense of the phrase. That has some interesting ramifications, and it draws upon Judge Keaton's point at lunch about what words mean to different people in different circumstances.

We might be able to synthesize all of this with use of the duty to settle framework: we know the defense lawyer represents the insurer for purposes of settlement, but certainly owes obligations to the policyholder under the duty of good faith. The conclusion I feel fairly comfortable in drawing is that one reason the insured is not alone in the liability situation is because of the duty of good faith.

The third major point John makes concerns the attributes of the insurance contract. He talks about trust, dependency, and public interest. I'll make one brief point here. We talked in this panel about unnecessary exposures that will result in high premiums. But let's not forget that the

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policyholder also faces uncertain losses. What the policyholder trys to do is to substitute for the consequences of uncertain losses and other risks in life a predictable set of obligations, i.e., the payment of periodic insurance premiums. The value to the policyholder is being free of the uncertainties. That's what the policyholder bargains for, and, as John clearly puts on the table, if we are uncertain about the solvency of the insurer, the policyholder's contract has little value. It's simply one set of uncertainties being substituted for another. More directly to the point of our discussion here—if I am in doubt as to whether the insurer is going to defend me or contest coverage in a declaratory judgment action, then the certainty I wanted is really not there at all. I'm just underscoring, as John does for us, what is at stake in this important area.

My fourth point: [speaker looks at clock] I recommend that you subscribe to the Connecticut Insurance Law Journal, and you can read my fourth point there.

My fifth point I will save for our host and friend Tom Baker, and I will come back to the tetrahedron briefly. Tom unveiled the tetrahedron in Washington in January, and I was the commenter on his paper there. I wasn't quite sure what to make of the tetrahedron. I assembled it beautifully as we all did, and I have it on the corner of my desk in Memphis; it looks at me every day, and I look back at it, and I think to myself, "What is this tetrahedron telling me?" I see it again this morning projected on the screen, and I looked at it in the middle of the luncheon table—it's hard to get my eyes off of the tetrahedron.

I've come to the conclusion that maybe the reason I'm uncomfortable with the tetrahedron is because it is simply not a geometric shape in my building block set I played with as a child. Therefore I'm not quite sure what to do with it. The blocks I play with now with my kids are Legos, and the shapes there are clear and unambiguous. The applications are predictable and when used properly, the results are certain. That does not describe the governing rules on insurance defense counsel responsibilities. I think what Tom is very ably doing, and what we are all trying to do, is to find a more stable geometric explanation of all this. It has to be Euclidean. It cannot be non-Euclidean. Chaos theory may work for Stephen Hawking and the cosmologists, but it will not work for us. Through the work undertaken in this symposium, I think we are getting closer to a more stable geometric metaphor. Thank you.

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FROM THE JOURNALS: INSURANCE LAW ABSTRACTS

*Edited by Jeffrey E. Thomas**

INSURANCE - GENERAL

Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation,* 95 MICH. L. REV. 541 (1996).

This article analyzes judicial interpretation of insurance policies by designating two common approaches: a traditional construct of *contra proferentum* (construe against the drafter) and a non-traditional construct of the same doctrine. The author argues that courts which follow the traditional approach tend to make pro-insured decisions when insurance policy language is truly ambiguous but such traditional courts also tend to refuse to make scope of coverage decisions based solely on theories of the insureds' expectation of coverage. Courts which use a non-traditional approach to *contra proferentum* interpretation are more likely to construe non-ambiguous language against the insurer by using doctrines such as expectation of the insured, waiver and estoppel. The author concludes that the traditional approach of construing against the drafter is the better of the two and will lead to more efficient, reliable and uniform outcomes in insurance coverage disputes.

Theodore Allegaert, *Derivative Actions by Policyholders on Behalf of Mutual Insurance Companies,* 63 U. CHI. L. REV. 1063 (1996).

This student comment addresses the legal issues associated with mutual insurance companies' policyholders' derivative suits in light of the recent scandal of "investment" versus "insurance" sales pitches within the industry. The author provides a brief summary of the legal framework of mutual insurance companies and analyzes the conflicting case law regarding policyholders' standing to sue. The article concludes by suggesting that the standing issues is less problematic than case law suggests and that policyholders have no less right to enforce management duties than do shareholders in the purely business context.

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Eugene R. Anderson, Richard G. Tuttle and Susannah Crego, *Draconian Forfeitures of Insurance: Commonplace, Indefensible, and Unnecessary,* 65 FORDHAM L. REV. 825 (1996).

This article offers a critical analysis of the forfeiture remedy often imposed on policyholders who fail to comply with exact terms of insurance policies. The authors assert that forfeiture of policy coverage for compliance failures is an unduly harsh and inequitable penalty for policyholders, especially in those circumstances in which the insurer is only slightly inconvenienced by the noncompliance. The authors compare the rare instances of court-enforced forfeiture in traditional contract cases to the common practice of forfeiture in the context of insurance coverage. The article concludes by suggesting that traditional contract remedies for breach of contract, such as actual damages awards, are more equitable and appropriate than coverage forfeiture in response to an insured's noncompliance.

Tom Baker, *On the Genealogy of Moral Hazard,* 75 TEX. L. REV. 237 (1996).

This article critically traces the history of the concept of the "moral hazard"doctrine, a concept which has found a new place in modern law and economics analysis. The article contains a comprehensive review of how the "moral hazard" concept has evolved over time from an insurer's protection devise against "bad characters" to the modern use of the concept as a reasonable basis on which to limit or eliminate welfare, health insurance, and worker's compensation benefits. The author asserts that the "moral hazard" concept - that insurance reduces incentives for the insured to minimize loss – has been inappropriately used to justify reduced social responsibility and correspondingly to place the blame for society's poor, sick and injured at the needy's feet.

Louis A. Chiafullo, *The Maelstrom at Lloyd's of London: Is It Sink or Swim for Policyholders?,* 26 SETON HALL L. REV. 1392 (1996).

This essay reviews Elizabeth Luessenhop and Martin Mayer's recent book chronicling the former's knowledge of the inner workings of the venerable London "insurer." The review is generally favorable, although the author notes that Ms. Luessenhop's acrimonious tone rings throughout the book. The book

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and its review discuss the intricacies and people behind Lloyd's of London and the current litigation resulting from recent scandals.

AUTOMOBILE INSURANCE

Dominick Cirelli, Jr., Girgis v. State Farm Mut. Auto. Ins. Co.: *Rescinding the Physical Contact Requirement in Ohio Uninsured Motorist Claims,* 30 AKRON L. REV. 153 (1996).

This student note analyzes the recent Ohio Supreme Court case which replaced a physical contact requirement for recovery under uninsured motorist polices with an independent third-party corroboration requirement. The note discusses the issues of fraud and legitimately injured motorists that create tension when identifying the scope of uninsured motorist coverage. The author concludes that the best alternative may be to allow jury trials to assess the merits of contested uninsured motorists claims.

Alan E. Mazur, Martin v. Midwestern Group Insurance Co.: *Something For Nothing,* 24 CAP. U. L. REV. 667 (1995).

This student piece critically assesses the impact of the recent Ohio Supreme Court case referred to by the title. The author asserts that the Ohio Supreme Court has curtailed the freedom of contract and endorsed financial irresponsibility by its holding that uninsured motorist coverage extends to all vehicles owned by the insured, regardless of whether each vehicle's policy contained uninsured motorist coverage. The article discusses the legislative limits that have been placed on an insured's right to uninsured motorist coverage and concludes that the Ohio Supreme Court's holding in the principle case is an example of overstepping by the judiciary.

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BAD FAITH

Tyler T. Ochoa and Andrew J. Wistrich, *Unraveling the Tangled Web: Choosing the Proper Statute of Limitation for Breach of the Implied Covenant of Good Faith and Fair Dealing,* 26 SW. U. L. REV. 1 (1996).

This article presents a detailed analysis of the issues involved in determining the appropriate statute of limitation for a breach of good faith and fair dealing claim. The authors focus on California cases and statutes in their discussion of the factors, such as tolling, accrual, and contractual modification, that have complicated the statute of limitations issue. The authors conclude that contract doctrines of statute of limitations should be applied outside the insurance context, while contractual modifications to the statute of limitations should generally be respected within the insurance context.

Douglas R. Richmond, *The Two-Way Street of Insurance Good Faith: Under Construction But Not Yet Open,* 28 LOY. U. CHI. L.J. 95 (1996).

This article addresses the duty of good faith and fair dealing to which all contracting parties are presumably subject. The author discusses the history of "bad faith" claims against insurance companies and the defense of comparative bad faith and reverse bad faith counterclaims which insurers may utilize to lessen their potential liability. The author asserts that the judicial system has failed to note the reciprocal nature of the good faith duty. He suggests that insurer's should raise affirmative defenses and counterclaims when appropriate in an effort to "untrench" the current doctrinal obstacles to reciprocity.

Gary Schuman, *The Covenant of Good Faith and Fair Dealing: Responsibilities of First-Party Insurers*, 47 FED'N INS. & CORP. COUNS. Q. 107 (1997).

This article discusses concerns about first-party extra-contractual damages because of failure to fully and quickly pay claims. It suggests that these concerns be addressed by a standard that would require an insurer to exercise ordinary care in conducting its investigation of the facts and the law, and that

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would require an insurer to have a reasonable basis for its decisions.

Jeffrey E. Thomas, *A Case Study of Bad Faith Refusal to Settle: A Doctrinal, Normative and Practical Analysis of Missouri Law,* 64 UMKC L. REV. 695 (1996).

