Slippery Slopes and Ethical Landmines In the Independent Counsel Context

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SLIPPERY SLOPES AND ETHICAL LANDMINES IN THE INDEPENDENT COUNSEL CONTEXT

One of the hot issues in insurance law is the insured's right to independent counsel. In particular, questions arise as to whether the insurer or the insured gets to select counsel, who has to pay for independent counsel, the appropriate rate to be paid by the insurer to independent counsel, and privilege issues arising out of the use of independent counsel. Prior to addressing these independent counsel issues, this paper will provide some background on the so-called tripartite relationship between the insurer, the insured, and defense counsel, as well as the use of captive counsel.

I.
The Tripartite Relationship

When an insurer assumes its insured's defense, generally it has the right to select defense counsel pursuant to the terms of the policy. If no conflict of interest exists, the insurer also may have exclusive control over the defense. When a conflict of interest does exist (e.g., when the outcome of a coverage issue can be affected by the manner in which the underlying action is defended), the relationships between the liability insurer, its insured, and the defense counsel selected by the liability insurer to defend the insured can give rise to ethical issues that can be tricky to navigate. The relationship among these parties is known as the "tripartite relationship."

A debate exists as to whether Texas is a one-client or two-client state. Essentially, the debate focuses on whether the insurer also is the client of defense counsel hired by the insurer to represent the insured. *See* Charles Silver, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 Duke L.J. 255 (1995); Charles Silver & Michael Quinn, *Wrong Turns on the Three-Way Street: Dispelling Nonsense about Insurance Defense Lawyers*, Coverage, Nov.–Dec. 1995, at 1. Texas law is far from clear on this point with some cases pointing to a one-client state and others pointing towards a two-client state. Even so, regardless of the one-client versus two-client debate, Texas law is clear that defense counsel owes "unqualified loyalty" to the insured. *See State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 628 (Tex. 1998); *Employers Ins. Cas. Co. v. Tilley*, 496 S.W.2d 552, 558 (Tex. 1973). As the Supreme Court of Texas pointed out in *Traver*, "the lawyer must at all times protect the interests of the insured . . . ." *Traver*, 980 S.W.2d at 628. Despite the fact that defense counsel undeniably owes its unqualified loyalty to the insured, the fact remains that the "so-called tripartite relationship has been well documented as a source of unending ethical, legal, and economic tension." *Traver*, 980 S.W.2d at 633 (Gonzalez, J., concurring and dissenting). As Justice Gonzalez further noted:

> The duty to defend in a liability policy at times makes for an uneasy alliance. The insured wants the best defense possible. The insurance company, always looking at the bottom line, wants to provide a defense at the lowest possible cost. The lawyer the insurer retains to defend the insured is caught in the middle. There is a lot of wisdom in the old proverb: He who pays the piper calls the tune. The lawyer wants to provide a competent defense, yet knows who pays the bills and who is most likely to send new business.

Id.

The import of *Traver* and *Tilley* in the duty to defend context is that an insurer should not use the same counsel to review coverage that it does to defend the insured. *See Employers Cas. Co. v. Mireles*, 520 S.W.2d 516 (Tex. Civ. App.—San Antonio 1975, writ ref'd n.r.e.) (holding that the employment of separate firms to defend the insured and to address coverage issues eliminates conflicts of interest). Accordingly, when an insurer offers a qualified defense under a reservation of rights and proceeds by hiring defense counsel, the defense counsel should remain "independent." Likewise, when a qualified defense is provided, defense counsel should never communicate with the insurer with respect to "coverage" issues. *See Rhodes v. Chicago Ins. Co.*, 719 F.2d 116 (5th Cir. 1983).

II.
The Use of Captive Firms

Another issue that has come to the forefront of late is the use of "captive firms" to defend insureds. A captive firm is a law office staffed by lawyers who actually are employees of the insurance company. The use of captive firms has increased over the past few years as insurers have searched for ways to be cost-effective. *See Traver*, 980 S.W.2d at 633 (Gonzalez, J., concurring and dissenting).

The Unauthorized Practice of Law Committee (UPLC) has waged war against the use of captive firms to defend insureds. According to the UPLC, the use of captive firms raises serious ethical issues. In particular, the UPLC questions whether captive lawyers truly will look out for the best interests of the insureds. The use of captive firms also has caught the attention of the Supreme Court of Texas. *See Traver*, 980 S.W.2d at 633 (Gonzalez, J., concurring and dissenting) (noting that "it is probably impossible for an attorney to provide the insured the unqualified loyalty that *Tilley* requires" where the insured is being represented by a captive firm).

Even so, the UPLC has been unsuccessful in its prosecution of insurers that use captive firms. *See Unauthorized Practice of Law Comm. v. Nationwide Mut. Ins. Co.*, 155 S.W.3d 590 (Tex. App.—San Antonio 2004, pet. filed); *Am. Home Assurance Co. v. Unauthorized Practice of Law Comm.*, 121 S.W.3d 831(Tex. App.—Eastland 2003, pet. granted).[1] Notably, both courts held that the use of staff counsel to represent insureds does not constitute the unauthorized practice of law. Interestingly, the Eastland Court of Appeals specifically held that a defense lawyer has two clients. *Am. Home*, 121 S.W.3d at 838 ("Reality and common sense dictate that the insurance company is also a client. The insurance company retains the attorney, controls the legal defense, decides if the case should be settled, and pays any judgment or settlement amount up to policy limits. It is a fiction to say that the insured is the only client in view of the contractual relationships."). Despite the result, no question exists that staff counsel still owe the insured unqualified loyalty. *See Nationwide*, 155 S.W.3d at 598; *Am. Home Assurance*, 121 S.W.3d at 838.

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[1] Oral argument took place in *American Home* on September 28, 2005. All of the briefing can be found on the Supreme Court's website at http://www.supreme.courts.state.tx.us/.

