

KENTUCKY BAR ASSOCIATION
Ethics Opinion KBA E-416
Issued: March 2001

Since the adoption of the Rules of Professional Conduct in 1990, the Kentucky Supreme Court has adopted various amendments, and made substantial revisions in 2009. For example, this opinion refers to Rule 1.2, which was amended to require that the client give informed consent, which is defined in Rule 1.0(e). In addition, the consent requirements of Rules 1.7 and 1.8 were amended. Lawyers should consult the current version of the rules and comments, SCR 3.130 (available at <http://www.kybar.org>), before relying on this opinion.

Question 1: In general, may an insurance defense lawyer agree to abide by insurer-prescribed case handling guidelines in representing the insured?

Answer: A lawyer may *not* agree to abide by such guidelines *unless*:

- a) the lawyer determines that the guidelines will not interfere with the lawyer's independent professional judgment and other duties owed to the insured under the Kentucky Rules of Professional Conduct; and
- b) the lawyer discloses the guidelines' existence to the insured, and provides a practical explanation of their import, at the outset of the representation and as may become necessary in specific situations thereafter, and the insured consents after consultation to any guideline that materially limits the representation; and
- c) the lawyer, upon undertaking the representation, performs all duties imposed by the Rules, regardless of compensation under the guidelines, so long as the representation continues.

Every lawyer is *strongly cautioned* that the insured is entitled to adequate representation despite limitations prescribed by the insurer. A lawyer who is unable or unwilling to accept the potential burden of this responsibility must decline the representation at the outset.

Question 2: More particularly, may the lawyer accept representation under guidelines that:

- a. Require approval by the insurer before the lawyer undertakes any discovery, conducts any legal research, or files any motion?

Answer: *No.* The lawyer may agree, however, to guidelines setting a reasonable, tentative budget and providing a process for ongoing consultation.

- b. Require all investigative work or all records review to be performed only by the insurer's employees or, if performed by the lawyer's firm, to be billed only at a paralegal rate?

Answer: *No.* The lawyer may agree, however, to guidelines establishing an appropriate allocation of lawyer and nonlawyer/paralegal tasks, or setting a reasonable tentative budget for investigative work or document review, and providing a process for ongoing consultation.

- c. Require prior approval of compensation for additional lawyers or experts with whom the principal lawyer may wish to confer, or for a lawyer's trial preparation exceeding a specified pretrial period (e.g., thirty days)?

Answer: *Yes,* if (and only if) such limitations are reasonable in relation to the issues in the case and the guidelines provide a process for ongoing consultation.

- d. Prescribe detailed billing and reporting procedures, with deadlines for certain submissions?

Answer: *Yes,* if (and only if) such procedures and deadlines do not create material disincentives to adequate representation of the insured and do not abridge the insured's right to confidentiality.

Even when a lawyer is permitted ethically to accept representation under an insurer's guidelines, he or she may choose not to do so. The lawyer is free to decline the representation, just as the insurer is free to offer the work to other counsel. The lawyer must decline, however, if he or she is unable or unwilling to provide adequate representation to the insured regardless of limitations prescribed by the insurer.

References: KBA Ethics Opinions E-331, 340, 359, 368, 378, 404, 409, 410; ABA Formal Opinion 96-403; S.C.R. 3.130 [Kentucky Rules of Professional Conduct], Rules 1.1, 1.2, 1.3, 1.6, 1.7(b), 1.8(f), 1.16, 5.4; American Insurance Association v. Kentucky Bar Association, 917 S.W.2d 568 (Ky. 1996); In the Matter of the Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedures, 2 P.3d 806 (Mont. 2000); 2 American Law Institute, Restatement (Third) of the Law Governing Lawyers (2000) §§ 121, 122, 134; 1 G. Hazard & W. Hodes, The Law of Lawyering (3d ed. 2000) §§ 12.13, 12.14.

Additional references, including ethics opinions from other states, appear throughout the text.

OPINION

Our analysis proceeds in four steps. First, we place the insurance guidelines issue in context by recalling previous opinions of this Committee and by noting the polarized contentions of partisans in the current nationwide debate over guidelines. Next, we examine professional responsibility in an insurance defense context, focusing on the key principles of informed consent by clients and independent professional judgment by lawyers. Then, we apply these principles to the general issue of insurer-prescribed case handling guidelines. Finally, we comment on particular limitations contained in some guidelines.

A. History and Current Controversy

A purchaser of a liability insurance policy acquires two things of value: an indemnity fund to pay claims covered by the policy, and an insurer-provided legal defense against the claims. *E.g.*, Wolford v. Wolford, 662 S.W.2d 835 (Ky. 1984). For insurers, the cost of providing the legal defense has become a major concern. Defense costs are significant components of total litigation expenses, which were reported recently to consume “nearly 55 cents of every claim dollar” in property-casualty insurance. Sullivan & Muldowney, “Changing Times in the Insurance Industry,” For the Defense (Defense Research Institute, Feb. 1998), Supp. p. 2, *quoted in* Indiana State Bar Ass’n Legal Ethics Committee, Op. 3 (1998). Cost containment, viewed by insurers as an urgent imperative, has generated ethical concerns that have found their way to our Committee.