This article addresses the issue of bad faith claims against insurance companies who refuse to settle claims against the policyholder within the limits of the policy's coverage. The author focuses on the two approaches of Missouri courts to such cases: one which attempts to determine the insurer's state of mind in refusing to settle a claim and the other a balancing test of the interests of the insurer and the policyholder. The author concludes that the balancing test is more appropriate than the "insurer's state of mind" approach, and provides proposed jury instructions designed to implement that balancing test.

HEALTH INSURANCE

Rebecca S. Fellman-Caldwell, New York State Conference Of Blue Cross & Blue Shield Plans v. Travelers Insurance Co.: *The Supreme Court Clarifies ERISA Preemption*, 45 CATH. U. L. REV. 1309 (1996).

This note begins with an analysis of ERISA's preemption clause prior to the *Travelers* decision and describes the conflicting methods of determining whether a state law triggers section 514's preemption. The analysis includes a summary of Supreme Court jurisprudence regarding the proper method for determining whether a state law falls within the scope of ERISA's preemption clause. This note also describes the two methods of analysis that developed within the circuit courts prior to the *Travelers*, and concludes that the Court effectively restricted the scope of ERISA's preemption clause. Finally, it comments on the impact of *Travelers* on the states' role in health care administration and reform.

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Mark A. Hall, Teresa Rust Smith, Michelle Naughton and Andrea Ebbers, *Judicial Protection of Managed Care Consumers: An Empirical Study of Insurance Coverage Disputes,* 26 SETON HALL L. REV. 1055 (1996).

One of several symposium articles, this article describes the methodology and findings of the authors' empirical research of judicial decisions regarding health care coverage disputes. The authors suggest that the judicial system offers aggrieved health care recipients another forum in which to address their complaints. Since the authors' research indicates that the courts are underutilized in the health care dispute context, the authors suggest that Alternative Dispute Resolution, or other less expensive and less formal procedures, may offer health care consumers more protection than they may realize.

Melody L. Harness, *What is "Experimental" Medical Treatment?: A Legislative Definition is Needed*, 44 CLEV. ST. L. REV. 67 (1996).

This note focuses on the highly publicized coverage disputes involving HDCT/ABMT for the treatment of breast cancer to illustrate the problems inherent in determining coverage for new medical treatments. After describing the drug approval process and off-label drug use, the note addresses HDCT/ABMT treatment and the lack of consensus regarding its efficacy. It then examines exclusionary provisions in insurance contracts for experimental treatment, and how courts have resolved coverage disputes. The note identifies the Office of Personnel Management's directive and state legislation that has been enacted or is being considered to address reimbursement for HDCT/ABMT treatment, and warns against the dangers of politicizing medical treatments. The note concludes with the recommendation that federal legislation be enacted which sets out a clear definition of "experimental" medical treatment, a uniform policy on off-label drug use, and requires coverage of patient care costs when associated with an approved clinical cancer trial.

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Laura H. Harshbarger, *ERISA Pre-emption Meets the Age of Managed Care: Toward a Comprehensive Social Policy,* 47 SYRACUSE L. REV. 191 (1996).

This student piece focuses on the current split among federal courts concerning ERISA's pre-emption of state law claims which allow managed health care organizations to be held vicariously liable for the malpractice of its physicians. The note provides a general overview of the growth of managed health care plans and ERISA's pre-emption policies and legislative history. Analysis of several cases addressing ERISA's pre-emption of state law vicarious liability claims is also included. The author argues against pre-emption based largely on public policy grounds.

Jennifer A. Hradil, *Patchwork Patient Protection: Must We Choose a Single Pattern?,* 27 SETON HALL L. REV. 203 (1996).

This student piece analyzes the means available to protect the health care consumer in light of the increasing dominance of managed care systems. The author discusses traditional malpractice liability and contract-based theories which provide varying degrees of protection to the health care consumer. The author suggests that the growing availability of comparative information regarding health care plans acts as another consumer protection device. The comment concludes that the current "patchwork" protection satisfactorily addresses the varied claims and injuries that may arise in managed care systems.

Robert H. Jerry, II, *Health Insurance Coverage for High Cost Health Care: Reflections on "THE RAINMAKER,"* 26 U. MEM. L. REV. 1347 (1996).

This essay uses a recent novel by popular author John Grisham to explore the real and difficult issues of access and affordability in modern health insurance coverage. The author addresses his subject pragmatically from both the insureds' and the insurers' perspective. The essay does not attempt to identify solutions to the health care issues of access and affordability. The author does, however, create a balanced and realistic assessment from which to begin the discussion.

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Christopher Aaron Jones, *Legislative "Subterfuge"?: Failing to Insure Persons with Mental Illness Under The Mental Health Parity Act and the Americans with Disabilities Act,* 50 VAND. L. REV. 753 (1997).

This note analyzes the regulation of private mental health insurance benefits, in particular under the MHPA and the ADA. It contends that the MHPA is likely to have a limited impact on the ability of those suffering from mental illness to secure private insurance benefits. It also argues that the ADA is not likely to provide protection. The note concludes with a brief discussion of managed mental health care and the parity issues it raises.

John V. Jacobi, *The Ends of Health Insurance*, 30 U.C. DAVIS L. REV. 311 (1997).

This article describes a growing consensus among state legislatures that statistically valid genetic indicators of future illness may not be used to deny or set prices for health coverage. It examines the interplay between ERISA's broad preemption of anti-risk selecting state laws, and the Americans with Disabilities Act (ADA), which, the author argues, prohibits broad categories of risk segmentation. It also explores broader and more explicit movements toward the social pooling principle evidenced by the recent state and federal adoption of insurance reform legislation, including the Health Insurance Portability and Accountability Act of 1996. Finally it discusses the natural next steps in the slow evolution of American insurance law toward a complex public/private model of universal health coverage.

Karen A. Jordan, *ERISA Pre-emption: Integrating Fabe* [United States Department of the Treasury v. Fabe, 113 S.Ct. 2202 (1993)] *into the Savings Clause Analysis,* 27 RUTGERS L.J. 273 (1996).

This article offers a comprehensive discussion of ERISA pre-emption and the limitation of pre-emption imposed by the statutes's "savings clause." The author asserts that the holding of the above-cited case has not been fully appreciated or applied by lower courts in the ERISA savings clause analysis. The author attempts to place the *Fabe* case in context with other Supreme Court statements regarding the extent of ERISA pre-emption of state laws, especially concerning the proper interpretation of the "business of insurance" phrase. The article concludes by suggesting that the integration of the *Fabe*

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case into ERISA interpretation will restore the proper balance between federal pre-emption and states' ability to institute health care reform.

Debra E. Kuper, *Newborns' and Mothers' Health Protection Act: Putting the Brakes On Drive-Through Deliveries*, 80 MARQ. L. REV. 667 (1997).

This comment supports the necessity for ensuring appropriate maternity stays. It discusses the medical risks associated with early discharge. It addresses the arguments for and against mandating stays through legislation, and it reviews the recently enacted law New Borns' and Mothers' Health Protection Act of 1996. Finally it focuses on alternatives to legislation.

Katy Chi-Wen Li, *The Private Insurance Industry's Tactics Against Suspected Homosexuals: Redlining Based on Occupation, Residence and Marital Status*, 22 AM. J.L. & MED. 477 (1996).

This article explores the extent of the problem of the denial of health insurance or the provision of insurance at above-average rates to people insurers suspect to be homosexual based on their occupation, place of residence and other factors. It contends that the use of such tactics is not justified because concerns that the AIDS crisis will destroy the insurance companies' financial soundness are unproven, and becasue other serious diseases pose a greater financial burden on the insurance industry, yet insurers have not attempted to exclude people who may gave a higher risk for contracting those diseases.

Dayna Bowen Matthew, *Controlling The Reverse Agency Costs of Employment-Based Health Insurance: Of Markets, Courts, and a Regulatory Quagmire*, 31 WAKE FOREST L. REV. 1037 (1996).

This article reviews the history of the employment-based system and its non-agency costs and benefits. It details the evidence that employer and employee interests diverge, supporting the agency cost model's application to that part of the employment relationship, which the author calls reverse agency. It explores the underlying objectives of regulatory and common law controls that currently govern the employment-based system. It is here that the author

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maintains that the explanatory power of the reverse agency cost model proves superior to traditional notions of contract in the employer-employee relationship.

Christine A. McAteer, *Health Care Mandates: The Delivery Debate,* 26 SETON HALL L. REV. 1691 (1996).

This student comment addresses the current debate over "drive-through" deliveries and the legislative response to the public outcry. The author discusses the proponents of legislative mandates position as well as insurance companies' counter-arguments to government interference. The comment concludes that the current lack of reliable research concerning the safety and risks involved with early maternity discharges suggest that legislative mandates are an appropriate response to consumer protection concerns.

F. H. Miller, *Symposium: Health Care Capitated Payment Systems,* 22 AM. J. L. & MED. 167 (1996).

This symposium offers seven articles which focus on the health care strategy of capitation: the practice of insurer's providing lump sum payments to health care providers who then become responsible for providing subscribers with comprehensive coverage. One articles focuses on the relationship between physician credentialing and the practice of capitation. Another author discuss the positive role capitated plans may play in the anti-fraud effort with in the health care community. Other articles address the benefits, problem areas, and impact of capitation in the context of workmen's compensation, medical ethics and procedural protection of patients. Two other articles focus on the aspect of risk-shifting from insurers to providers that is the distinguishing feature of capitation.

Katie Cook Morgan, *Leaving the Management of "Managed Care" Up to the States: The Health Insurance Industry and the Need for Regulation of the Regulators,* 64 U. CIN. L. REV. 225 (1996).