III.
The Right to Independent Counsel

Whether an insurer has the right to control the defense, which involves the right to select counsel, is a matter of contract. *See N. County Mut. Ins. Co. v. Davalos*, 140 S.W.3d 685, 688 (Tex. 2004); *see also Traver,* 980 S.W.2d at 627. Most policies vest this right in insurers. In fact, it may be a violation of the cooperation clause to refuse to allow an insurer to select counsel and control the defense when the insurer agrees to provide an unqualified defense. *See Burney v. Odyssey Re (London) Ltd.*, 2005 WL 81722 (N.D. Tex. Jan. 14, 2005), *aff'd*, 169 Fed. Appx. 828 (5th Cir. 2006). "Under certain circumstances, however, an insurer may not insist upon its contractual right to control the defense." *Davalos*, 140 S.W.3d at 688. In particular, an insurer must relinquish this right when a "conflict of interest" exists. *Traver*, 980 S.W.2d at 627. Even so, according to the Supreme Court of Texas, not every disagreement about how the defense should be conducted rises to the level of a conflict of interest. *See Davalos*, 140 S.W.3d at 689 (holding that a disagreement as to the proper venue for the defense of a third-party claim did not amount to a conflict of interest).

A big issue is whether the issuance of a reservation of rights constitutes a per se conflict of interest. To date, most courts that have addressed the issue have concluded that a reservation of rights can create a sufficient conflict of interest that would warrant an insurer to relinquish its contractual right to control the defense. *See Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 120 (5th Cir. 1983) ("When a reservation of rights is made, however, the insured may properly refuse the tender of defense and pursue his own defense" and the "insurer remains liable for attorneys' fees incurred by the insured and may not insist on conducting the defense."); *Arkwright-Boston Mfrs. Mut. Ins. Co. v. Aries Marine Corp.*, 932 F.2d 442, 445 (5th Cir. 1991) ("The insured, confronted by notice of the potential conflict [through a reservation of rights], may then choose to defend the suit personally."); *Am. Eagle Ins. Co. v. Nettleton*, 932 S.W.2d 169, 174 (Tex. App.—El Paso 1996, writ denied) ("Upon receiving notice of the reservation of rights, the insured may properly refuse tender of defense and defend the suit personally."); *see also Britt v. Cambridge Mut. Fire Ins. Co.*, 717 S.W.2d 476, 481 (Tex. App.—San Antonio 1986, writ ref'd n.r.e.); *Steel Erection Co. v. Travelers Indem. Co.*, 392 S.W.2d 713 (Tex. App.—San Antonio 1965, writ ref'd n.r.e.).

One of the most recent opinions to address this issue was authored by Judge Lindsay from the Northern District. *See Hous. Auth. of City of Dallas v. Northland Ins. Co.*, 333 F. Supp. 2d 595 (N.D. Tex. 2004). In *Northland*, Judge Lindsay noted as follows:

> Northland contends that despite that the facts in the [underlying lawsuit] are the same as those upon which coverage depends, there is no evidence that the facts could have been "steered" to exclude coverage. In other words, Northland contends that DHA has offered no evidence that the counsel it selected would have manipulated the facts of the case, thereby allowing it to avoid coverage.
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> Northland next contends that regardless of whether the reservation of rights letter created a potential conflict of interest, DHA's only opposition at the time it tendered a defense was the slow progress of DHA's cases . . . which, it contends, is insufficient

> to create a disqualifying conflict of interest. It is true that the record establishes that the slow progress of its cases . . . was DHA's only concern, and that the conflict of interest matter seemingly just fell into DHA's lap; however, the facts are what they are and necessarily establish or create a disqualifying conflict of interest. Specifically, Northland issued a reservation of rights letter, which created a potential conflict of interest. . . . As previously stated, Northland acknowledged that the liability facts and coverage facts are the same, or at a minimum, did not dispute that the facts were the same, although it had the opportunity to do so. The court, therefore, determines that because the liability facts and coverage facts were the same and because a potential conflict of interest was created by the issuance of the reservation of rights letter, a disqualifying conflict existed; therefore Northland could not conduct the defense of the *Bell* lawsuit. Under these circumstances, DHA properly refused Northland's qualified tender of defense and defended the *Bell* lawsuit on its own.

Northland, 333 F. Supp. 2d at 601-02. Thus, under *Northland*, a reservation of rights creates a disqualifying conflict so long as the facts to be developed in the underlying lawsuit are the same facts upon which coverage depends.

Judge Rosenthal recently issued an opinion that addresses this issue:

> Not every reservation of rights creates a conflict of interest allowing an insured to select independent counsel. Rather, the existence of a conflict depends on the nature of the coverage issue as it relates to the underlying case. If the insurance policy (like the policy in this case) gives the insurer the right to control the defense of a case the insurer is defending on the insured's behalf, the insured cannot choose independent counsel and require the insurer to reimburse the expenses unless "the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends."

RX.Com Inc. v. Hartford Fire Ins. Co., 426 F. Supp. 2d 546, 559 (S.D. Tex. 2006) (citing *Davalos*, 140 S.W.3d at 689). In other words, according to *RX.Com*: "A conflict of interest does not arise unless the outcome of the coverage issue can be controlled by counsel retained by the insurer for the defense of the underlying claim." *Id.*

Thus, in those cases where a conflict of interest of sufficient magnitude arises between the insurer and the insured, Texas courts require that the insurer's rights under the policy to select counsel and control the defense pass to the insured. In those instances, courts are responding to the perceived unfairness of allowing the insurer, which has not unequivocally accepted a duty ultimately to indemnify its insured, to control the defense and potentially manipulate or steer the outcome of the defense toward a denial of coverage. In the event an insured is entitled to independent counsel, the next question is how much the insurer is required to pay independent counsel selected by the insured.

IV.
Fees of Independent Counsel

In those instances when the carrier recognizes its insured's right to independent counsel, the carrier then often wrangles with its insured over how much they must pay independent counsel. For example, if independent counsel normally charges $250 per hour whereas the counsel selected by the insurer charges $150 per hour, can the insurer insist on paying the lower rate? The most rational answer is that the insurer should be forced to pay what is reasonable and customary for the type and sophistication of the particular case. Carriers, on the other hand, argue that they should only be required to pay those rates they normally pay defense counsel. In fact, some carriers now are including provisions in their policies that contractually provide for this result. For example, an Arch Specialty Insurance Policy issued in 2004 states: "In the event that you are entitled by law to select independent counsel to defend you at the Company's expense and you elect to select such counsel, the attorney's fees and all other litigation expenses we must pay are limited to the rates we actually pay to counsel we retain in the ordinary course of business in the defense of similar claims in the community where the claim arose or is being defended."