In Opinion KBA E-331, issued in 1988, the Committee considered a broad inquiry as to whether any ethical problems could arise if a liability insurer “instruct[ed] defense counsel to conduct or limit a defense so as to minimize the insurer’s costs,” even though the claim was within coverage limits. The Committee answered “yes,” but disavowed “any generalization” on the question. The tone was cautionary, not prescriptive:

We issue this opinion only to advise of ethical considerations that may arise in this context. We are not suggesting that counsel has carte blanche to needlessly run up a bill. Such conduct would be just as reprehensible as yielding professional control of his or her work to an adjuster or claims manager. Nor are we suggesting that costs and expenses are not a legitimate concern of the insurer. Conflicts are not inevitable, or irreconcilable. Presumably these matters can be resolved amicably and responsibly in the great majority of cases. We only wish to emphasize that the insured is defense counsel’s client, and that counsel owes professional obligations to his or her client that flow from the attorney-client relationship and are not bounded by the “hardboiled commercial” relationship between the insured and the insurer.

Five years later, the Committee approved, with some caveats, an attorney fee arrangement creating an incentive (i.e., a “reverse” contingent fee) for insurance defense counsel to achieve the best outcome on the claim. *See* Opinion KBA E-359 (1993). Such an

arrangement was not perceived to create a conflict between the lawyer and the insured client. The following year, however, when the Committee returned to the subject of litigation costs -- as opposed to indemnity payments -- it encountered a "hardboiled commercial" approach to cost containment. The question was whether a lawyer could contract with an insurance carrier to do all defense work for a set fee, or could agree to take such work while foregoing reimbursement of all litigation costs (experts, court reporters, etc.). Answering both questions "no," the Committee noted that such arrangements would interpose the lawyer's economic interests directly against those of the insured client. The Committee acknowledged that such an economic tension "is inherent in other lawyer-client arrangements; but here the insured client ... [would] have no control over the choices that will be made." See Opinion KBA E-368 (1994). As explained more fully below, the Committee's opinion was later endorsed by the Supreme Court of Kentucky in American Insurance Association v. Kentucky Bar Association, 917 S.W.2d 568 (Ky. 1996) (hereinafter *AIA*).

Today, upon inquiry from an organization of Kentucky defense lawyers, the Committee must examine the ethical dimensions of a more complex and nuanced form of cost containment: insurer-prescribed case handling guidelines. Such guidelines vary widely from insurer to insurer, and their actual administration may vary from case to case, but they have certain core characteristics. As suggested by the term "guidelines," they often contain disclaimers of any intent by the insurer to override a lawyer's ethical duties; nonetheless, the guidelines usually are expressed as conditions of a lawyer's engagement to represent the insured client. They mandate the form and timing of a law firm's billings and reports, and they warn that no payment will be made for unauthorized expenses or for services that are outside the guidelines and not otherwise approved. They usually limit (absent prior approval) the number and identity of lawyers working on a case at any particular stage, the extent of motion practice or discovery to be conducted, and the amount or manner of legal research to be undertaken, on the client's behalf.

These guidelines have generated national controversy in academic, professional, and judicial venues. In several respects, unfortunately, the controversy has come to resemble a minefield of false dichotomies. Guideline opponents contend that the controversy is about ethics; proponents argue that it is only about economics. Opponents decry a loss of the lawyer's independent professional judgment under the Rules of Professional Conduct; proponents declare that the insurer has a contractual right to control the defense of claims covered by the insurance policy. Opponents maintain that the lawyer has but one client, the insured; proponents assert the lawyer has obligations to the insurer regardless of whether the insurer is deemed a co-client or merely a third-party payer. Opponents complain that the guidelines reduce defense practice and the needs of each client to a formulaic regime, often administered on behalf of insurers by poorly trained and overworked nonlawyer case managers. Proponents respond that the guidelines allow for exceptions when justified and provide a framework for dialogue between counsel and insurers. The Committee finds, for reasons appearing below, that each of these contentions has some merit, and some limitation. Distilling the truth of both sides is essential to making sense of the guidelines controversy.