This student article addresses the issue of insurance regulation in light of recent class action suits by consumers which charge that health insurance companies are misrepresenting the actual coverage percentage in managed

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health care systems. The article discusses the current framework charged with regulation of insurance companies and considers the advantages of direct regulation as opposed to judicial regulation. The author concludes with a suggestion for regulation at the federal level to obtain a uniform, more efficient and more fair system of insurance regulation.

Note, *In Vitro Fertilization: Insurance and Consumer Protection,* 109 HARV. L. REV. 2092 (1996).

This student piece addresses recent attempts by consumers to force insurers to provide coverage for in vitro fertilization (IVF) and other reproductive technologies. The article suggests that state legislatures are the appropriate forum in which to address IVF coverage, and that legislative mandates to offer IVF coverage, rather than mandates to provide such coverage, are the most rational and efficient solution to the current debate. The note also addresses the consumer protection aspects of IVF and the need for reliable and comprehensible success rate reporting, regardless of the decisions made by states.

Walter E. Schuler, *The ERISA Pre-emption Narrows: Analysis of* New York State Conference of Blue Cross & Blue Shield Plans v. Travelers Insurance Company *and Its Impact of State Regulation of Health Care,* 40 ST. LOUIS U. L.J. 783 (1996).

This student note explores the impact of the above-cited Supreme Court case on the ability of states to enact comprehensive health care reform. The author asserts that ERISA's pre-emption clause had been construed overly broadly in past Supreme Court decisions. *Travelers*, according to the author, correctly restricts the previously broad interpretation of ERISA pre-emption, and establishes a new presumption against pre-emption which will allow states to experiment with health care reform initiatives.

Marc A. Rodwin, *Managed Care and Consumer Protection: What are the Issues?,* 26 SETON HALL L. REV. 1007 (1996).

As part of a symposium, this article provides an overview of consumer protection issues which have arisen in the context of managed health care. The

author considers the current splintered group advocacy and the potential effectiveness of reform proposals. The author suggests that real consumer protection in health care will require a shifting of focus from individiual interests to general consumer interests.

David T. Shapiro, *The Remission of ERISA Pre-emption: An Examination of* Blue Cross/Blue Shield v. Travelers Insurance Co., 28 CONN. L. REV. 917 (1996).

This note addresses the narrowed scope of ERISA's pre-emption clause in light of the above-cited case. It reviews the history of ERISA and earlier Supreme Court decisions interpreting the statute's pre-emption clause broadly. The author concludes that the new standard adopted by the Supreme Court will allow states to take a more pro-active stance in responding to health care concerns of access and affordability.

Tracy Wilson Smirnoff, *"Drive-Through Deliveries": Indiscriminate Postpartum Early Discharge Practices Presently Necessitate Legislation Mandating Minimum Inpatient Hospital Stays*, 44 CLEV. ST. L. REV. 231 (1996).

This note argues that legislation mandating minimum inpatient postpartum hospital stays is presently the best possible solution to the overreaching control managed care organizations have over doctors, the standard of care, and the length of hospital stays. After reviewing the development of postpartum care during the twentieth century and discussing the statutes and regulations mandating minimum hospital stays, it examines anecdotal and statistical evidence concerning the negative effects of early discharge on newborns and their mother. The note then addresses the arguments for and against the legislative solution.

Anthony Szczygiel, *Long Term Care Coverage: The Role of Advocacy,* 44 U. KAN. L. REV. 721 (1996).

This article offers a comprehensive and critical assessment of long term care insurance policies. The author approaches his analysis from a consumer advocacy viewpoint and addresses the general and specific costs that are often

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excluded in long term care policies. The article focuses on the disparities between various long term care policy coverages and the current ability of insurers to "hide the ball" regarding the scope, effect, and ramifications of policies available to consumers. The author concludes that advocates for those in need of long term care services can be especially useful in designing specific policies and coverage for the needs of those they represent.

Alan I. Widiss, *"Bad Faith" in Fact and Fiction: Ruminations on John Grisham's Tale About Insurance Coverages, Punitive Damages, and the Great Benefit Life Insurance Company,* 26 U. MEM. L. REV. 1377 (1996).

This essay explores the implication of novelist John Grisham's recent offering, "The Rainmaker," on perceptions of insurance companies and bad faith claims. The author suggests that the glorification of litigation and massive punitive damage awards desribed in the novel lead to the oversimplification of bad faith claims and do not address the financial realities with which insurance companies are faced. The author concludes that individual fines on executives responsible for bad faith conduct is a more appropriate deterrent to egregious behaviour than huge punitive damage awards which place entire companies, their innocent shareholders, and their employees in financial jeopardy.

INSURANCE REGULATION

Roberta M. Berry, *The Human Genome Project And The End Of Insurance*, 7 U. FLA. J.L. & PUB. POL'Y 205 (1996).

This article examines the unintended consequences of the knowledge gleaned from the Human Genome Project for life, disability, or health insurance coverage. As genetic test information becomes widely available, insurance companies will increasingly seek access to this information. If insurance companies are permitted access to this information individuals whose tests reveal that they are predisposed to disease, vulnerable to risk factors for disease, or destined to suffer disease may face increased costs for coverage, reduced offers of coverage, or refusals of coverage altogether. If insurance companies are permitted access to this information, the consequence may be the end of insurance.

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Helen R. Davis and Janice V. Mitrius, *Recent Legislation On Genetics And Insurance*, 37 JURIMETRICS J. 69 (1996).

This article catalogs and describes federal and state legislation regulating the use of genetic information by insurance companies. It states that the legislation focuses on health insurance, and it generally prohibits internal use and disclosure of genetic information by these insurers. Insurers have questioned the fairness of much of this legislation, and the record to date shows few, if any acts of "genetic discrimination" or invasions of "genetic privacy."

Theodore Einhorn, *Reigning In ERISA Preemption? Any Willing Provider Statutes After* New York Blue Cross Plans v. Travelers Insurance Co., 13 J. CONTEMP. HEALTH L. & POL'Y 265 (1996).

This article analyzes the text and legislative history of ERISA's preemption provision, and certain key court decisions. It discusses the background and rationale of the New York surcharges at issue in *Travelers*, and the rationale of the District Court and the Second Circuit in holding that the statutes were preempted by ERISA. It then analyzes the Supreme Court's decision announcing a new standard for determining whether a state law "relates to " employee benefit plans within the meaning of ERISA's preemption provision. It addresses the impact of the Court's decision on the litigation that is currently pending in Arkansas, and on the future of AWP statutes. It concludes that although the *Travelers* decision appears to remove ERISA preemption as an obstacle to health care reform measures, the Court will need to clarify its decision and revisit the meaning of ERISA's preemption provision in light of the two current challenges to Arkansas' AWP statute.

Mark A. Hall, *Insurers' Use Of Genetic Information*, 37 JURIMETRICS J. 13 (1996).

This article surveys the arguments for and against allowing insurers to use genetic information in setting premiums or determining coverage. Noting that access to this information raises both discrimination and privacy issues, the article discusses the fit between various rationales for prohibiting this use of genetic information and the actual statutes that have been enacted and proposed. The article concludes with a call for more empirical research into the actual impact of these statutes and the magnitude of the social problems that

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led to their enactment.

Eric Mills Holmes, *Solving the Insurance/Genetic Fair/Unfair Discrimination Dilemma in Light of the Human Genome Project*, 85 KY. L.J. 503 (1997).

This article addresses how the field of genetics presents a unique set of problems because of the information it can reveal. It states that the information to be obtained from the Human Genome Project (HGP) is neither intrinsically good nor intrinsically bad. Rather, what gives the HGP value is what our society chooses to do with the information. The article raises insurance and risk issues relating to genetic information, and discusses the advantages and disadvantages of using that information. It suggests that a comprehensive federal "Insurance Genetics Act" implemented by the states in conjunction with a moratorium on insurers' use of genetic testing information offers a potential solution to the insurance/genetic fair/unfair discrimination dilemma.

Paul B. Mengedoth, *National Banks, The "Business Of Insurance," And An Interpretive Analysis Of The McCarran-Ferguson Act Following* Barnett Bank Of Marion County, N.A. v. Nelson, 30 CREIGHTON L. REV. 457 (1997).

This note reviews the facts and holding of *Barnett Bank*, and examines the line of cases in which the United States Supreme Court developed the meaning of the "business of insurance" prior to, and after the enactment of the McCarran-Ferguson Act. Next, this note scrutinizes the Supreme Court's decision in *Barnett Bank* and reaches three conclusions: (1) it was appropriate for Court to not consider whether the Florida's anti-affiliation statute had the purpose of regulating the business of insurance; (2) the sequence of analysis avoided the onerous presumption created by the Eleventh Circuit's approach; and (3) the Court's brief reference to three factors from *Pireno* minimized the significance of these factors in determining the meaning of the "business of insurance."

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Ellen J. Morrison, *Insurance Discrimination Against Battered Women: Proposed Legislative Protections,* 72 IND. L.J. 259 (1996).

This note analyzes recently proposed legislation addressing the practice of insurance discrimination against victims of domestic violence. It reviews the plight of battered women and addresses the purported justifications for present insurance practices. It argues that underwriting on the basis of domestic violence is discriminatory and advocates regulation as an appropriate measure to prevent and defray the social costs of domestic violence.

Troy Paredes, *Stop-Loss Insurance, State Regulation, And ERISA: Defining The Scope Of Federal Preemption,* 34 HARV. J. ON LEGIS. 233 (1997).

This note provides an overview of ERISA, emphasizing the statute's dual regulatory scheme and the practical effect of ERISA's preemption provisions. It discusses the general distinction between insured and self-funded plans under ERISA. The discussion focuses on the Court's opinions in *Metropolitan Life Ins. Co. v. Massachusetts*, and *FMC Corp. v. Holiday*. It introduces stop-loss plans under ERISA. Finally, it argues that ERISA should not be constructed to preempt states from enforcing their insurance laws against a stop-loss plan's insurer.