Similarly, the Legislatures of Alaska and California have enacted statutes declaring that in independent counsel situations, the reasonableness of defense costs must be measured from the carrier's perspective based upon what the carrier typically pays defense counsel. Alaska Stat. § 21.98.100(d) (1995) ("[T]he obligation of the carrier to pay the fee charged by the independent counsel is limited to the rate that is actually paid by the carrier to an attorney in the ordinary course of business in the defense of a similar civil action in the community in which the claim arose or is being defended."); Cal. Civ. Code § 2860(c) (1987) ("The carrier's obligation to pay fees to the independent counsel selected by the insured is limited to the rates which are actually paid by the carrier to attorneys retained by it in the ordinary course of business in the defense of similar actions in the community where the claim arose or is being defended.").

The Legislatures of Alaska and California seem to ignore the fact that defense counsel who receive a large volume of work from a particular insurer oftentimes discount their rates and thus their fees usually are significantly lower than those charged by independent counsel selected by insureds in conflict-of-interest situations. Independent counsel, who may or may not ever have another case involving the insurer, should not be forced to accept the discounted rate. Likewise, the insured should not be forced to pay the difference between what the carrier typically pays defense counsel and what independent counsel charges. Simply put, it should come down to what is reasonable under the circumstances of the particular case.

At least two Texas courts are in agreement. In *Northland*, after deciding that the carrier had breached its duty to defend, Judge Lindsay issued a subsequent opinion in which he concluded that the fees charged by the lawyers that the insured had retained to represent it after the insured refused to accept the insurer's qualified defense were "on the low end of reasonableness," despite the fact that they were significantly higher than the rates that would have been charged by the insurer's selected counsel. *See Hous. Auth. of City of Dallas v. Northland Ins. Co.*, Civil Action No. 3:03-CV-385-L,

In the United States District Court for the Northern District of Texas, Order dated January 27, 2005.[2] In *Kirby v. Hartford Casualty Insurance Co.*, a magistrate judge from the Northern District of Texas stated:

> In addition to its failure to offer any evidence to support its assertion that $135.00 per hour represents the only "reasonable and customary" rate for defense counsel in a matter like the Underlying Lawsuit . . . , Hartford cites no authority for its conclusion that Kirby is obligated to accept defense counsel "appointed" by Hartford or be limited to any rate the insurer is able to negotiate with such counsel. Hartford cites one case confirming that the insurer is obligated to pay "reasonable and necessary" defense costs. . . . (*Travelers Ins. Co. v. Chicago Bridge & Iron Co.*, 442 S.W.2d 888, 900 (Tex. Civ. App.—Houston [1st Dist.] 1969, writ ref'd n.r.e.). Neither that case nor any other authority establishes, as Hartford contends, that "any rate above [$135 per hour] simply cannot be deemed as necessary." *See Ripepi v. Am. Ins. Cos.*, 234 F. Supp. 156, 158 (W.D. Pa. 1964) (insured "was not required to employ the cheapest lawyer he could get, or solicit competitive bids" after insurer failed to defend, *aff'd*, 349 F.2d 300 (3d Cir.1965)).
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> Hartford's position flies in the face of cases from Texas and other jurisdictions confirming that an insurer forfeits its control of an insured's defense by not promptly tendering a defense or by creating a conflict of interest. *See Witt v. Universal Auto. Ins. Co.*, 116 S.W.2d 1095, 1098 (Tex. Civ. App.—Waco 1938, writ dism'd); *see also Grube v. Daun*, 496 N.W.2d 106, 124 (Wis. Ct. App. 1992) (insurer lost its right to control insured's defense by initially breaching duty to defend); *Home Indem. Co. v. Leo L. Davis, Inc.*, 145 Cal. Rptr. 158, 163 (Cal. Ct. App. 1978) (insured not "obligated to content himself" with a defense offered "only after almost a year's delay . . . by an insurer who persistently maintained a position adverse to his interests").

2003 WL 23676809, *2 (N.D. Tex. 2003).

Overall, other than to recite the general rule that the insurer must pay "reasonable" attorney fees of independent counsel, there is a dearth of case law from any jurisdiction that defines what constitutes a reasonable fee for independent counsel. *See, e.g., Golotrade Shipping & Chartering, Inc. v. Travelers Indem. Co.*, 706 F. Supp. 214, 219 (S.D.N.Y. 1989) (stating that once a conflict of interest arises, "the duty to defend includes a duty to provide independent defense counsel to the insured, whose reasonable fee is to be paid by the insurer but who is to be appointed by the insured"); *U.S. Fid. & Guar. Co. v. Louis A. Roser Co.*, 585 F.2d 932, 941 (8th Cir.1978) ("USF & G must now reimburse appellant for the fair and reasonable value of the services rendered by appellant's independent counsel in defending the Kemp action."); *Armstrong Cleaners, Inc. v. Erie Ins. Exch.*,

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[2] In determining the amount of fees to be awarded, Judge Lindsay relied on the factors set out in *Johnson v. Georgia Hwy. Express, Inc.*, 488 F.2d 714 (5th Cir. 1974). The *Johnson* factors are virtually identical to the factors that the Texas Supreme Court has set out as a guide when awarding attorneys' fees. *See Arthur Anderson & Co. v. Perry Equip. Corp.*, 945 S.W.2d 812, 818 (Tex. 1997). There is no published Texas case law at this time that applies the *Arthur Anderson* (or *Johnson*) factors in the independent counsel context; however, no rational basis exists for departing from applying these factors in the insurance context.