B. Professional Responsibility and Insurance Defense

Insurance has been described as “a regulated industry clothed with a substantial public interest.” 7C J. A. Appleman, Insurance Law and Practice 2 (W. F. Berdal ed. 1979). Subject to legislative and administrative oversight (which varies considerably in quality and intensity from state to state), liability insurance companies collect premiums, invest funds, and pay claims. To secure protection against unwarranted or excessive claims, insurers generally are authorized to contract with policyholders for control and settlement of litigation. *Id.* at 2-4. Most insurance policies contain such provisions; moreover, they treat an insurer-provided defense as an obligation. Thus, the insurer’s right of control is linked to fulfillment, in good faith, of the insurer’s duty to defend. R. E. Keeton & A. I. Widiss, Insurance Law: A Guide to Fundamental Principles, Legal Doctrines, and Common Practices (1988) § 7.6(b). Conversely, the insured has a contractual duty to cooperate in the defense and, absent conflicting interests, is deemed to have consented to the role of the insurer in designating defense counsel. *Id.*

Juxtaposed against this regulatory and contractual authority of the insurer are the case law and Rules of Professional Conduct regulating the relationship between a lawyer and client. In Kentucky (as noted in Opinions E-331 and E-368 cited above), when an insurance company engages a lawyer to defend an insured against a claim, the insured – not the insurer – is the lawyer’s client. The one-client doctrine also has been articulated in this Committee’s Opinion KBA E-410 (1999) (stating, *inter alia*, that absent informed consent by the insured, defense counsel may not reveal to the insurer confidential information obtained from the insured that could adversely affect coverage); in Opinions KBA E-409 (1999) and E-404 (1998) (both stating that insurance defense counsel must obtain the insured client’s full and informed consent before submitting billing information to the insurer’s outside auditor); in Opinion KBA E-378 (1995) (counsel engaged to represent the insured may not also defend the insurer against an unfair settlement practices claim arising from same action); and in Opinion KBA E-340 (1990) (insurance defense counsel may not permit the insurer’s representative to sit in on the lawyer’s conferences with the insured without the insured’s informed consent).

Kentucky’s one-client view differs from the position taken in some states, and expressed by some commentators, that the tripartite relationship (or “eternal triangle”) of insured, insurer, and defense counsel actually entails two clients: the insured and the insurer. *See, e.g.*, Maryland State Bar Ass’n Comm. On Ethics, Op. 00-23 (2000); State Bar of Wisconsin Ethics Opinions, Op. E-99-1 (1999); E. Cothran, *Can Carriers Legitimately Evaluate Independent Counsel Fees without Impeding Counsel’s Independent Judgment?* Vol. 29, No. 3, The Brief (ABA Tort & Insurance Practice Section, Spring 2000), at 38-46; K. Syverud, *The Ethics of Insurer Litigation Management Guidelines and Legal Audits*, Ins. Litig. Rep. (May 1, 1999), at 180-94; D. Richmond, *The Business and Ethics of Liability Insurers’ Efforts to Manage Legal Care*, 28 U. Mem. L. Rev. 57 (1997). Kentucky’s view, however, is shared by many other states. *See, e.g.*, In the Matter of the Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedures, 2 P.3d 806 (Montana 2000) (hereinafter *Montana Rules*); Rhode Island Supreme Court Ethics Advisory Panel Opinion No. 99-18 (1999); Alabama Ethics Opinions, Op. RO-98-02 (1998). *See generally* J. Pitulla, *Three-Way Street: Discord between Insurers and Insureds Puts Defense Lawyers on Perilous Path*, 81 A.B.A.J. 102 (August, 1995) (characterizing single-client view as the majority approach); D. O’Roark, *In Kentucky the Insured is Your Client – Not the Insurer!* Ky. Bench & Bar, Vol. 60, No. 1 (Winter 1996), 49-52 (observing that Kentucky’s

one-client view is “with the national trend”). The one-client view also has received favorable scholarly commentary. *E.g.*, 1 G. Hazard & W. Hodes, The Law Of Lawyering (3d ed. 2000) (hereinafter *Hazard & Hodes*), at §12.14; S. Pepper, *Applying the Fundamentals of Lawyers’ Ethics to Insurance Defense Practice*, 4 Conn. Ins. L. J. 27 (1997).

Under the one-client view, the insurer is a third-party payer, not a client. Third-party payment is a phenomenon seen not only in insurance defense cases, but also in litigation involving persons represented by lawyers in public legal aid programs or private pre-paid legal service plans; cases involving officers of corporations, or members of organizations, who are represented by entity-hired attorneys; and litigation in which lawyers have been engaged by the parties’ friends or families. *See generally*, *Hazard & Hodes* §12.13. Among third-party arrangements, however, the insured-insurer-defense counsel relationship may be unique because it is rooted in an underlying contract and involves “primarily standardized protection afforded by a regulated entity in recurring situations.” 2 American Law Institute, Restatement (Third) Of The Law Governing Lawyers (2000) (hereinafter *Third Restatement*), at §134, comment *f*. As noted above, the insurer has contracted to provide a defense and it possesses a correlative right to control the defense. This right of control, however, is limited by another source of law: the cases and ethical rules governing lawyer-client relations.