Willy E. Rice, *Race, Gender, "Redlining," and the Discriminatory Access to Loans, Credit, and Insurance: An Historical and Empirical Analysis of Consumers Who Sued Lenders and Insurers in Federal and State Courts, 1950-1995*, 33 SAN DIEGO L. REV. 583 (1996).

This article presents a brief overview of federal and state fair-lending and anti-mortgage "redlining" statutes. It briefly reviews federal and state statutes that prohibit insurance discrimination and redlining, and analyzes of both federal and state administrative enforcement activities. It contends that federal agencies have not eliminated nor significantly reduced mortgage redlining and the discriminatory access to loans and credit. It also contends that state agencies are not effective. The article then examines judicial enforcement of fair-lending, access-to-insurance, and redlining laws, and finds that judicial proceedings are inadequate as well.

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LIABILITY INSURANCE

Roger M. Baron, *Subrogation: A Pandora's Box Awaiting Closure,* 41 S.D. L. REV. 237 (1996).

This article offers a critical assessment of the doctrine of subrogation, focusing specifially on the personal injury claim context. The author discusses the history and rationale behind the subrogation doctrine and urges curtailment of the doctrine. The author identifes several means by which a minority of jurisdictions have successfully restricted the insurance industry's attempts to expand subrogation from its original context in property insurance to personal injury claims. The author concludes that subrogation of personal injury claims is an unfair practice and that the court system may and should adopt equitable ameliorating doctrines to curtail its use.

Karon O. Bowdre, *"Litigation Insurance": Consequences Of An Insurance Company's Wrongful Refusal To Defend*, 44 DRAKE L. REV. 743 (1996).

This article examines the problem of inconsistent approaches to damages for failure to defend and then suggests that the better approach to wrongful-failure-to-defend cases would be to allow the insured full compensation for all damages that naturally result from the insurer's breach. Reaching this result requires an examination of the insurer's obligation to defend and an examination of foreseeable consequences of its refusal to do so in light of the expectations of the insured.

F. Joseph Du Bray, *A Response to the Anti-Subrogation Argument: What Really Emerged From Pandora's Box?,* 41 S.D. L. REV. 264 (1996).

This brief practitioner's article responds to anti-subrogation proponents by discussing the history of the subrogation doctine and its role in the risk management rationale of insurance. The author asserts that since subrogation clauses are usually contractual, bargained for, and subject to good faith requirements, the court system should not redefine or ameliorate the results of such clauses.

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James M. Fischer, *Insurance Coverage For Mass Exposure Tort Claims: The Debate Over The Appropriate Trigger Rule*, 45 DRAKE L. REV. 625 (1997).

This article analyzes the various tests that courts have developed to determine when an insurance policy is triggered. Because the trigger issue cannot be evaluated in isolation, this Article also examines the larger context of legal issues within which the trigger decision is made. The Article concludes that courts, in developing insurance trigger rules for mass exposure torts, have placed too much emphasis on the desire to provide compensation for claimants, and given too little attention to the basic structure of the insurance contract in attempting to resolve the trigger issue.

Timothy M. Gebhart, *A "Timeless" Interpretation of the "Sudden and Accidental" Exception to the Pollution Exclusion,* 41 S.D. L. REV. 314 (1996).

This article addresses the common insurance policy exclusion for pollution-related injuries or damages and the "sudden and accidental" exception to that exclusion. The author focuses on three federal court cases that have construed South Dakota policies containing the exception. The author asserts that the tendency of the federal courts has been to incorrectly construe accidental and sudden as synonymous terms, thereby removing any temporal requirements to the exception. The author concludes that a more consistent and careful reading is required by courts for the exception to be properly applied.

Garrett G. Gillespie, *The Allocation Of Coverage Responsibility Among Multiple Triggered Commercial General Liability Policies In Environmental Cases: Life After Owens-Illinois*, 14 VA. ENVTL. L.J. 525 (1996).

This article discusses the background information needed to understand the allocation issue. It sets out three approaches to allocation which courts have chosen, and the recent *Owens-Illinois v. United Insurance Company* decision from New Jersey. The author contends that, because the magnitude of the claims brought in environmental cases often greatly exceeds the size of the claims filed in asbestos cases, courts should allocate coverage somewhat

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differently in environmental and asbestos coverage actions. The author proposes to resolve the allocation problem through an analysis of contract language, the doctrines of contract interpretation, and public policy. The author concludes that the policy language at issue does not provide a clear solution to the allocation issue.

Kyle D. Logue, *Toward A Tax-Based Explanation Of The Liability Insurance Crisis,* 82 VA. L. REV. 895 (1996).

This article briefly summarizes the existing theories of the crisis and highlights their main weaknesses. It then explains why, during the period leading up to the enactment of the Tax Reform Act of 1986, property-casualty insurers had a temporary tax-based incentive to overstate their reported loss reserves. It takes a preliminary look at the insurance industry data that bear on the question whether insurers responded to the incentives created by the enactment of the '86 Act by overstating their loss reserves during this period. Finally, assuming that insurers were in fact induced by the '86 Act to change their loss-reserving patterns, it explains how such a change in loss reserves could have contributed to the crisis phenomena.

Jim L. Julian and Charles L. Schlumberger, *Insurance Coverage for Environmental Clean-Up Costs Under Comprehensive General Liability Policies,* 19 U. ARK. LITTLE ROCK L.J. 57 (1996).

This article, written by and for practitioners, provides an overview of the issues that environmental clean-up costs have spawned in the insurance industry. The authors address the background of comprehensive general liability policies, and the pollution exclusion clause. The article focuses on practical concerns and issues of which practitioners, especially in Arkansas, should be aware.

Robert J. Johnson, *In-house Council Employed by Insurance Companies: A Difficult Dilemma Confronting the Model Code of Professional Responsibility,* 57 OHIO ST. L.J. 945 (1996).

This student comment analyzes the Model Code of Professional Responsibility and Ohio Supreme Court Committee decisions in the context of

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conflicts of interest issues with arise between the insured and insurer when one in-house attorney represent both parties. The author proposes a revision tot he Model Code to specifically address the inherent ethical dilemmas faced by in-house counsel in the insurance industry.

Christopher Lyle McIlwain, *Clear as Mud: An Insurer's Rights and Duties Where Coverage Under a Liability Policy is Questionable*, 27 CUMB. L. REV. 31 (1996).

This article addresses the issues that general liability insurer's should address when presented with a claim. The author articulates four scenarios of potential coverage and offers guidance for insurance companies faced with each scenario. The author also examines the potential liabilities that may be incurred if insurers are not careful in determining the proper scope of coverage. The author concludes by urging the ultimately cost-saving practice of thorough investigation of facts and applicable law before coverage decisions are made.

LIFE INSURANCE

Kelvin H. Dickinson, *Divorce and Life Insurance: Post Mortem Remedies for Breach of a Duty to Maintain a Policy for a Designated Beneficiary*, 61 MO. L. REV. 533 (1996).

This article examines the application of legal and equitable remedies after the death of an insured who was subject to a life insurance mandate but failed to comply fully with its terms. The article examines the ability of the parties, and/or the court, in a divorce to impose a duty to obtain or maintain a life insurance policy, and to mandate a specific beneficiary. The author finds that many problems stem from the failure of the parties, their lawyers, and judges to develop a clear understanding of the purposes to be served by each mandate, and from poorly drafted mandates whose application is unclear in marginal cases. The article then considers the remedies available for the breach of such a duty, and the significant issues affecting such remedies.

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Denise M. Schultz, *Angels of Mercy of Greedy Capitalists? Buying Life Insurance Policies from the Terminally Ill*, 24 PEPP. L. REV. 99 (1996).

This article focuses on the protection of terminally ill individuals who take advantage of the funds offered by viatical settlement companies. It discusses the moral debate that has plagued the industry since its inception, and the recent attempts to regulate the industry to protect viators from exploitation and to ensure the legitimacy of the industry. It concludes with suggested steps that can be taken to protect viators and ensure that they receive the greatest amount possible for their insurance policies.

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RECENT CASE DEVELOPMENTS

*Jeffrey W. Stempel**

WASHINGTON SUPREME COURT REJECTS ALLOCATION OF RESPONSIBILITY FOR POLLUTION DAMAGES BETWEEN INSURED AND UNINSURED YEARS

B & L Trucking & Constr. Co., Inc. v. Northern Ins. Co. of N.Y., 951 P.2d 250 (Wash. 1998).

When tort claims against a policyholder involve damages spanning several years, the damage claims may also span several different liability insurers. In such cases, policyholders argue that any policy "triggered" by the presence of liability-creating injury during the policy period should be responsible for providing defense and indemnity for the claim, so long as the insurers collectively responsible for coverage are not required to pay more to the policyholder than the amount of liability loss. Where the policy limits of the triggered policies exceed the amount of liability, policyholders argue that insurers may seek contribution from one another but should not be permitted to reduce their own coverage responsibility because of the presence of other triggered insurers or periods where the policyholder was uninsured. A number of courts have adopted the policyholder's view of coverage in multiyear tort cases. *See, e.g.*, Keene Corp. v. Insurance Co. of N. Am., 667 F.2d 1034 (D.C. Cir. 1981); Montrose Chem. Corp. v. Admiral Ins. Co., 913 P.2d 878, 901 (Cal. 1995); Armstrong World Indus., Inc. v. Aetna Cas. & Sur. Co., 52 Cal. Rptr. 2d 690, 705 (Cal. Ct. App. 1996).