364 F. Supp. 2d 797, 801 (S.D. Ind. 2005) ("[T]he policyholders are entitled to select their own counsel to defend the underlying claim, subject to reasonable approval by the insurer, with reasonable fees and expenses paid by the insurer."); *HK Sys., Inc. v. Admiral Ins. Co.*, 2005 WL 1563340, *18 (E.D. Wis. June 27, 2005) (opining that the Wisconsin Supreme Court "would find that the insurer's responsibility for defense costs extends only to a reasonable charge"); *Aquino v. State Farm Ins. Cos.*, 793 A.2d 824, 832 (N.J. Super. 2002) ("It does not follow, however, that he is entitled to be compensated by the carriers for that defense work on the same basis that he is entitled to be compensated for work performed in connection with the declaratory judgment action. While [the insured] may have been entitled to an attorney of his selection to handle the claim of intentional conduct, he does not have the right to dictate to the insurers the hourly rate they must pay. The trial court here should have determined a reasonable hourly rate for defense work of this nature and set a fee accordingly.").

For the time being, therefore, insureds and their independent counsel may simply have to negotiate the rates of independent counsel with their carriers, which in some cases may result in independent counsel agreeing to compromise their rates somewhat. Insureds and independent counsel should not, however, agree to accept below market rates simply because the insurer oftentimes receives a volume discount.

V.
Litigation/Billing Guidelines

Beginning in 1997, a large number of ethics advisory opinions were issued across the country in response to inquiries from defense counsel, regarding whether counsel must follow a carrier's litigation/billing guidelines.[3] In almost every instance, the ethics opinions concluded that defense counsel could not allow a carrier's litigation guidelines to interfere with or otherwise impede their professional judgment about how best to competently represent the insured. In fact, the various state ethical boards nearly uniformly treated insurers' attempts to impose guidelines as being directly at odds with the ethical obligations of attorneys to their clients. Based on these opinions, while a prohibition on block billing or other non-substantive restrictions may be permissible, it likely would not be permissible for an insurer to restrict research, discovery, motions practice, or other matters that fall within the professional judgment of the defense counsel.

Texas courts provide very little guidance on this issue. A Texas ethics opinion, however, does provide some insight. *See* Tex. Comm. on Prof'l Ethics, Op. 533 (2000) ("It's impermissible under the Texas Disciplinary Rules of Professional Conduct for a lawyer to agree with an insurance company to restrictions which interfere with the lawyer's exercise of his or her independent professional judgment in renders such legal services the insured/client."). Ethics Opinion 533 basically stands for the proposition that a defense lawyer can follow billing/litigation guidelines so long as such guidelines do not interfere with the defense counsel's professional judgment. *Id.* In *Traver*, the Texas Supreme Court recognized that "the lawyer must at all times protect the interests of the insured if those interests would be compromised by the insurer's instructions." *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 628 (Tex. 1998). *See also In re Rules of*

[3] The attached appendix contains summaries of ethics opinions from across the country.

Professional Conduct and Insurer Imposed Billing Rules and Procedures, 2 P.3d 806 (Mont. 2000) (finding that insurer's litigation guidelines requiring defense counsel to obtain the insurer's prior approval of depositions, motions, research, and experts fundamentally interferes with counsel's exercise of independent judgment and undivided loyalty).

In *WNS, Inc. v. American Motorists Insurance Co.*, WNS had accused American Motorists of engaging unfair settlement practices by using Kemper litigation guidelines to avoid paying reasonable and necessary defense costs related to a claim covered under WNS' CGL policy with American Motorists. (270th Judicial District of Harris County, Texas, Cause No. 98-49195, June 19, 2000). WNS argued that the litigation guidelines, which required the attorney paid by the insurer (in this case, independent counsel) to seek approval prior to undertaking certain legal tasks, interfered with WNS' attorneys' exercise of professional judgment. WNS further alleged that the audit, which was performed after the conclusion of the litigation, was nothing more than a sham and pretext to deny payment of reasonable and necessary attorneys' fees and costs. A Houston jury found that the guidelines and the audit constituted unfair settlement and deceptive trade practices, and awarded WNS more than $900,000 in damages.

In *WNS*, the audit company was a wholly-owned subsidiary of American Motorists' parent company. Oftentimes, however, the audit company is an outside company that the carrier hires to perform the audits. In that context, questions often arise as to whether the release of fee bills to an outside audit company results in a waiver of privilege. Around thirty jurisdictions have issued case law, ethics rulings, or opinions concerning whether fee bills may be released to third-party auditors without the consent of the insured. Out of that number, at least twenty-eight have found that the insured's consent is required before fee statements containing confidential information may be submitted to auditors. Texas follows the majority in that regard.

Texas Ethics Opinion Number 532 states:

> When a lawyer is retained by an insurance company to represent an insured, the lawyer is obligated to protect the confidential information of the insured as defined in Texas Disciplinary Rule 1.05. A lawyer's invoice or fee statement describing legal services rendered by the lawyer constitutes "confidential information." Without first obtaining the informed consent of the insured, a lawyer cannot, at the request of the insurance company paying his fees for the representation, provide fee statements to a third-party auditor describing legal services rendered by the lawyer for the insured.

Tex. Comm. on Prof'l Ethics, Op. 532 (2000). *See also* Tex. Comm. on Prof'l Ethics, Op. 552 (2004) ("A lawyer's fee statement or invoice is confidential information, which the lawyer must protect, notwithstanding the payment of the lawyer's fees by the insured's insurance company. The delivery of confidential information to a third party, by any means or media, without the informed consent of the insured client violates Rule 1.05 of the Texas Disciplinary Rules of Professional Conduct."). The question then becomes, once the lawyer obtains the informed consent of the insured, does submission of the fee statements to a third-party auditor result in a loss of the attorney-client privilege with respect to the information described in the fee statement?