In case law, it appears well settled as a general proposition that a lawyer may accept direction from a person other than the client if, but only if, (a) the direction does not interfere with the lawyer’s independence of professional judgment; (b) the direction is reasonable in scope and character, *e.g.*, reflecting obligations borne by the person directing the lawyer; and (c) the client gives informed consent to the direction. *See*, *Third Restatement* § 134 (2) (cross-referencing §§ 121, 122). This three-part test applies regardless of whether the person giving the direction is a third-party payer or another client. *See* comment *f* to *Third Restatement* § 134; *see generally*, ABA Formal Opinion 96-403 (1996) (hereinafter *ABA Opinion*) (upholding insurer’s right to give direction regarding settlement within policy limits, while noting that insured who objects can assume responsibility for his or her own defense, and declaring that “[f]or the purposes of this opinion, nothing fundamental turns on whether the lawyer represents the insured alone or both the insurer and the insured”). Generally speaking, when the three-part test is fully satisfied, the client is deemed to have conferred the power of directing the defense to the insurer. *Third Restatement* § 134, comment *d*.

If this three-part test were applied to an insurance company directive to defense counsel on the conduct of litigation, element (b) -- the requirement of reasonableness -- might be satisfied simply by the insurer’s obligation to pay for the defense. But element (c), the requirement of informed consent by the insured, would require more than the bare language of the insurance contract; and element (a), the requirement of noninterference with the lawyer’s independent professional judgment, would be even more problematic. As this Committee noted in Opinion E-331, and as our Supreme Court later recognized in *AIA*, the interests of insurers and insureds are subject to wide divergence, even in cases where claims appear to fall within the subject-matter coverage and dollar limits of the insurance policy. An insured may have a reputational stake in the case, or may have another legitimate personal interest, that could be affected adversely by the insurer’s direction to counsel concerning discovery, settlement, trial or appeal.

In such a situation, counsel's candid advice to the client might be contrary to the insurer's strategy. Moreover, the perceived interests of the insured and insurer can evolve – just as coverage issues and claim values can evolve – while litigation progresses. Accordingly, in the insurance defense context, an insured's acts of conferring the power of direction upon the insurer (signing the insurance contract and giving informed consent at the outset of the representation) are subject to change if substantial risks to the insured's interests become apparent during the representation. *Third Restatement* § 134, comment *f*.

The requirements of informed consent and independent professional judgment, and the necessity of satisfying those requirements throughout the litigation, also emerge when the question of insurance company directives is examined in light of the Kentucky Rules of Professional Conduct (S.C.R. 3.130). Under Rule 1.2 (c) and comment 4 to the rule, an insurer's directive requires the insured's informed consent – i.e., a consent “after consultation” (not merely a consent implied by the insurance contract) -- if the directive limits the objectives of the representation. Similarly, counsel's right to accept direction from a person other than the client is recognized, but limited, by Rule 1.7 (b), which provides in pertinent part as follows:

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

Thus, Rule 1.7 (b) echoes the necessity of consultation with the insured and also requires that counsel determine independently that the representation – shaped by the objectives established under Rule 1.2 (c) – will not be adversely affected. As mentioned in Comment 4 to Rule 1.7, the reasonableness of the lawyer's belief that the representation will not be adversely affected must be measured by the standard of a disinterested lawyer. Moreover, the adequacy of consultation must be considered in light of Rule 1.4, which requires a lawyer to keep the client “reasonably informed” and to “explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.” *See also* Opinion KBA 410 (1999). The disclosure should occur at the outset of the representation and periodically thereafter when specific circumstances so require. It must be “sufficient to permit the client to appreciate the significance of the matter in question,” and it may take the form of 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.” *ABA Opinion* at 2. *See generally*, *Third Restatement* § 134, comment *f*.

Rule 1.8(f) repeats the reference to consultation and makes explicit the protection of independent professional judgment in a third-party payment situation:

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.

Although the wording of Rule 1.8 (f) differs somewhat from that of Rule 1.7 (b) above, the two rules are intended to provide the same protection for counsel's independence of professional judgment. *Hazard & Hodes* § 12.13. Rule 5.4(c) further reinforces that protection, as follows:

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.

Indeed, the thrust of Rule 5.4 in its entirety is to safeguard the professional independence of a lawyer. The importance of professional independence is underscored by Rule 5.4 (d) (2), which prohibits a lawyer from practicing with a for-profit entity in which a nonlawyer has the right to direct or control the lawyer's professional judgment. Although Rule 5.4 (d) (2) does not apply by its literal terms to insurance defense retainers, it highlights the general need under Rule 5.4 (c) and the other rules cited above to scrutinize arrangements in which a lawyer regularly receives direction from a nonlawyer, such as an insurance company's claims manager.