Insurers conversely argue that where multiple policy periods are involved, courts should pro-rate the coverage responsibility of the insurers, with the most popular allocation method being the time period in which each insurer was on the risk. Where there are periods of self-insurance or no insurance, insurers seek to have policyholders pay a pro-rated share of the costs of liability coverage. Several courts have adopted this view. *See, e.g.*, Stonewall Ins. Co. v. Asbestos Claims Mgmt. Corp., 73 F.3d 1178 (2d Cir. 1995) (applying New York law, but refusing to allocate responsibility to

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policyholder during years when insurance was unavailable due to asbestos claims exclusion made nonnegotiable in standard liability policies); Sharon Steel Corp. v. Aetna Cas. & Sur. Co., 931 P.2d 127 (Utah 1997); Northern States Power Co. v. Fidelity & Cas. Co. of N.Y., 523 N.W.2d 657 (Minn. 1994); *see also* Owens-Illinois, Inc. v. United Ins. Co., 650 A.2d 974 (N.J. 1994) (endorsing allocation and policyholder bearing of costs for uninsured periods and suggesting temporal proration as default formula but refusing to adopt per se formula if it is possible to determine percentage of injury that took place during different coverage periods). For a more in extensive discussion of the allocation controversy and its case law, see JEFFREY W. STEMPEL, INTERPRETATION OF INSURANCE CONTRACTS § T3.4 (1994 & Supp. 1998).

The Washington Supreme Court recently rejected allocation of liability responsibility by time on the risk and also strongly disagreed with the rationale supporting pro-rata allocation in a case involving wetlands pollution and a subsequently ordered remediation. In 1978, Policyholder William Fjetland purchased the B & L Landfill near Tacoma Bay. The landfill was the recipient of slag hauled from nearby log yards until 1980, when the landfill was closed due to its proximity to area wetlands. But the damage was done—or in process—in that contaminants leached from the slag at the outset and continued for years. Arsenic contamination in the Tacoma tideflats area was attributed to the leaching slag and remediation costs were imposed on the owners of the landfill and others pursuant to the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA" or "Superfund").

Policyholder Fjetland's insurers commenced a declaratory judgment action resulting in a finding that Fjetland was not liable for pollution prior to January 1981 (apparently because the contaminants had not leached from the landfill to third-party property prior to that date) and that the pollution damage was expected by Fjetland as of June 1982, thus making damage after that date "expected or intended from the standpoint of the insured" and therefore excluded from coverage under the terms of the standard commercial general liability (CGL policy). The date of the cleanup order was April 29, 1987. The trial court determined that the period for which the responsibility for the liability claims would be allocated was January 1981 to April 1987.

Thus, there were seven annual increments of pollution/CERCLA cleanup over which responsibility was to be allocated. Fjetland was insured by a Northern insurance policy in effect from August 1980 to August 1983 and another Northern policy from August 1983 to August 1984. The trial court thus found Fjetland to have coverage from Northern for the 1980-81 policy period (when the pollution liability started) and the 1981-82 policy period (when the pollution was still causing injury to other property) up to the point

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when Fjetland began to expect pollution damage from the slag in the landfill. The trial court then allocated coverage responsibility according to the time on the risk and found Northern to be responsible for 2/7ths of the liability, with Fjetland holding responsibility for the remaining 5/7ths of the matter (for all policy periods or portions thereof after the June 1982 realization of the ongoing pollution damage).

The Washington Court of Appeals reversed, rejecting the allocation method. In its February 1998 decision, the Washington Supreme Court similarly rejected not only the trial court's allocation calculation but strongly rejected the rationale of allocation to the policyholder altogether. However, three of the eight deciding judges dissented and endorsed allocation prorata by time on the risk. *B & L Trucking* thus provides a current illustration in microcosm of the pro and con views of allocation.

The *B & L Trucking* majority specifically endorsed the approach of Gruol Constr. Co. v. Insurance Co. of N. Am., 524 P.2d 427 (Wash. 1974), a well-known case applying a continuous trigger of coverage to claims against a builder for negligent construction resulting in years of "dry rot" that proceeded unseen prior to detection in a home. Endorsing *Gruol*'s continuous trigger and broad view of coverage-triggering injury, the *B & L Trucking Court* stated:

> The Gruol Court held when an insured sustains damages of a continuing nature, its insurers are jointly and severally liable. All insurers providing coverage during any portion of the total time period of the continuing damage were held liable for the total amount of the continuing property damage. We agree with Fjetland that Gruol stands for the proposition that all insurers on the risk during the time of ongoing damage have a joint and several obligation to provide full coverage for all damages. . . . . In other words, when damage occurs during a policy period, that policy is triggered.

B & L Trucking, 951 P.2d at 254.

> [I]n a continuing damage situation, each insurer is held jointly and severally liable for the full amount of damage, regardless of the amount that occurred during its policy period.

Id. at 254 n.4.

> We [have] accepted that when damage is continuing, all triggered policies provide full coverage. Northern's argument that it can be held liable only for property damage occurring during the policy

> period is misguided. this argument addresses only which policies are triggered, not whether costs should be allocated.
>
> * * *
>
> The jury's finding that Fjetland "expected" damage after June 1982 precludes the policies after that date from being triggered. It does not, as the dissent urges, preclude Northern's liability under the triggered policies for continuing damage.

Id. at 255.

The *B & L Trucking* Court rejected the argument of the insurers (and the dissenters) that failure to apportion damage over the seven annual policy periods of pollution liability would essentially mandate coverage for periods when he was not insured. On the contrary, the majority found that Fjetland had effective insurance in force and triggered for 1980-81 and 1981-82 and that Fjetland was entitled to coverage up to those policy period limits for occurrences taking place in those two years irrespective of whether coverage was available in other years.

Although the *B & L Trucking* Court and others refer to this as "joint and several liability" for triggered policies, the term is unfortunate and misleading. In fact, *B & L* and similar cases simply say that a triggered carrier is responsible for coverage according to the terms of its policy without any reduction in coverage liability simply because the injury triggering coverage also took place in other years triggering other policies. The "joint & several" liability discussed in *B & L* and other cases rejecting allocation is not a real tort law joint and several liability where each tortfeasor (even the one that is one percent at fault) is responsible to pay all of the plaintiff's damage under a judgement. Under *B & L Trucking* and other cases rejecting prorata allocation among insurers or between insurer and policyholder, a triggered insurer is never responsible for more than its policy limits (absent a bad faith judgment) even where the policyholder's liability is far greater. This is quite different than the joint and several liability of tort law, where a torfeasor responsible for only 10 percent of the negligence may be required to pay 100 percent of a plaintiff's damages. *See* JEFFREY W. STEMPEL, INTERPRETATION OF INSURANCE CONTRACTS § T3.4 (1994 & Supp. 1998) ("joint and several liability" a misnomer).

In particular, the *B & L Trucking* Court found any proration of coverage responsibility and consequent reduction of Northern's 1980 and 1981 coverage responsibility unwarranted because "if Northern intended solely to be liable on a pro rata basis, it could have included that language in its policy." Rather, "Northern drafted the policy language; it cannot now argue

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its own drafting is unfair. . . . We will not add language to the policy that the insurer did not include. Instead, Northern agreed to pay 'all sums' arising out of an 'occurrence' which, by its own policy definition, may take place over a period of time." *B & L Trucking*, 951 P.2d at 256-57.

The three dissenting justices attacked the nonapportionment result in part on public policy grounds, arguing that "the majority's imposition of 'joint and several' liability requires Northern to provide coverage for years after that date, when property damage was expected by the insured." *Id.* at 258. However, the dissent's perspective seems to misperceive the issue. According to the case report of the trial jury's finding, the pollution that created liability was not expected prior to June 1982 even though the pre-1982 pollution continued to do damage for years afterward. In this type of situation, it is not at all unusual for a tortfeasor to have coverage for injuries taking place for negligence of years gone by even though the damage takes place well after the policyholder has become aware that its past negligence brings or may well bring a particular kind of harm.

For example, in the asbestos cases, many of the claims were made years after the industry itself was aware of the dangers of the product. However, courts generally held that coverage for asbestos makers was not negated by the intentional act exclusion because the injurious exposure of the claimant to asbestos took place as much as perhaps decades earlier when the tortfeasor had no expectation of causing injury through sale and use of the product.

A more common insurance situation also illustrates problems with the dissent's characterization of the majority's anti-allocation decision as one that permits the policyholder to recover for expected losses and thus permits an impermissible introduction of moral hazard into liability insurance. Consider the "garden variety" lawsuit where an insured tortfeasor is negligent by, for example, running into a pedestrian and the pedestrian has years of medical expense and expenditures for rehabilitation and care. In these situations, the liability insurance policy (usually an automobile insurance policy) in effect at the time of the insured's infliction of injury on another remains responsible through the ensuing years of ongoing damage until policy limits are exhausted. Nothing is thought improper about this "long tail" of payments under the original policy.

Insurers raise an interesting fairness argument for proration by pointing out that in continuous trigger states such as Washington, many policies may be regarded as triggered. Without apportionment of the coverage responsibilities, argue the insurers, the insured enjoys a windfall of more coverage than is reasonable. However, this argument appears inconsistent with the language of the occurrence policy itself, which provides for triggering of the policy if there is injury during the policy period for which the insured policyholder is liable. Even though the typical liability policy also

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states that it will pay for "damage" that "occurs during the policy period", the treatment of ongoing damages from a policy period injury such as the hypothetical automobile accident case previously discussed demonstrates that prior to the asbestos and pollution coverage cases that spawned the pro-rata allocation debate insurers never expected to stop paying under a triggered policy simply because the calendar had turned a page.