VI.
Waiver of Privilege

Texas courts provide very little guidance on the issue of waiver of privilege in the insurance context. Ethics Opinion 532 states that when an insurance company submits billing invoices or statements to outside auditors, confidentiality and privilege may be jeopardized with respect to the information described in the fee statement. Tex. Comm. on Prof'l Ethics, Op. 532 (2000). *See also Rules of Professional Conduct*, 2 P.3d at 822 ("Depending upon the facts and circumstances, such disclosure may waive a specific privilege."); *Traver*, 980 S.W.2d at 634 (Gonzalez, J., concurring in part) ("Some insurance companies impose billing restrictions and subject the lawyers to billing audits. These audits threaten the attorney-client privilege.") Thus, the inclusion of such information as the subject matter discussed, the identity of the participants in a meeting or conference, the subject matter of research, and the recipient and purpose of a letter may result in a waiver of privilege with respect to that information. *Id.*

The case law provides a bit more guidance outside the insurance context. For example, the United States Court of Appeals for the Fifth Circuit has held that revealing privileged documents to accountants for tax consultation waives the privilege with respect to that information. *U.S. v. El Paso Co.*, 682 F.2d 530, 539-40 (5th Cir. 1982). A similar result was reached by the United States Court of Appeals for the First Circuit in *United States v. MIT*, 129 F.3d 681 (1st Cir. 1997). When the United States challenged MIT's tax exempt status, it sought copies of attorney billing statements that MIT had been required by its contract with the government to submit to auditors. The court held that the attorney-client privilege was waived as to the materials supplied to outside auditors, despite the fact that the federal government required this as a condition of the contract. The court explained that the privilege is maintained when documents are disclosed to a small "magic circle" of "others"—secretaries, interpreters, counsel for a cooperating co-defendant, or a parent present when a child consults a lawyer. The court stated:

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

Id. at 686. The court also found a waiver of the work-product privilege because the issue of the reasonableness of the fees could become a point of adversity between MIT and the audit agency. *Id.* at 687.

The Fifth Circuit also has held that disclosure of attorney-client communications to a third party who lacks a "common legal interest" waives the attorney-client privilege. *In re Auclair*, 961 F.2d 65, 69 (5th Cir. 1992); *U.S. v. El Paso Co.*, 682 F.2d 530, 540 (5th Cir. 1982). Moreover, a client's disclosure of documents directly to an auditor, accountant, or tax analyst destroys

confidentiality with respect to those documents. *El Paso Co.*, 682 F.2d at 540; *U.S. v. Miller*, 660 F.2d 563, 570 (5th Cir. 1981). If a client seeks only accounting services instead of legal advice, "or if the advice sought is the accountant's rather than the lawyer's, no privilege exists." *U.S. v. Kovel*, 296 F.2d 918, 922 (2d Cir. 1961). *See also Nguyen v. Excel Corp.*, 197 F.3d 200, 207 (5th Cir. 1999) ("When relayed to a third party that is not rendering legal services on the client's behalf, a communication is no longer confidential, and thus it falls outside of the reaches of the privilege.").

Thus, the privilege is retained when communications are submitted to a third party who assists an attorney in rendering legal advice. *Kovel*, 296 F.2d at 922. In *Kovel*, the court held that the attorney-client privilege "must include all other persons who act as the attorney's agents." *Id.* at 921 (citations omitted). This logic extends to financial professionals such as accountants. *See id.* at 921-22. When an attorney "retains an accountant as a listening post," or "direct[s] the client . . . to tell his story in the first instance to an accountant engaged by the lawyer . . . so that the lawyer may better give legal advice, communications by the client reasonably related to th[ose] purpose[s] ought to fall within the privilege." *Id.* This exception also protects documents produced as a result of those communications. *See id.*

In *Kovel*, the court stated further that a lawyer may not render communications between the attorney's client and the accountant privileged just by placing an accountant on the payroll. *Id.* at 921. A mere agency relationship between an attorney and an accountant will not automatically establish protection under the attorney-client privilege. *Id.* The Fifth Circuit, like most, has adopted the *Kovel* test. *See El Paso Co.*, 682 F.2d at 541. Thus, an attorney claiming the attorney-client privilege for communications between an attorney and an accountant or for documents prepared by an accountant for an attorney must prove that the accounting services enabled the giving of legal advice. *U.S. v. Davis*, 636 F.2d 1028, 1043 n.17 (5th Cir. 1981); *see also U.S. v. Pipkins*, 528 F.2d 559, 562 (5th Cir. 1976); *Ferko v. Nat'l Ass'n for Stock Car Auto Racing, Inc.*, 218 F.R.D. 125, 134B135 (E.D. Tex. 2003).

In the insurance defense context, the Montana Supreme Court followed the federal courts' lead when it held that a third-party auditor is not within the "magic circle" or community of interest that the court in MIT recognized. *In the Matter of the Rules of Professional Conduct & Insurer Imposed Billing Rules & Procedures*, 2 P.3d 806, 821 (Mont. 2000). The court rejected a litany of arguments and concluded that disclosures to third-party auditors constituted disclosure to a potential adversary because there "is always the possibility of disputes between auditors, defense counsel and their clients that could result in litigation." *Id.* at 821. The court stated further: "Third-party auditors are not agents of defense counsel, nor are disclosures to them communications passing from one party to the attorney for another party." *Id.* Moreover, the Montana Supreme Court stated:

> In determining that third-party auditors fall outside the "magic circle," however, we do not hold that the disclosure of detailed descriptions of professional services to a third-party auditor necessarily violates any privilege that may attach to them. Resolution of that issue would clearly entail findings of fact that we have not made in the present case.

2 P.3d at 821.

Thus, counsel defending insureds should keep in mind that third-party auditors hired by the insurance company to audit counsel's fee bills very likely will not be found to fall within the "magic circle" of persons that would fall within the purview of attorney-client privilege. In addition, third-party auditors, at least according to the Montana Supreme Court, do not have a "common legal interest" with the insured that would preserve the privilege.

Further, independent counsel should keep in mind that communications sent to the carrier, in certain circumstances, may not fall within the "common interest" doctrine. For example, in cases where the insurer has denied coverage, and counsel for the insured sends written communications to the insurer to encourage it to contribute toward settlement, are such communications privileged from discovery by the plaintiff? Would it make a difference if, rather than an outright denial of coverage, the carrier was defending under a reservation of rights? What about communications sent by the insured's counsel to apprise an excess carrier of the status of litigation, where the excess carrier does not (yet) have any duty to defend the insured?

In *In re Imperial Corp. of America*, the United States District Court for the Southern District of California found that certain letters that independent counsel sent to the carrier under a directors' and officers' policy in connection with a shareholders derivative action were not protected from disclosure to plaintiffs in the shareholders action under the attorney-client privilege. 167 F.R.D. 447, 451 (S.D. Cal. 1995). The court pointed out that under the policy, the carrier did not have a duty to defend or the right to retain counsel, and did not have the right to directly control the insured's defense. In addition, the letters at issue were not written for the purpose of seeking or imparting legal advice, but rather "they were written for the purpose of apprising [the carrier] of the status of the litigation and requesting that [the carrier] contribute to settlement of the case." *Id.* The court thus found that the letters at issue were not protected from disclosure by the attorney-client privilege. *Id.* at 453.