The rules -- with their thematic emphasis upon ongoing informed consent by clients and upon the exercise of independent professional judgment by lawyers -- are part of a comprehensive ethical framework that shapes all lawyer-client relationships. Within this framework, the requirements of informed consent and independent professional judgment secure the insured client's entitlement to competent legal services (Rule 1.1) and the right to understand any material limitations upon the scope and objectives of the insurer-supplied representation (Rule 1.2). The lawyer is expected to act with reasonable diligence and promptness (Rule 1.3), keeping the insured informed (Rule 1.4), protecting the insured's confidences (Rule 1.6), and rendering candid advice (Rule 2.1 and comments to Rule 1.7). Counsel must perform these duties without charging the insurer more than a reasonable fee (Rule 1.5). These duties comprise a professional mandate that continues until the relationship concludes or is terminated in a manner permitted by Rule 1.16. A lawyer may not narrow his or her duties, by accepting direction that limits the objectives of the representation, unless the client consents after consultation and the lawyer concurs, exercising independent professional judgment. In any event, the representation may not be so limited as to impair the competence of legal services as required by Rule 1.1. (*See* Comment 5 to Rule 1.2.)

C. Informed Consent, Independent Professional Judgment, and Case Handling Guidelines

The principles of informed consent and independent professional judgment are foundations of insurance defense, although their importance has not always been recognized. During much of the twentieth century, the insurer's contractual right to control the litigation, subject to an implied covenant of good faith, was considered the dominant force in the insurer/insured/defense lawyer relationship. *E.g.*, *Gribaldo, Jacobs, Jones & Associates v. Agrippina Versicherungen A. G.*, 476 P.2d 406 (Cal. 1970) (upholding policy provision that forbade incurring defense costs without the insurer's prior consent, and holding that the provision could be ignored only if the insured had requested and had been denied a defense by the insurer). More recent decisions, however -- such as the Kentucky Supreme Court's opinion in *AIA* -- have made it clear that insurance defense lawyers must follow the case law and rules of professional responsibility that define and safeguard the lawyer-client relationship. This does not mean, however, that insurers' contractual rights have disappeared or that lawyers today may simply disregard all efforts by insurance companies to control litigation costs. Rather, the issue has become whether, and to what extent, such cost controls intrude upon informed consent and independent professional judgment.

The potential variety of insurer-prescribed case handling guidelines makes it impossible to eschew or embrace all of them categorically. Our Committee recognized in Opinion E-331 that guidelines must be evaluated on a case-by-case basis. Referring to fees and expenses incurred by defense counsel, the Committee said:

[T]he insurer has a legitimate interest in keeping such costs down. ... *At some point* [however], carrier imposed restrictions may threaten counsel's ability to provide [zealous and competent] representation and impact on the lawyer's ability to bring to bear his independent professional judgment on behalf of the insured. [Emphasis supplied.]

Later, when our Supreme Court in *AIA* upheld this committee's Opinion E-368, the Court similarly stopped short of declaring all insurer-imposed guidelines invalid. In fact, the Court declared that "the ethics opinions and case law cited in E-368 are on point..." 917 S.W.2d at 573. As noted above, Opinion E-368 cited Opinion E-331, in which this Committee sounded a warning about insurer-imposed budget limitations but was careful not to lay down a categorical prohibition.

Our long-standing view, that insurer-prescribed guidelines must be examined in each case to determine their impact upon informed consent and independent professional judgment, is also expressed in the ethics opinions of many other states. Indeed, the case-by-case approach appears to be nearly universal, so far as our research discloses. *See, e.g.*, Alabama State Bar Disciplinary Commission Opinion No. RO-98-02 (1998); Colorado Bar Association Ethics Committee Formal Opinion No. 107 (1999); Florida Bar Association Ethics Committee Opinion No. 97-1 and Staff Opinion 20591 (1997); Hawaii Supreme Court Disciplinary Board Opinion 37 (1999); Idaho State Bar Committee on Ethics Opinion No. 136 (1999); Indiana State Bar Association Legal Ethics Committee Opinion No. 3 (1998); Iowa Supreme Court Board of Professional Ethics and Conduct, Opinion No. 99-01 (1999); Mississippi Bar Ethics Committee Opinion No.

246 (1999); New York State Bar Association Committee on Professional Ethics Opinion 721 (1999); Rhode Island Supreme Court Ethics Advisory Panel Opinion No. 99-18 (1999); Tennessee Supreme Court Board of Professional Responsibility Formal Ethics Opinion 2000-F-145 (2000); Wisconsin State Ethics Opinion E-99-1 (1999). These opinions, as we read them, do not categorically preclude *all* insurer-prescribed guidelines, but allow defense counsel to accept them to the extent they do not significantly encroach upon the principles governing the attorney-client relationship. *Accord, Third Restatement*, at § 134, comment *f*, particularly Illustration 5, at p. 409.