So long as courts do not make erroneous trigger decisions (e.g., confusing an injury during a policy period with continued progression of an injury that took place during an earlier policy period) there would appear to be nothing untoward with requiring a triggered policy to be responsible for the financial consequences of the triggering injury up to its limits. Where the nature of the liability-creating tort triggers injury in different policy years, this is a product of the policy language and the insuring agreement rather than "joint and several" liability. Requiring triggered insurers to provide policy proceeds without any reduction due to proration thus seems merely reasonable enforcement of reasonably clear contract language so long as the court does not inaccurately treat continuing deterioration of the claimant's person or property from the original injury as a new injury triggering coverage.

The problem, of course, is that cases such as asbestos and pollution present difficult problems of proof, making it difficult or impossible to know exactly when an injury took place. However, under the available facts in such cases, it does not seem unreasonable to find multiyear triggering of policies for workers who were exposed to asbestos particles for several years while working in a shipyard or for a landowner whose property was adjacent to a continuously leaking landfill.

In the ongoing debate about allocation, the *B & L Trucking* opinion will undoubtedly be important because it both endorses a broad view of coverage-triggering injury under the CGL, and endorses the continuous trigger. This officially places the Washington Supreme Court on record as supporting the important *Gruol Construction* opinion rendered 25 years ago by the Washington Court of Appeals and frequently cited by policyholder attorneys, and roundly rejects the rationale of apportionment of coverage liability among the years during which damage occurs, particularly where this has the effect of making the policyholder responsible for otherwise insured liability claims or where apportionment among insurers reduces each insurer's own policy limits of responsibility.

Despite its potential significance, however, *B & L Trucking* can be viewed as a case where the discussion of the allocation issue was unnecessary. Rather than being characterized as an allocation case, *B & L Trucking* can be seen as a case concerning when a liability insurer's responsibility for ongoing damage can be terminated. Recall that the 1980-81 and 1981-82 Northern CGL policies were triggered. Assume that only the 1981-82 policy existed.

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Once triggered, this policy would presumably be required to pay its policy limits to indemnify Fjetland for CERCLA clean-up liability. Even if after the trigger, the risk becomes uninsurable, this should have no effect on the triggered policy's responsibility to defend and indemnify the covered occurrence that predates the uninsurability. Whether subsequent insurance policies must pay is not so much a question of allocation as one of end point—at what point do coverage responsibilities end? For a triggered insurer, the coverage responsibility ends when the triggered policy is exhausted regardless of the insurer's conduct or risk management practices after trigger. Viewed in this way, the *B & L Trucking* decision could have been rendered by simply deciding that a triggered insurer is not relieved of coverage responsibilities for ongoing damage merely because the policy period has ended. The end of the policy period may preclude any other triggering occurrences but it does not relieve the insurer of responsibility for the already triggered coverage responsibility. In this sense, *B & L Trucking* as recharacterized could be viewed as uneventful and could perhaps have avoided venturing into a lengthy examination about allocation in general.

The *B & L Trucking* case also noted that apportioning coverage responsibility across years during which there is no coverage also tends to violate the language and purpose of the CGL as well as disappointing the expectations of the policyholder in that the policyholder receives less from the insurer than what it paid for in premiums merely because the liability creating tort spans more than one policy period. Although insurers are understandably upset when multi-year torts and continuous trigger precedents expand the number of policies on the risk, insureds argue that this does not justify reducing the policyholder's protection. In a pollution tort that spans decades, the impact of apportionment could dramatically reduce or effectively eliminate coverage purchased by the policyholder, a result the *B & L Trucking* majority regarded as distinctly unfair.

APPLYING SECOND CIRCUIT'S RULE FAVORING PRO-RATA ALLOCATION OF COVERAGE RESPONSIBILITY, FEDERAL DISTRICT COURT HOLDS OLIN RESPONSIBLE FOR HALF THE COSTS OF POLLUTION CLEAN-UP DUE TO 14 YEARS OF SELF-INSURANCE

Olin Corp. v. Insurance Co. of N. Am., 986 F. Supp. 841 (S.D.N.Y. 1997).

In Stonewall Ins. Co. v. Asbestos Claims Mgmt. Corp., 73 F.3d 1178 (2d Cir. 1995), a case discussed in connection with *B & L Trucking, supra*, the United States Court of Appeals for the Second Circuit applying New York

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law held that in cases of multiyear triggering of liability insurance, the coverage responsibility must be pro-rated by time on the risk and that this included pro-rating the years during which the policyholder was uninsured or self-insured. However, the *Stonewall* court refused to impose responsibility on the insured via proration for years during which it was impossible to purchase insurance coverage for asbestos claims. The New York law applied in *Stonewall* has not been definitively pronounced by New York State's highest court. Under the balance of power between state and federal courts, federal courts ruling on matters of state law apply the law as enunciated by the state's highest court and attempt to discern or "predict" state law on novel questions based on lower court decisions and general legal principles. Thus, *Stonewall* may not be the definitive word on New York allocation of coverage responsibility for multiyear torts but neither has the New York Court of Appeals (New York's highest court; unlike other states, New York trial courts are called the "Supreme" court) suggested any rejection of *Stonewall*'s approach, making it likely that the New York high court will eventually expressly adopt the *Stonewall* view of pro-rata allocation.

Left open after *Stonewall* is the showing a policyholder must make to prove unavailability of insurance in order to avoid proration of coverage responsibility to the policyholder. In *Olin*, a pollution liability coverage matter, the federal trial court in Manhattan held that the *Stonewall* exception to pro-rata allocation "applies only where insurance is unavailable in the marketplace." *Olin*, 986 F. Supp. at 844.

The case arose out of an EPA order requiring Olin to cleanup a fertilizer plant site near Williamston, North Carolina. An earlier opinion sets forth the underlying facts in some detail. *See* Olin Corp. v. Insurance Co. of N. Am., 972 F. Supp. 189 (S.D.N.Y. 1997). After jury trial, it was determined that "there was injury to property covered by insurance for the years 1958 through 1985." *Olin,* 986 F. Supp. at 842. However, Olin was self-insured for the 1971 through 1985 period.

Olin argued that under *Stonewall* it had been deprived of the opportunity to obtain insurance because of the presence of the "sudden and accidental" pollution exclusion in post-1970 liability policies. Under New York law, this exclusion permits pollution coverage only if the pollution liability stems from an abrupt or rapid discharge rather than the gradual release of pollutants that took place at the Olin plant in North Carolina. However, the court found that this standard exclusion in the Comprehensive or Commercial General Liability Policy (CGL) did not make insurance unavailable because Olin could have purchased environmental liability (EIL) insurance beginning at least as early as 1980 and that Olin could have kept in force this claims-made form of insurance, which would have provided insurance to Olin.

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As a consequence of its failure to purchase five years' worth of EIL insurance, Olin will be required to shoulder 14 years worth of the 27-year pollution period at its plant. Applied to the $400,000 cleanup cost, this makes Olin responsible for more than $200,000 at this facility. Other facilities in dispute in this insurance coverage declaratory judgment action commenced by Olin could ultimately be the subject of additional jury trials regarding the timing of pollution and the knowledge of the polluter but it is also quite possible that disputes over the other facilities will be informally settled by Olin and INA now that the court has ruled, although further appeal is of course possible as well. According to the Court:

> Due to the nature of gradual pollution, and under the framework which we have used in this case, this was not a situation where there was one injury with consequential damages. This was a situation where there were continual instances of injuries, each of which would be sufficient to be a separate trigger for liability under a policy if the policy were in effect during the particular year.
>
> We start with the proposition that the insurance company is normally liable only for injury occurring during the time covered by the insurance under a general comprehensive liability policy. If the injury or the occurrence does in fact happen during the period of the policy, then there is coverage. If it occurs or happens after the conclusion of an insurer's policy period, it is not the responsibility of that insurance company. This case involves annual policies, and thus, if the occurrence or injury did not happen during the year of coverage, it is not covered by that policy.
>
> * * *
>
> We know that the nature of gradual pollution does not permit us to literally learn what particular injury occurs in a particular year leading to what particular monetary amount of damages. So proration is necessary.

Id at 843. Therefore, the Court stated:

> I am holding that the proration in a case such as was involved in the Williamston, North Carolina site, this proration should take place over all the years of the injury. I am further holding that the insurance company is to pay its share of the years in which insurance coverage existed. I am further holding that Olin will be required to

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> accept responsibility for the years in which injury occurred and in which it did not have insurance in effect.

Id. at 845.

Olin and *Stonewall* thus provide a current and interesting counterpoint to the Washington Supreme Court's view of allocation in *B & L Trucking*. A policyholder's attorney might take issue with Olin's approach regarding Olin's failure to purchase EIL insurance from 1980 on. Most claims-made policies, including EIL policies, provide for a retroactive date that prohibits coverage for claims based on events occurring prior to the retroactive date. Many claims-made policies also contain language seeking to exclude any claims that arise from events predating the inception of the claims-made policy. Either of these provisions in an EIL policy could preclude coverage for the 1971-1980 period and perhaps for some or all of the 1980-85 period as well. The *Olin* Court's opinion is unclear regarding whether in such a case Olin would have been required to pay half the cleanup costs even if it had faithfully maintained EIL insurance during the 1980 to 1985 period.

ARGUABLE MANIFESTATION OF AIDS PRIOR TO INCEPTION OF DISABILITY IS INSUFFICIENT TO PERMIT RESCISSION BECAUSE OF BOTH AMBIGUOUS POLICY LANGUAGE AND STATE STATUTES REGULATING INCONTESTABILITY

Estate of John Doe v. Paul Revere Ins. Group, 948 P.2d 1103 (Haw. 1997).