In contrast, in *Lectrolarm Custom Systems, Inc. v. Pelco Sales, Inc.*, the United States District Court for the Eastern District of California found that the insurer and insured were entitled to a protective order precluding the plaintiff (Lectrolarm) from obtaining all communications between the insured defendant (Pelco) and the insurer (Fireman's Fund) concerning the litigation. 212 F.R.D. 567 (E.D. Cal. 2002). In *Lectrolarm*, unlike *Imperial Corp.*, Fireman's Fund was defending its insured under a reservation of rights, and the insured had thus hired independent counsel. Fireman's Fund and its insured argued that the requested documents reflected candid analysis of the factual and legal issues in the case as well as the risk of exposure presented by Lectrolarm's claims, and that their interests were aligned. Moreover, Fireman's Fund argued that production of the documents would have a chilling effect on cases where litigation and settlement are funded by insurance in that there can be no meaningful exchange of information with respect to case strategy or settlement value if the information is subject to production by the opposing party. *Id.* at 569. Lectrolarm, on the other hand, argued that Fireman's Fund and its insured did not share a common interest sufficient to shield the totality of their communications from discovery, and that even if there was a "common interest," that interest did not apply to all requested communications.

The court disagreed with Lectrolarm, reasoning:

Where an insurer has agreed that it has a duty to defend and to indemnify its insured, they are both clients of the lawyer. The lawyer is retained to defend both in the underlying action and the attorney client privilege applies to protect communications between the lawyer and the insurer. However, where, as here, the insurer defends under a reservation of rights, denying the duty to indemnify on some or all claims, the attorney represents only the insured on the denied claims. In such a situation, *Cumis* counsel is retained by the insured, not the insurer and no attorney client relationship exists between the insurer and *Cumis* counsel. There exists in this situation an inherent tension between the carrier's interests and the interests of the insured. Thus, the attorney client relationship, the first and most important element of the attorney client privilege, is missing between *Cumis* counsel and the insurer. Nor can it be accurately said that the insurer is a necessary party to communications between *Cumis* counsel and the insured. Finally, in general, it is not likely that communications between the insurer and *Cumis* counsel would be for the purpose of giving or receiving legal advice because in such a case (where coverage is disputed) each is likely to have their own attorney just as Pelco and Fireman's Fund do here. Accordingly, communications between Pelco and Fireman's Fund are not privileged per se.

However, notwithstanding that communication between Pelco and Fireman's Fund is not in and of itself privileged, the Court finds that as to the underlying lawsuit, there is a "common interest" between Pelco and Fireman's Fund and therefore disclosure of privileged information by Pelco to Fireman's Fund does not waive the attorney client privilege or the work product doctrine.

Generally, disclosure of otherwise privileged communication to a third party waives the attorney client privilege and/or the attorney work product privilege. However, a line of cases beginning with *United States v. Kovel*, 296 F.2d 918, 922 (2nd Cir. 1961), has recognized that the attorney-client privilege is not automatically waived if an otherwise privileged document is disclosed to a third party. The most common situation in which disclosure occurs without waiver is where parties have a common interest. The existence of a common defense allows the parties and counsel allied in that defense to disclose privileged information to each other without destroying the privileged nature of those communications. This "common defense doctrine" also referred to as the "joint defense privilege" expands the application of the privileges to circumstances in which parties are represented by separate counsel but engage in a common legal enterprise. The doctrine only protects communications when they are part of an ongoing and joint effort to set up a common defense strategy. Where a "joint defense effort or strategy has been decided upon and undertaken by the parties and their respective counsel," communications may be deemed privileged whether litigation has been commenced against both parties or not.

> The Court finds that the common interest doctrine applies to protect at least those communications between Pelco and Fireman's Fund relating to the claims and defenses in the underlying lawsuit. As to these communications, there is a commonality of interest and the attorney client privilege and the attorney work product privilege are not waived by the disclosure to Fireman's Fund.
>
> In arguing that there is no common interest between Pelco and Fireman's Fund, Lectrolarm cites *First Pacific Networks, Inc. v. Atlantic Mutual Insurance Co.,* 163 F.R.D. 574 (N.D.Cal.1995), which held that the common interest doctrine did not apply to the insured/insurer context in that case. However, *First Pacific Networks, Inc. v. Atlantic Mutual Insurance Co.* was a coverage case between the insured and the non-defending insurer. The non-defending insurer was seeking communications between the insured and a defending insurer about the underlying case. There, the sought after communications were relevant to the claims in the action, i.e., coverage and the insured's characterization of the underlying action for purposes of coverage was highly relevant. The insured and the defending insurer had no common interest *vis a vis* coverage or the insured's claims against the non-defending insurer. Thus, there was no common interest in that coverage case. Here, there is a common interest with regard to the underlying case against Lectrolarm and with regard to communications relating to that common interest the privilege is not waived by disclosure to Fireman's Fund.

Lectrolarm Custom Systems, Inc. v. Pelco Sales, Inc., 212 F.R.D. 567, 571-73 (E.D. Cal. 2002) (internal citations omitted).[4]

It is important to keep in mind that, unlike California, it is unclear whether Texas is a one-client or two-client state, as discussed above. Texas does recognize the "joint defense" or "common interest" doctrine with regard to privilege, which is included within the attorney-client privilege. Texas Rule of Evidence 503(b)(1)(C) states: "A client has a privilege to refuse to disclose . . . confidential communications made for the purpose of facilitating the rendition of professional legal services to the client: . . . (C) by the client or a representative of the client, or the client's lawyer or a representative of the lawyer, to a lawyer or a representative of a lawyer representing another party in a pending action and concerning a matter of common interest therein." Tex. R. Evid. 503(b)(1)(C). Whether Texas courts would find that the common interest doctrine protects communications between an insurer and its insured relating to claims and defenses in litigation where the insurer is defending under a reservation of rights (or where the insurer has denied coverage, and the purpose of the communication is to encourage the carrier to reconsider its decision) remains to be seen.