Some states, such as Missouri and Virginia, also utilize the case-by-case approach and have stated that insurer-prescribed guidelines may be permissible, even if they materially limit the scope of representation, so long as the insured consents after consultation. *See* Missouri Office of Chief Disciplinary Counsel, Informal Advisory Opinion No. 980188 (1998); Virginia Legal Ethics Opinion No. 1723 (1998). The Tennessee opinion cited above also contains language to this effect.

Two other states, Ohio and Texas, arguably follow the case-by-case approach as well, but they have condemned certain offending guidelines in emphatic terms. The Ohio Supreme Court Board of Commissioners on Grievances and Discipline, in Opinion No. 2000-3 (2000) has disallowed guidelines that provide for “demeaning” motion-by-motion evaluation of the lawyer’s work. The Board observed that “[i]f an insurer is unsatisfied with the overall legal services performed, the insurer has the opportunity in the future to retain different counsel.” The Board concluded in a more conciliatory tone, however, saying that it “encourag[ed] attorneys to cooperate with insurers, but [they] must not abdicate control of their professional judgment to non-attorneys.” The Texas Professional Ethics Committee also sounded contrasting themes – or, at least, different emphases -- in its Opinion No. 533 (2000). It began with a conventional statement that “[a]lthough the lawyer is free to enter into an agreement with the insurer regarding his fee and services to be rendered to the insured/client, such agreement cannot override the ethical responsibilities of the lawyer” But the Committee may have implied a narrow scope of permissible guidelines when it went on to say that procedures for billing and payment could be followed if they did “not [affect] the actual representation of the client.”

Finally, the Montana Supreme Court, in the previously cited *Montana Rules* case, has undertaken the sharpest critique to date of insurer-prescribed guidelines, taking particular exception to any guideline requiring “prior approval” by the insurer of certain defense services and costs. The Court held: “[D]efense counsel in Montana who submit to the requirement of prior approval violate their duties under the Rules of Professional Conduct to exercise their independent professional judgment and to give their undivided loyalty to insureds.” 2 P.3d at 817 (¶ 51). If by this holding the Montana Court meant that a lawyer could not agree to guidelines materially affecting the scope and quality of the insured’s representation – which would implicate the client’s right of informed consent and would intrude upon the lawyer’s duty to exercise independent professional judgment -- then the Court’s decision is broadly consistent with our Committee’s prior opinions and with the general pattern of opinions in other states. In fact, this reading of the Montana decision draws support from the fact that the Montana Court cited extensively the Kentucky *AIA* decision which, as mentioned earlier, approved this

Committee's Opinion E-368 (and the authorities it had cited, including Opinion E-331).

In other passages of its opinion, however, the Montana Court may have created some confusion about the dimensions of its ethical guidance to the lawyers of that state. On one hand, the Court said that its decision, adopting the one-client view of the insured/insurer/defense lawyer relationship, "should not be construed to mean that defense counsel have a 'blank check' to escalate litigation costs nor that defense counsel need not ever consult with insurers." 2 P.3d at 814 (¶ 39). On the other hand, the Court also said, "Without reaching the issue here, we caution further that a mere *requirement* of consultation [with the insurer] may be indistinguishable, in its interference with a defense counsel's exercise of independent judgment and ability to provide competent representation, from a requirement of prior approval." 2 P.3d at 814-15 (¶ 44) (emphasis original). The Court later added that "prior approval creates a substantial appearance of impropriety in its suggestion that it is insurers rather than defense counsel who control the day to day details of a defense." 2 P.3d at 815 (¶ 47). If by these dicta the Court was attempting to create an ethical preclusion against *any* requirement of prior "approval" regardless of the process connected with it, or against even a simple requirement of prior "consultation" with an insurer, then (and to that extent) we believe the Court's language was overbroad and – we respectfully observe -- contrary to the better reasoned authorities.

Evidently, we are not alone in refraining from reading too much into the Montana decision. On September 8, 2000, approximately four months after the Montana Court rendered its opinion, the the Board of Professional Responsibility of the Tennessee Supreme Court, writing *en banc* in Opinion 2000-F-145 (cited above), undertook to synthesize the ethical requirements for insurance defense lawyers. The Board, citing In Re Petition of Youngblood, 895 S.W.2d 322, 328 (Tenn. 1995) -- a decision quoted with approval by the Montana Court -- provided the following guidance:

The [insurer] cannot control the details of the attorney's performance, dictate the strategy or tactics employed, or limit the attorney's professional discretion with regard to the representation [quoting Youngblood] Counsel receiving a retention purporting to require undeviating compliance should inform the insurer that such compliance cannot be assured, but that counsel will comply to the extent permitted by counsel's duties to the insured.

It is not proper to call upon the insured to make a decision about the directives in question. ... Rather, the insured should be informed at the outset that the insurer ordinarily issues such directions. Counsel may further explain that, in light of the insurance policy and the insured's tender of defense, counsel assumes that such directions should be followed unless counsel identifies some reasonable probability that following the directive might differ from an interest of the insured.... But if counsel identifies a reasonable possibility of an interest being advanced that differs from that of the insured, counsel will consult with the insured about the decision at the time it is to be made and in light of all the circumstances then prevailing.