Dentist John Doe (a pseudonym used to protect the privacy of the plaintiff in this coverage action) applied for disability insurance with Paul Revere in October 1985. He completed a pre-printed application, and was issued a policy on October 22, 1985. In November 1991, Doe sought benefits for total disability due to HIV infection. Revere made three monthly benefit payments, stopped, and demanded a refund, claiming the AIDS-related disability was not covered due to its manifestation prior to the issuance of the policy. Doe died in September 1997 and the coverage claim was pursued by this estate.

In his 1985 application, Doe fully disclosed his history of doctor visits and made his medical records available to the insurer by signing a release. However, Revere did not obtain records of Doe's visits to Dr. E. Blossom Wang during 1983 when Doe complained of swelling of the lymph glands, occasional diarrhea, and fatigue, which Dr. Wang diagnosed as amebiasis (a parasitic infection) or Lymphadenopathy (disease of the lymph nodes), which

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could have resulted from any number of factors, including allergies, mononucleosis, or Hodgkin's disease as well as AIDS. Doe also had an abnormal decrease of white blood corpuscles. Although Dr. Wang's examination revealed some concern about Doe's T cells, extensive lab tests led the physician to conclude that Doe did not have AIDS. Referral to an infectious disease specialist revealed no diagnosis of AIDS. Both Wang and the specialist essentially concluded that, at least in 1983, Doe was healthy. In January and July 1985, further examination and testing by Wang showed significant improvement for Doe and suggested Doe "looked well physically and had no complaints".

Although Doe's disability policy had been in effect more than six years prior to his disability claim, Revere challenged the claim as one resulting from a pre-existing condition that should have been disclosed to the insurer. However, the Revere policy stated that it became incontestable after two years. In addition, Hawaii Revised Statutes § 432:10A-105(2)(A)(1993) provided that all accident or sickness policies must include the following language:

> After three years from the date of issue of this policy, no misstatements, except fraudulent misstatements, made by the applicant in the application of this policy shall be used to void this policy or to deny a claim for loss incurred or disability (as defined in the policy) commencing after the expiration of the three-year period.
>
> No claim of loss incurred or disability (as defined in the policy) commencing three years from the date of issue of this policy shall be reduced or denied on the ground that a disease or physical condition not excluded from coverage by name or specific description effective on the date of loss had existed prior to the effective date of coverage of this policy.
>
> [policies with rights of continuation for premium payment may contain the following provision in lieu of the forgoing:] "Incontestable: After this policy has been in force for a period of three years during the lifetime of the insured (excluding any period during which the insured is disabled), it shall become incontestable as to the statements contained in the application."

Estate of John Doe, 948 P.2d at 1113 (citing HAW. REV. STAT. § 431:10A-105 (1993). The Hawaii law making policies incontestable for any statements made in connection with the application and underwriting is similar to those of virtually all states for live, health, and disability policies. *See* Oglesby v.

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Penn Mut. Life Ins. Co., 889 F. Supp. 770, 774 (D. Del. 1995) (47 states with such legislation).

Despite the policy language and the Hawaii law, Revere sought to avoid coverage, arguing that the pre-existing condition language of the policy permitted it to rescind coverage if the insured had an undisclosed prior condition materially affecting the risk that had "manifested" itself prior to the issuance of the policy. Reasoning retroactively on the basis of the 1983 medical records which it appeared not to have sought to obtain prior to the issuance of the policy, Revere argued that it could rescind even where there had been no fraud or concealment if the AIDS was sufficiently manifest in 1983.

The Hawaii Supreme Court rejected Revere's argument on both contractual and statutory grounds. Regarding the insurance policy, the Court found Revere's language hopelessly ambiguous, referring to it as "an oxymoron" and a 'hall of mirrors'. Regarding the statute, the Court read the law as requiring the insurer to provide coverage where it had failed to clearly exclude a particular cause of disability and where there was no evidence of policyholder fraud in obtaining the policy.

Although *Doe* is a significant victory for the policyholder, it is important to note that *Doe* would permit an insurer to specifically exclude from life, health, or disability coverage specific causes of loss. For example, an insurer could state that it provides disability insurance so long as the disability is not caused in whole or in part by AIDS, other sexually transmitted diseases, cancer, heart or lung disease of any type, automobile accidents, industrial accidents, homicide, etc. The resulting policy would be something far less comprehensive than what we normally think of as insurance but it would apparently be permitted under the rationale of the Hawaii Court.

In addition, the actual facts of the claim in *Doe* are not particularly damning to Doe. Only with 20-20 hindsight can the 1983 medical records be seen as showing the onset of AIDS (although when viewing these records prior to October 1985, two insurers other than Revere had declined the risk). There was no fraud by Doe and he worked for six years after issuance of the policy, paying premiums throughout this time. Even after his total disability, Doe lived an additional six years. However much the 1983 medical records might have raised a red flag, Doe was clearly not at death's door when he sought insurance.

Although the *Doe* opinion is quite critical of Revere's policy language and implicitly critical of Revere's underwriting and payment practices, *Doe* is considerably less dramatic than Amex Life Assurance Co. v. Superior Court, 930 P.2d 1264 (Cal. 1997) (discussed at greater length below), in which the California Supreme Court ruled that a claim for life insurance was incontestable even though the life insurance applicant knew he was HIV-

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positive and intentionally arranged for an imposter to take his physical examination. There, the California Court read the application narrowly to find no literal misstatement to the insurer negating the incontestability clause despite the obvious fraud upon the insurer.

LIFE INSURANCE INCONTESTABLE DESPITE FRAUD BY INSURED WHO APPLIED KNOWING HE WAS HIV-POSITIVE AND USED IMPOSTER FOR PHYSICAL EXAM

Amex Life Assurance Co. v. Superior Court, 930 P.2d 1264 (Cal. 1997).

Jose Morales "knew he was HIV (human immunodeficiency virus) positive when he applied for life insurance. He lied on the application form and sent an imposter to take the mandatory medical examination." Despite this almost classic example of defrauding an insurer, the California Supreme Court ruled that Morales's beneficiary was entitled to collect the policy proceeds. More than two years elapsed from the issuance of the policy and the insured's death and the policy contained a two-year incontestability clause. According to the Court, California law treats incontestability clauses as being in the nature of a "statute of repose", forever extinguishing the insurer's opportunity to rescind coverage on grounds of fraud or any other available defense within the time prior to the vesting of incontestability. Furthermore, the Court found that the truth about the imposter was "long available" to the insurer and could have been discovered and used well before the two-year period expired.

The Court rejected an imposter defense urged by the insurer. The Court distinguished cases where such a defense had been recognized based on differing facts or law. For states treating incontestability as a statute of repose, the common thread appears to be that the insurer must have issued a policy to someone who is not the named insured rather than merely having issued the policy to the named insured on the basis of fraud. The insurer agreed to insure Morales but simply was fooled into thinking that Morales met its underwriting criteria. By contrast, if Morales had pretended to be a healthy John Smith, the resulting policy issued to Smith would not be liable to pay upon Morales's death. Although this seems something like Monty Python reasoning, it comports with formal contract law. A policy issued to John Smith would not be a contract between the insurer and Morales. However, a contract issued to Morales under false pretenses was still a contract between Morales and the insurer—albeit a contract procured by fraud. But the Court reasoned that the insurance contract specified that if the

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insurer did not discover and act upon the false pretenses within two years, it must honor the contract, whatever the reprehensible behavior that led to its formation. However, the incontestability provisions of most life insurance policies are statutorily mandated and the Amex Life decision has the practical effect of rewarding the life insurance applicant for knowing and calculated fraud.

WORDING OF POLICY APPLICATION LANGUAGE REGARDING PRE-EXISTING CONDITIONS KEY IN DETERMINING WHETHER APPLICANT'S INCOMPLETE DISCLOSURE SUFFICIENT TO WARRANT DENIAL OF MEDICAL BENEFITS; FLORIDA SUPREME COURT RESOLVES CONFLICT OF INTERMEDIATE COURTS IN PLACING GREATER EMPHASIS ON APPLICANT STATE OF MIND AND POLICY WORDING RATHER THAN OBJECTIVE MATERIALITY OR QUALITY OF INFORMATION CONVEYED IN APPLICATION

Allen Green v. Life & Health of Am., 704 So. 2d 1386 (Fla. 1998).

In March 1991, Harold Green applied for a home health care benefits policy from Life & Health of America. Among other things, the application asked whether Green or his wife had been told during the past five years that they had any of a list of enumerated conditions, including kidney failure and "chronic obstructive lung disease." Green checked "no" and signed the application, which contained a statement that the answers he had given were "full, true and complete to the best of my knowledge and belief' and that the statements were representations and not warranties. (An untrue warranty acts under the common law to void the policy, even if the warranty does not relate to the risk insured or the actual cause of a loss. A representation by contrast vitiates coverage only if it is material to the risk, or in some states, material to the actual cause of law in coverage litigation over a claim. The modern trend in insurance law, by both statute and judicial decision, has been to treat statements made by applicants or policyholders as representations so that a nonfraudulent inaccuracy will not void coverage unless it relates to the risk or loss).

The insurer issued the policy, apparently without obtaining and reviewing Green's medical records. A year later, Green filed a claim (the precise nature of the current disability claim was not noted in the Supreme Court's opinion). Thereupon, the insurer reviewed Green's medical records and "discovered that he suffered from chronic renal failure. As a result, Life & Health rescinded the policy and returned all of the previously paid premiums." *Id.* at 1388.

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Green sued for benefits and prevailed, although he died shortly after the onset of the litigation. The deposition of Green's treating physician and other discovery suggested that layman Green may have known that he had sluggish kidneys but had not been told by his doctor that he suffered from "chronic renal failure". The lower court found it "undisputed" that "Green had no knowledge of his condition and any misrepresentation was therefore unintentional." *Id.* at 1389.