[4] This paper does not address the issue of waiver of privilege in the context of discovery disputes between the insurer and the insured in insurance coverage disputes. Rather, this paper is limited to whether third parties, in the context of third-party litigation, are entitled to obtain communications between the insurer and the insured.

VII.
Conclusion

Issues surrounding the tripartite relationship, the use of captive counsel, and the selection and control of defense counsel are extremely prevalent. To date, Texas courts have provided little guidance in resolving these issues. It is expected that at least some of the issues discussed above will be resolved by the Texas Supreme Court in the near future. Other issues, such as reasonable rates to be paid to independent counsel, the application of litigation/billing guidelines, and privilege issues simply may need to be decided on a case-by-case basis.

VALIDITY OF LITIGATION MANAGEMENT GUIDELINES

COURT DECISIONS

In re Rules of Professional Conduct, 2 P.3d 806 (Mont. 2000)

The requirement of prior approval fundamentally interferes with defense counsel's exercise of their independent professional judgment (notwithstanding the insured's duty to cooperate with its insurer).

ETHICS OPINIONS

ABA Comm. on Ethics and Prof'l Resp., Op. 01-421 (2001)

Defense counsel may not agree to abide by litigation guidelines if they will materially impede his/her independent professional judgment. If the lawyer believes that his representation will be materially impaired, he must consult with both the insurer and the insured. If the insurer insists on retaining the limitation on the lawyer's representation and the insured refuses to consent to this limited representation, a conflict exists that would require the lawyer to either withdraw from the case or continue to appear on behalf of the insured without compensation from the insurer.

Alabama State Bar Disciplinary Comm., Op. RO-98-02 (1998)

Although litigation management guidelines may often interfere with the exercise of defense counsel's independent judgment, they are not a per se violation of the Rules of Professional Conduct. A case-by-case analysis is required to determine how the guidelines may affect representation. If defense counsel finds himself/herself in a conflict of interest, he/she may have to withdraw from the case.

Arizona State Bar Comm. on the Rules of Prof'l Conduct, Formal Op. 99-08 (1999)

Litigation guidelines inherently violate the Rules of Professional Conduct. Defense lawyers cannot ethically abide by programs that direct, regulate, or restrict the counsel's independent professional judgment.

Colorado Bar Ass'n Ethics Comm., Formal Op. 107 (1999)

Litigation guidelines inherently violate the Rules of Professional Conduct. Defense lawyers cannot ethically abide by programs that direct, regulate, or restrict the counsel's independent professional judgment. Whenever an attorney reasonably believes that a particular action is reasonably necessary to the defense but finds that it is impermissible under relevant guidelines, the attorney must advise the insurer and request authority to take the action and incur the related fees and costs. If the request is denied, the attorney must inform the insured of the decision and advise why the specified action is necessary or recommended. If the insured desires for the attorney to take the action one of the following will happen. The insured may convince the insurer to authorize the action or the insured may pay the legal fees and associated legal costs. If neither the insurer nor the insured are willing or able to make satisfactory arrangements for payment, the attorney may decide to take the action and waive the fee or the attorney may determine whether it is permissible or mandatory to withdraw from the representation.

Florida Bar Staff, Informal Op. 20591 (1997)

"Guidelines discourage use of senior, experienced attorneys when preparing cases for settlement and trial, even when use of a senior attorney would be best for the insured. Some . . . forbid summarizing depositions . . . which in the inquirer's opinion places the insured at a distinct disadvantage. Other billing guidelines forbid defense attorneys from preparing for trial until the last minute."

Florida Ethics Op. 97-1 (1997)

Although litigation management guidelines may often interfere with the exercise of defense counsel's independent judgment, they are not a per se violation of the Rules of Professional Conduct. A case-by-case analysis is required to determine how the guidelines may affect representation. If defense counsel finds himself/herself in a conflict of interest, he/she may have to withdraw from the case.

Illinois State Bar Ass'n, Advisory Op. on Prof'l Conduct 98-08 (1998)

Although litigation management guidelines may often interfere with the exercise of defense counsel's independent judgment, they are not a per se violation of the Rules of Professional Conduct. A case-by-case analysis is required to determine how the guidelines may affect representation. If defense counsel finds himself/herself in a conflict of interest, he/she may have to withdraw from the case.

Indiana State Bar Ass'n Legal Ethics Comm., Op. 3 (1998)

Although litigation management guidelines may often interfere with the exercise of defense counsel's independent judgment, they are not a per se violation of the Rules of Professional Conduct. A case-by-case analysis is required to determine how the guidelines may affect representation. If defense counsel finds himself/herself in a conflict of interest, he/she may have to withdraw from the case.

Iowa Supreme Court Bd. of Prof'l Ethics and Conduct, Op. 99-01 (1999)

Litigation guidelines inherently violate the Rules of Professional Conduct. Defense lawyers cannot ethically abide by programs that direct, regulate, or restrict the counsel's independent professional judgment. It would be improper for an Iowa lawyer to agree to, accept or follow guidelines which seek to direct, control or regulate the lawyer's professional judgment or details of the lawyer's performance; dictate the strategy or tactics to be employed; or limit the professional discretion and control of the lawyer.

Kentucky Bar Ass'n Ethics Comm., Op. 00-416 (2001)

Although litigation management guidelines may often interfere with the exercise of defense counsel's independent judgment, they are not a per se violation of the Rules of Professional Conduct. A case-by-case analysis is required to determine how the guidelines may affect representation. Requirements of prior approval before defense counsel can undertake discovery, legal research or motion practice constitute unethical constraints on a lawyer's independent professional judgment. If defense counsel finds himself/herself in a conflict of interest, he/she may have to withdraw from the case.

Michigan Ethics Op. RI-293 (1997)

Lawyers may not comply with litigation management guidelines that interfere with the exercise of independent professional judgment. However, insureds may consent to limitations imposed on the representation after receiving full disclosure and consulting with the lawyer.