If this explanation is acceptable to the insured, counsel may proceed with the representation unless and until it appears that one of the directives will (or is likely to) become operative and that compliance presents a reasonable possibility of advancing an interest that differs from that of the insured.

When and if a reasonable probability becomes apparent of an interest being advanced by one of the directives that differs from that of the insured, counsel should first point this out to the insurer and inquire whether it will vary its procedure to avoid that probability. If the insurer will do so, the problem is solved and the insured protected.

If the insurer will not vary its directive, counsel must then consult with the insured. ... If the insured objects to the insurer's directive, counsel must advise the insurer that counsel cannot comply. The insurer then has a choice of accepting the insured's position, by withdrawing the objected-to directive (perhaps reserving its own right to assert that the insured has breached the policy); seeking to persuade the insured to withdraw the objection; or discharging counsel.

In no event may counsel permit the insurer's directive to cause counsel to take action – without the insured[‘s] informed consent – if counsel believes that action has a reasonable possibility of advancing an interest that would differ from that of the insured.

Like the Tennessee Board of Professional Responsibility, our Committee adheres to the widely accepted view that some insurer guidelines may be acceptable. There is no ethical (as opposed to economic) reason to condemn guidelines that standardize insurance billing practices, enhance lawyer accountability without eliminating professional judgment, require a legitimate sharing of nonconfidential information, or provide a framework for communication about the cost (and cost-effectiveness) of legal services -- not unlike the dialogue a lawyer would expect to have with a sophisticated client paying for services with first-party money. Such guidelines serve salutary purposes without infringing materially upon the attorney-client relationship. They are permissible under the case law and rules governing professional responsibility.

The guidance offered by the Tennessee Board comports well with our Committee's prior opinions, and it is broadly consistent with the Kentucky *AIA* decision mentioned above. As noted, our Supreme Court in *AIA* held that lawyers could not agree to take all of an insurance company's defense work at a fixed fee, nor could they accept such work on condition that litigation expenses would not be reimbursed. In rejecting such arrangements -- and, in a separate part of the opinion, by disallowing insurance companies to engage in the unauthorized practice of law through in-house defense counsel -- the Kentucky Court recognized that such extreme cost containment measures, to which no client had given informed consent, nakedly pitted the economic interests of the lawyer against the insured's interest in adequate representation. Such measures purposely created a material disincentive to the exercise by counsel of independent professional judgment on behalf of clients, and *AIA* condemned them. *AIA* does not preclude less intrusive, more ethically sensitive, case handling guidelines.

An effort to develop ethically sound guidelines has been undertaken recently by the Defense Research Institute. Without pronouncing or implying any judgment on particular provisions of DRI's recommended guidelines (which can be found at the organization's Web site), our Committee notes that the proposed guidelines represent a two-year, and ongoing, collaborative project of national defense bar leaders and major insurance company representatives. Implicitly, such an effort demonstrates the view of its participants that guidelines can be crafted within ethical boundaries, and it confirms our Committee's observation in KBA Ethics Opinion E-331, quoted earlier: "Conflicts are not inevitable. Presumably these matters can be resolved amicably and responsibly in the great majority of cases."

D. Illustrative Situations

The Kentucky lawyers who requested today's opinion from our Committee have not tendered a particular set of guidelines for review, but they have raised many specific questions in addition to the broad inquiry about guidelines in general. We will consolidate and address some of those questions here. In doing so, we re-invite attention to the comments of the Tennessee Board of Professional Responsibility, quoted above, and we note the following observation of the Indiana State Bar Association Ethics Committee:

There can be no bright-line test as to the kinds of controls to which insurance defense counsel may agree. Because of the breadth of activities which a given insurer may seek to manage, the ethical propriety of a given set of guidelines is necessarily somewhat subjective. There are no better standards than those provided by Rules 5.4(c) incorporated in 1.8(f) and 1.7 (b). When confronted by proposed guidelines which cannot be followed ethically, the lawyer is well-advised to seek an acceptable modification. If such modification cannot be agreed upon, the representation must be declined. [Indiana State Bar Ethics Committee Opinion No. 3 (1998).]

We recognize that when guidelines are evaluated on a case-by-case basis, many questions will arise, not at the outset of representation -- when counsel presumably has made a threshold determination that the guidelines will be acceptable and the client has been generally informed about them -- but rather during the course of litigation. In most instances, such questions will be resolved amicably because the insurer usually shares the insured's interest in the lawyer's preparation of an effective defense.