However, the insurer prevailed at trial and before the intermediate court of appeals on the basis of prior Florida precedent that approved rescission for applicant misrepresentation even when the misstatement was innocent and the insurance application contained the "to the best of my knowledge and belief" type language contained in Green's application. *See, e.g.,* Continental Assurance Co. v. Carroll, 485 So. 2d 406 (Fla. 1986); Life Ins. Co. of Va. v. Shifflet, 201 So. 2d 715 (Fla. 1967) (under then applicable statute, all misrepresentations material to the acceptance of risk will invalidate an insurance policy even if made in good faith; "knowledge and belief" language in the Carroll's policy not deemed to modify this absolute rule). However, there also existed recent contrary law in federal court decisions applying Florida law. *See, e.g.*, William Penn Life Ins. Co. v. Sands, 912 F.2d 1359 (11th Cir. 1990); Carter v. United of Omaha Life Insurance, 685 So. 2d 1 (Fla. Dist. Ct. App. 1996) (holding that where the insurer uses the less draconian "knowledge and belief" language, this lower standard for judging misrepresentation and rescission applies, permitting the policyholder to recover so long as he or she answered the application truthfully based on his or her actual knowledge and belief).

In *Green*, the Florida Supreme Court moved away from the absolute rule of *Carroll* and *Shifflet* and adopted the *Carter* approach: where the insurer's own application hinges the veracity of the applicant's statements on knowledge and belief, even a material untruth in the application will not void coverage if innocently made. The *Green* Court noted:

> It is well settled that, as a general rule, "parties are free to 'contract-out' or 'contract around' state or federal law with regard to an insurance contract, so long as there is nothing void as to public policy or statutory law about such a contract."

Green, 704 So.2d at 1390 (quoting King v. Allstate Ins. Co., 906 F.2d 1537, 1540 (11th Cir. 1990).

Although contracting around the default rules of the law is normally done by the insurer to advantage the insurer, which directs the arrangement and drafts the contract language, the *Green* Court found that the insurer was

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logically bound by chosen language which favors the insured, as occurred in the *Green* case.

After *Green*, health, life, and disability insurers operating in Florida will presumably revise their application forms to remove "knowledge and belief" or "good faith" language and will instead provide that any material misrepresentation or inaccuracy in the application will provide grounds for rescinding the policy.

MINNESOTA HOLDS THAT CAR RENTAL COMPANY MAY BY CONTRACT MAKE RENTER'S AUTO INSURANCE POLICY PRIMARILY RESPONSIBLE FOR ACCIDENT COVERAGE; RENTAL COMPANY POLICY OR SELF-INSURANCE IS PRIMARY AS IT IS "CLOSEST TO THE RISK" OF RENTAL MISHAP

Hertz Corporation v. State Farm Mutual Insurance Co., 573 N.W.2d 686 (Minn. 1998).

Hertz's rental car operations in Minnesota sought to provide pursuant to the car rental agreement that Hertz would be liable for auto liability claims arising out of the rental only to the extent that the renter or operator of the rented vehicle does not have other automobile liability insurance. Hertz had earlier obtained authorization to operate as a self-insurer pursuant to the terms of the Minnesota No-Fault Automobile Insurance Act, Minn. Stat. §§ 65B.41-.71 (1996). State Farm challenged the Hertz contract as violative of the Act and prevailed before the state Supreme Court. Said the Court:

> A self-insured car rental agency does not meet its obligations as an automobile owner under the No-Fault Act by thrusting upon the renter its responsibility to provide liability coverage—that is, by providing liability coverage only in the event that the renter is without liability coverage.
>
> [The Act's provisions] do not on their face require that an automobile owner maintain coverage that is not contingent upon the presence of other coverage. Nevertheless, it is inconsistent with the general purpose of the No-Fault Act to read the statute in a manner advocated by Hertz. Hertz's interpretation of the Act would create a practical exemption to the broad statutory mandate that all automobile owners carry liability insurance, an exemption nowhere evident in the language of the statute.

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Id. at 688-89.

The Court thus interpreted the state no-fault statute to require that all users of automobiles provide primary coverage through either purchase of a policy or approved self-insurance, rejecting Hertz's argument that this requirement violated Hertz's freedom of contract to structure its rental agreements to place the burden of insurance upon the renter.

In addition, the Court required that the Hertz self-insurance program must provide primary coverage and that the renter's policy would provide secondary liability coverage. Minnesota law requires that the insurance policy "closest to the risk" be primary for purposes of coordination of benefits. If the policy closest to the risk is insufficient to satisfy the liability claim, the secondary policy is triggered for additional coverage. *See* Interstate Fire & Cas. Co. v. Auto-Owners Ins. Co., 433 N.W.2d 82 (Minn. 1988). In making this determination, *Hertz v. State Farm* and other Minnesota cases examine which policy most specifically describes or contemplates the "accident-causing instrumentality" and "[w]hich premium is reflective of the greater contemplated exposure". *Hertz*, 573 N.W.2d at 691.

> Applying these factors to this case, the Hertz self-insurance policy specifically describes the rental vehicle involved in the accident because Hertz is the owner and its self-insurance is specifically available to cover the vehicle at issue, while Powers' [the renter] State Farm policy only describes Powers' personal automobile. . . . because Hertz chose to self-insure, it avoided the payment of premiums to cover its liability. However, it is clear that Powers' State Farm policy did not contemplate primary coverage for more then damage to a rental vehicle, and its premiums are reflective of that fact. . . . the State Farm policy specifically states that its non-owned vehicle coverage is excess and incidental to any other policy covering the vehicle. While Hertz attempts to shift primacy to the State Farm policy through its rental agreement, Hertz's self insurance must provide liability coverage for damages caused by the use of vehicles it owns and offers for rent. Therefore, Hertz's self-insurance coverage is primary even under common law principles.

Id.

Two Justices concurred specially, suggesting they disagreed with the majority's common law analysis but finding a statutory amendment that became effective a day prior to the rental at issue in the case to be dispositive. Justice Alan Page, widely know for his prior career as a star NFL defensive lineman for the Minnesota Vikings and Chicago Bears, was the lone dissenter, arguing that the majority approach would not provide increased coverage but

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would merely require Hertz to absorb more of the cost of rental car accidents, with the increased cost "likely to be passed on by Hertz to all of its rental car customers. There is no sound reason why individual renters should not be required to bear the cost of their own liability insurance protection."

Despite its appealing law & economics argument, the Page dissent appears to underestimate the reduction in auto insurance protection effected by the Hertz rental agreement, which would "not grant any defense or indemnity protection under [the agreement if the renter is] covered by any valid and collectible automobile liability insurance, whether primary, excess or contingent, with limits at least equal to the minimum required by the applicable state financial responsibility law." *Id.* at 687. In Minnesota, like most states, the minimum required by no-fault is low—$10,000 per person and $30,000 per accident of liability coverage—hardly enough to provide full compensation in the event of a serious automobile accident. Consequently, enforcement of the Hertz provision would appear to open the door to rental car accidents in which the third party victim would be able to pursue only the relatively shallow pocket of a minimum level no-fault policy but be effectively barred from full compensation absent active fault by Hertz (e.g., faulty car maintenance contributing to the hypothetical accident) or a tortfeasor renter with sufficient personal assets to pay the claim. Consequently, the *Hertz v. State Farm* decision would appear not merely to shift coverage burdens but to expand available automobile liability coverage generally.

RECENT FEDERAL DISTRICT COURT DECISIONS HIGHLIGHT VARIANT ISSUES IN INSURANCE ARBITRATIONS

In re National Broadcasting Company, Inc. and NBC Europe, Inc., No. M-77, 1998 U.S. Dist. LEXIS 385, 1998 WL 19994 (S.D.N.Y. Jan. 21, 1998).

Clarendon National Insurance Co. v. TIG Reinsurance Company, No. 97 Civ. 5911, 1998 U.S. Dist. LEXIS 191, 1998 WL 12110 (S.D.N.Y. Jan. 12, 1998).

Two recent decisions by noted federal district judge Robert W. Sweet bring focus to two seldom litigated but potentially important aspects of insurance arbitration. In *Application of NBC*, the issue was whether 28 U.S.C. § 1782, which authorizes the issuance of documentary or testimonial subpoenas for "use in a proceeding in a foreign or international tribunal" applies to private commercial arbitration. The *NBC* Court's review of the

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statute's history led it to conclude that Section 1782 applies only to publically operated tribunals and not to private arbitrations such as the International Chamber of Commerce arbitration at issue in NBC. *Accord In re* Medway Power Ltd., 985 F. Supp. 402 (S.D.N.Y. 1997); *contra In re* Technostroyexport, 853 F. Supp. 695 (S.D.N.Y. 1994).

In *Clarendon National Insurance*, the court reviewed a reinsurance arbitration award and largely confirmed the award but remanded a portion of the arbitrator's determination on the ground that this particular aspect of the award exceeded the scope of the arbitrator's authority established by the arbitration clause. The arbitrators had awarded interest to the prevailing party based on the damage award even though the arbitration clause had plainly provided that any award of interest would be calculated pursuant to a Memorandum of Understanding the parties executed when the disputants settled most issues between them and submitted the remaining issues to arbitration. The *Clarendon National* Court found some uncertainty in the law regarding the power of a reviewing court to confirm or remand a portion of an arbitration award rather than the entire award but resolved the issue in favor of partial vacating and remand of the infirm component of the award on grounds of judicial and arbitral economy as well as deference to the portion of the arbitrators' award that was entitled to prompt confirmation.

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