Insurance Law Update

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What *Peppers* Counsel Needs to Know Before Agreeing to Follow Insurer Litigation Guidelines

When an insurer agrees to defend its insured against a potentially covered claim without reserving the right to deny coverage, the insurer usually has the right to control the defense of the underlying lawsuit. *See* 3 Jeffrey E. Thomas, New Appleman on Insurance Law Library Edition § 16.04(1) (LexisNexis). This right permits the insurer to dictate how much money will be spent on litigation, which tactical choices will be made, and whether and when the case will be tried or settled. The insurer loses the right to control the defense under Illinois law, however, if it reserves its rights to deny coverage pursuant to a coverage defense that turns on facts that may be developed in the underlying litigation. *See Maryland Cas. Co. v. Peppers*, 64 Ill. 2d 187, 197 (1976). For example, when an insurer agrees to defend a suit alleging both negligence and intentional misconduct, but reserves the right to deny coverage for damages because of intentional misconduct, it creates a conflict of interest. If the insured is found liable, the insurer would benefit from a finding that the liability was caused by uncovered intentional misconduct, yet the insured would benefit from a finding that the liability was caused by covered negligence. *See Peppers*, 64 Ill. 2d at 198-99. In other words, there is a risk that an insurer controlling the defense may "steer" the defense toward uncovered counts or theories of liability.

When a "*Peppers*" conflict arises, the insurer loses its right to select defense counsel or control the defense of the underlying action. Instead, the insurer is obligated to discharge its contractual duty to defend by reimbursing the insured "for the reasonable cost of defending the action" by "independent" counsel who is selected and controlled solely by the insured, and who represents the sole interests of the insured, and not the insurer. *Id.* The insurer must reimburse the insured for defense costs as they are incurred. *See Ins. Co. of the State of Penn. v. Protective Ins. Co.*, 227 Ill. App. 3d 360, 368-69 (1st Dist. 1992). Of course, insurers and insureds do not always agree on how to measure what constitutes a reasonable defense cost, and disputes can arise between the insured's right to direct its defense and the insurer's right to limit defense expenditures to those that are reasonable and necessary.

Moreover, as discussed below, defense counsel must ensure that an insurer's litigation guidelines do not compromise the attorney's duty to the insured of loyalty and independent professional judgment. Litigation guidelines that restrict a defense attorney's ability to defend a case effectively because they state that the insurer will not pay for certain costs or defense activities could present serious ethical concerns if the attorney believes that such costs or activities are necessary to the defense of the case. Moreover, reporting obligations set forth in litigation guidelines do not trump defense counsel's duty to obtain the consent of the insured, their sole client, prior to disclosing to the insurer confidential or privileged information that might impair the insured's right to coverage.

Insurers Often Attempt to Control Litigation Costs by Requiring Compliance with "Litigation Guidelines" or "Billing Guidelines"

Insurers often ask their insureds and their defense counsel to abide by insurer-drafted litigation guidelines as a prerequisite to reimbursement for defense costs. Requirements imposed by such guidelines can include: caps on hourly rates; restrictions on staffing (both by seniority and number of attorneys); refusal to pay for certain tasks (such as meetings among attorneys); refusal to pay certain expenses as "overhead" (such as copying, online research, work by paralegals and other non-attorney staff); and requiring the use of task-based billing codes instead of block billing to limit further the work for which the

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attorney (and the insured) can seek reimbursement.

Litigation Guidelines Are Not Mandatory

Although litigation guidelines are often presented to defense counsel as mandatory, there is usually nothing in the insurance policy that requires compliance with litigation guidelines. The touchstone for whether an insurer must pay for a specific defense activity or associated cost is whether the work or cost is a "reasonable cost of defending the action." *Peppers*, 64 Ill. 2d at 199. Litigation guidelines cannot supersede the general rule that an insurer in a conflict situation must pay all reasonable and necessary defense expenses, and an insurer's prospective refusal to pay for specific defense activities does not constitute a valid basis for the insurer to refuse to pay for such activities. *See Philadelphia Indem. Ins. Co. v. Chicago Title Ins. Co*., No. 09 C 7063, 2012 WL 2115487, at *5 (N.D. Ill. June 10, 2012) (finding "any alleged noncompliance with the billing guidelines does not render the fees legally unreasonable and does not otherwise affect the amount that [the insurer] owes").