Mississippi State Bar Ass'n, Op. 246 (1990)

Defense counsel's obligation to independently exercise professional judgment on behalf of an insured client may not be waived or compromised by compliance with claims handling or litigation guidelines from an insurance company.

Missouri Office of Chief Disciplinary Counsel, Informal Op. 980188 (1998)

Defense counsel is required to fully disclose guidelines to the insured and obtain the insured's consent in order to abide by billing guidelines which restrict the use of certain attorneys or discovery and otherwise defer legal activity until the time of trial. If the insured does not consent or the insurance company does not waive its guidelines and requests in the case, defense counsel should withdraw.

State Bar of Montana Ethics Comm., Op. 900517 (1999)

"(C)ounsel may not comply with those billing practice and procedure requirements which materially limit his representation of the insured (Rule 1.7), which interfere with his independence of professional judgment, or which interfere with the client-lawyer relationship (Rule 1.7 (f)(2))."

Nebraska Advisory Comm., Advisory Op. 00-1 (2000)

Litigation guidelines inherently violate the Rules of Professional Conduct. Defense lawyers cannot ethically abide by programs that direct, regulate, or restrict the counsel's independent professional judgment.

North Carolina State Bar, Formal Ethics Op. 1723 (1999)

Defense counsel may follow any guideline if the client gives fully informed consent after disclosure of the possible risks and implications of the limitations.

Ohio Supreme Court Bd. of Comm'rs on Grievances and Discipline, Op. 2000-3 (2000)

Litigation guidelines inherently violate the Rules of Professional Conduct. Defense lawyers cannot ethically abide by programs that direct, regulate, or restrict the counsel's independent professional judgment. Guidelines that interfere with the lawyer's professional judgment include those that (1) restrict or require prior approval before performing computerized or legal research, (2) dictate how work is to be allocated among defense team members, and (3) require approval before discovery, taking a deposition, or consulting with an expert witness.

Oregon Formal Op. 2002-166 (2002)

Although litigation management guidelines may often interfere with the exercise of defense counsel's independent judgment, they are not a per se violation of the Rules of Professional Conduct. A case-by-case analysis is required to determine how the guidelines may affect representation. If defense counsel finds himself/herself in a conflict of interest, he/she may have to withdraw from the case.

Pennsylvania Bar Ass'n Comm. on Legal Ethics, Formal Op. 2001-200 (Jun. 28, 2001)

Although litigation management guidelines may often interfere with the exercise of defense counsel's independent judgment, they are not a per se violation of the Rules of Professional Conduct. A case-by-case analysis is required to determine how the guidelines may affect representation. If defense counsel finds himself/herself in a conflict of interest, he/she may have to withdraw from the case.

Rhode Island Supreme Court Ethics Advisory Panel, Op. 99-18 (1999)

Litigation guidelines inherently violate the Rules of Professional Conduct. Defense lawyers cannot ethically abide by programs that direct, regulate, or restrict the counsel's independent professional judgment. "It is reasonably apparent to this Panel that certain guidelines under consideration, even though intended to achieve cost efficiency, infringe upon the independent judgment of counsel and induce violations of our rules."

Tennessee Supreme Court Bd. of Prof'l Resp., Formal Ethics Op. 2000-F-145 (Sep. 8, 2000)

Defense counsel may follow any guideline if the client gives fully informed consent after disclosure of the possible risks and implications of the limitations.

Texas Comm. on Prof'l Ethics, Op. 533 (2000)

Litigation guidelines inherently violate the Rules of Professional Conduct. Defense lawyers cannot ethically abide by programs that direct, regulate, or restrict the counsel's independent professional judgment. It is impermissible under the Texas Disciplinary Rules of Professional Conduct for a lawyer to agree with an insurance company to restrictions which interfere with the lawyer's exercise of his or her independent professional judgment in rendering such legal services to the insured/client.

Utah State Bar Ethics Advisory Op. Comm., Op. 02-03 (2002)

Although litigation management guidelines may often interfere with the exercise of defense counsel's independent judgment, they are not a per se violation of the Rules of Professional Conduct. A case-by-case analysis is required to determine how the guidelines may affect representation. If defense counsel finds himself/herself in a conflict of interest, he/she may have to withdraw from the case.

Vermont Bar Ass'n Comm. of Prof'l Resp., Ethics Op. 98-7 (1998)

Before complying with claim handling guidelines, the defense counsel must obtain informed consent after informing insured of the Company's demands and/or restrictions with regard to trial preparation.

Virginia Bar Standing Comm. on Legal Ethics, Op. LEO 1723 (1998)

Defense counsel may follow any guideline if the client gives fully informed consent after disclosure of the possible risks and implications of the limitations. The opinion warned Virginia practitioners against influence in the guise of overly restrictive litigation management guidelines.

Washington State Bar Ass'n Formal Op. 195 (1999)

"(A)ttorney whose professional services are paid for by a person other than the client can ethically comply with (guidelines) of the person paying the billing, provided the billing guidelines do not: (1) require disclosure of confidential or secret information of the client, without the client's consent; (2) interfere with the attorney's independent professional judgment or with the attorney-client relationship; or (3) direct or regulate the attorney's independent professional judgment in rendering legal service to the client." "Where a lawyer reasonably believes that representation of the client will be materially affected by any limitations in (litigation) guidelines of the person paying the billings, the lawyer must withdraw, subject to the requirements of RPC 1.15, and notify the client of the basis of the withdrawal."

West Virginia Lawyer Disciplinary Bd., LEI 2005-01 (2005)

Defense counsel cannot ethically agree to adhere to guidelines that (1) dictate how work is to be allocated among defense team members, (2) restrict or require approval before conducting discovery, engaging in motion practice, preparing for trial, or otherwise performing substantive work, or (3) otherwise impose a financial penalty or create an economic disincentive with respect to the exercise of independent professional judgment.

Wisconsin State Bar Comm. on Prof'l Ethics Comm., Formal Op. E-99-1 (1999)

Although litigation management guidelines may often interfere with the exercise of defense counsel's independent judgment, they are not a per se violation of the Rules of Professional Conduct. A case-by-case analysis is required to determine how the guidelines may affect representation. If defense counsel finds himself/herself in a conflict of interest, he/she may have to withdraw from the case.