In some circumstances, however, a disagreement may arise regarding the necessity of certain legal services as the representation unfolds. In such a situation, the lawyer may act at his or her own expense as a matter of professional duty (perhaps reserving a right on behalf of the client to seek subsequent judicial review of the insurer's decision). With the informed consent of the client, the lawyer also may perform the service in question at the client's expense or may dispense with the service if the lawyer's judgment is that the client's representation would still satisfy the basic requirement of competence under Rule 1.1. The lawyer cannot acquiesce, however, in an insurer-imposed limitation if it endangers professional competence or places

other client interests significantly at risk.

A lawyer must understand that the client comes first. The lawyer prudently should decline a proffered insurance defense if it is freighted with potentially troublesome guidelines. If the lawyer agrees to guidelines that initially seem acceptable but later collide with the lawyer's independent professional judgment, and if the client does not -- and, upon consultation, should not -- consent to the limited representation, then the lawyer must protect the client by providing adequate representation regardless of the guidelines. Bearing in mind this caveat, we now turn to questions regarding particular kinds of guidelines:

1. *May a lawyer accept representation under guidelines requiring approval by the insurer (i.e., by an insurance claims adjuster) before undertaking any discovery, conducting any legal research, or filing any motion?* The question implies that the insurer would be in the position of reviewing and approving a lawyer's choice of the methods and content of discovery, or the topics and time invested in the lawyer's legal research, or the lawyer's decisions to seek rulings or relief from the court. Because each of these functions falls within the lawyer's independent professional judgment, the answer to the question is *no*. A lawyer cannot agree to representation of the insured client under guidelines that shift the exercise of professional judgment to the insurer. The lawyer could agree, however, to guidelines setting a reasonable tentative budget for these functions and providing a process for ongoing consultation if the client's interests require a budget exception.

2. *May a lawyer agree to guidelines requiring that all investigative work or all documentary review be performed only by the insurer's employees or that it be billed only at paralegal rates if performed by the lawyer's firm?* The answer is *no*. With respect to investigative work, the determination as to whether a lawyer should gain first-hand exposure to certain places, things or individuals important to the client's case, in order to prepare adequately for trial, is a matter of professional judgment. Similarly, the determination as to whether the lawyer must examine certain documents -- e.g., medical records -- directly, rather than relying upon lay or paralegal summaries, is a matter of professional judgment. Indeed, in some instances, the lawyer's first-hand review may be necessary in order to avoid potential malpractice liability. Limiting compensation for such fact-gathering or document review to paralegal rates would create a material disincentive to the lawyer's exercise of independent professional judgment, putting the client's interests at unacceptable risk. On the other hand, guidelines providing a tentative allocation of lawyer and nonlawyer/paralegal tasks appropriate to the case, or setting a reasonable tentative budget for investigative effort or document review, and providing a process for ongoing consultation, would be acceptable.

3. *May a lawyer agree to representation under guidelines requiring prior approval of compensation for additional lawyers or experts with whom the*

principal lawyer may wish to confer, or prior approval of compensation for a lawyer's trial preparation exceeding a specified pretrial period (e.g., thirty days)? The answer is *yes*, if (but only if) the lawyer reasonably determines that the issues in the case do not immediately appear to require such conferences or protracted trial preparation, and that approval of additional costs can be obtained for needs becoming manifest as the case unfolds. Thus, the guidelines must provide a process for ongoing consultation with the insurer.

4. *May a lawyer agree to guidelines establishing detailed billing and reporting procedures, with deadlines for certain submissions?* The answer is *yes*, if (but only if) the guidelines contain reasonable time frames, provide a consultation process to accommodate extenuating circumstances, and do not impose upon the lawyer extreme and uncompensated time burdens that impede, or create a material disincentive to, the lawyer's performance of duties required by the attorney-client relationship. Pursuant to KBA Ethics Opinions E-404 and E-409, the lawyer also would be required to ascertain that no billing information and reports containing confidential information would go to the insurer or to outside auditors for review, without the client's informed consent.

In all of the foregoing situations, the lawyer-insurer relationship contemplates a process for ongoing consultation. Such consultation must be genuine, with the lawyer basing each expenditure or activity request on the needs of the insured, and the insurer giving each request careful consideration in light of the lawyer's independent professional judgment. If the insurer's guidelines do not provide such a process, the lawyer should decline a proffered representation. In any event, the lawyer must not undertake, and an insured client cannot be asked to accept, a representation so limited in scope that it abridges the client's rights, or narrows the lawyer's duties, under the Rules. *See* Comment 5 to Rule 1.2. After the representation of a client has begun -- and continuously thereafter until the representation concludes or is properly terminated under Rule 1.16 -- the lawyer must perform his or her professional duties fully, and must exercise independent professional judgment in loyalty to the client, regardless of limitations imposed by the insurer.

Note to Reader

This ethics opinion has been formally adopted by the Board of Governors of the Kentucky Bar Association under the provisions of Kentucky Supreme Court Rule 3.530 (or its predecessor rule). The Rule provides that formal opinions are advisory only.