The Determination of Whether Attorney Fees are Reasonable Should be Determined on a Case-By-Case Basis

In general, courts follow the factors set forth in Illinois Rule of Professional Conduct 1.5 when determining whether attorneys' fees incurred in the defense of a matter are reasonable. *See Williams v. Am. Country Ins. Co*., 359 Ill. App. 3d 128, 142 (1st Dist. 2005). Such factors include:

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> the time and labor required, the novelty and difficulty of the issues, the skill required, the preclusion of other employment necessary to accept the case, the customary fee charged in the community, the amount of money involved in the case, the results obtained, and the attorney's reputation, experience, and ability.

Mobil Oil Corp. v. Maryland Cas. Co., 288 Ill. App. 3d 743, 758 (1st Dist. 1997). When an insurer disputes its obligation to reimburse the insured for defense expenses, such expenses are deemed to be *prima facie* reasonable if they have been paid by the insured. *See American Service Ins. Co. v. China Ocean Shipping Co. (Americas) Inc.*, 402 Ill. App. 3d 513, 530 (1st Dist. 2010) (quoting *Taco Bell Corp. v. Continental Cas. Co.*, 388 F.3d 1069 (7th Cir. 2004)). S*ee also Knoll Pharmaceutical Co. v. Automobile Ins. Co. of Hartford*, 210 F. Supp. 2d 1017, 1025 (N.D. Ill. 2002) (finding fact that insured paid defense expenses sought from insurer "strongly implies commercial reasonableness of the fees, especially in light of the fact that ultimate recovery of the fees was uncertain because [the insurers] repeatedly refused to pay").

Rule 5.4(c) Precludes Defense Counsel from Allowing an Insurer's Refusal to Pay for Necessary Litigation Activities or Costs to Interfere with the Attorney's Independent Professional Judgment

When an insurer's reservation of rights requires it to discharge its duty to defend as a third-party payer of legal services, independent defense counsel cannot permit the insurer's prospective refusal to pay for certain defense activities or costs to compromise the attorney's duty of loyalty to the insured. *See* Ill. Sup. Ct. R. Prof'l Conduct, R 5.4(c) (2014). In that regard, Illinois Rule of Professional Conduct 5.4(c) states that "[a] lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services." *Id*. In other words, if an attorney believes that certain activities are necessary for the insured's defense, the attorney cannot permit the insurer to interfere with the defense by refusing to pay for such activities. *See* ABA Standing Comm. on Ethics & Prof'l Responsibility, Formal Op. 01-421 (2001). Moreover, an insurer will be in

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breach of its duty to provide independent defense counsel if it attempts to control the defense by controlling the purse strings. *See Peppers*, 64 Ill. 2d at 198-99.

At least one court has held that defense counsel "who submit to the requirement of prior approval violate their duties under the Rules of Professional Conduct to exercise their independent judgment and to give their undivided loyalty to insureds." *In Re Rules of Prof'l Conduct and Insurer Imposed Billing Rules and Procedures*, 2 P.3d 806 (Mont. 2000). Other courts and bar associations have stated that litigation guidelines require a case-by-case analysis to ensure that the guidelines, as applied, do not put a lawyer in a position that compromises the duty of loyalty owed to the client under state rules of professional responsibility. *See, e.g.*, Ky. Bar Ass'n Ethics Comm. Op. KBA E-416 (March 2001), *available at* http://www.kybar.org/documents/ethics_opinions/kba_e-416.pdf.

Numerous courts and bar associations have identified restrictions in litigation guidelines that so clearly interfere with the independent professional judgment of an attorney that it would be improper for an attorney to comply with them. Such restrictions include requiring an attorney to obtain the insurer's approval prior to: (1) performing legal research (*See* Ohio Bd. of Comm'rs on Grievances and Discipline, Advisory Op. 2000-3 (June 1, 2000), *available at* https://www.supremecourt.ohio.gov/Boards/BOC/Advisory_Opinions/2000/Op%2000-003.doc); (2) conducting discovery, taking depositions, or retaining expert witnesses (*See* Va. State Bar Standing Comm. on Legal Ethics, Op. 1723 (November 23, 1998), *available at* http://www.vacle.org/opinions/1723.htm;); and (3) filing motions or pleadings (*See* State Bar of Ariz. Op. 99-08 (September 1999), *available at* http://www.azbar.org/Ethics/EthicsOpinions/ViewEthicsOpinion?id=502).

The Illinois State Bar Association has recognized that without the consent of the insured, a defense attorney cannot disclose to an insurer confidential communications or information that might prejudice the insured's right to coverage.

Other guidelines that have been found to be improper include: (1) refusing to pay for reasonable discussions between members of the defense team (*See* Ind. State Bar Ass'n Legal Ethics Comm. Op. 3 of 1998, *available at* http://www.inbar.org/Portals/0/downloads/ethics/1998.pdf); (2) "dictat[ing] the use of personnel within the lawyer's own office" (*Id.*); and (3) requiring the attorney to obtain the insurer's approval prior to conducting investigations or visiting accident sites (*See* R.I. Supr. Ct. Ethics Advisory Panel Final Op. No. 99-18 (Oct. 27, 1999), *available at* http://www.courts.ri.gov/AttorneyResources/ethicsadvisorypanel/Opinions/99-18.pdf).

Defense Counsel Cannot Disclose Information that Could Adversely Affect Coverage without the Insured's Consent

Litigation guidelines often require defense counsel to provide status reports and case evaluations regarding the defense of the underlying action. Although an insured's obligation to cooperate with its insurer requires the insured to provide information regarding the defense of the case, this duty does not necessarily require the insured to provide information that would support a coverage denial. *See Waste Mgmt., Inc. v. Int'l Surplus Lines Ins. Co.*, 144 Ill. 2d 178, 204 (1991) ("While the insured has no obligation to assist the insurer in any effort to defeat recovery of a proper claim, the cooperation clause does obligate the insured to disclose all of the facts within his knowledge and otherwise to aid the insurer in its determination of coverage under the policy.")

The Illinois Rules of Professional Conduct preclude an attorney from disclosing a client's confidential information without the client's consent. Specifically, Illinois Rule of Professional Conduct Rule 1.6(a) provides that "[a] lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent . . ." and Illinois Rule of Professional Conduct Rule 1.8(b) provides that "[a] lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client gives informed consent . . ."

The Illinois State Bar Association has recognized that without the consent of the insured, a defense attorney cannot disclose to an insurer confidential communications or information that might prejudice the insured's right to coverage. In that regard, the Illinois State Bar Association provided the following commentary regarding a defense attorney's ethical obligations when reporting to an insurer:

[T]he Committee does not believe that the insured has the duty under the "cooperation clause" to reveal adverse information concerning possible late notice, misrepresentation, or other matters which may prejudice the insured's coverage under the policy. To the extent that the reports to the insurer may involve any such disclosures, it is the Committee's opinion that the insured's general counsel has a right to insist that they be deleted, since the insured's duty to cooperate with the insurer in the conduct of the litigation does not extend to incriminating itself with respect to possible policy defenses of the insurer. In such circumstances, the retained attorney must refrain from disclosing any such facts, since he has the same obligation in his representation of the insured as if he had been personally retained by the insured.

If the retained counsel and general counsel cannot agree on the content of reports with regard to the "cooperation clause" question, counsel retained by the insurer should advise general counsel that the particular deletions or omissions may expose the insured to a claim of breach of cooperation by the insurer. If the conflict becomes irreconcilable, retained counsel should move for leave to withdraw pursuant to Rule 1.16(b)(D) so as not to jeopardize the attorney-client relationship with either the insurer or the insured.

Ill. State Bar Ass'n, Advisory Op. on Prof'l Conduct No. 92-2, p. 3 (July 17, 1992) (internal citation omitted), *available at* http://www.isba.org/sites/default/files/ethicsopinions/92-02.pdf. In other words, the Illinois Rules of Professional Conduct require a defense attorney to obtain the consent of his or her client, the insured, before disclosing confidential communications or information to an insurer, especially if such communications or information might prejudice the insured's right to coverage.

An Insurer's Use of an Outside Fee Auditor Could Result in a Privilege Waiver

Some litigation guidelines require defense attorneys to submit their invoices to outside auditors retained by the insurer to review billing invoices and write off fees charged for work deemed unnecessary. Attorney invoices often contain detailed information regarding the defense of the case that may be protected by the attorney-client privilege. Even though the disclosure to an insurer of privileged defense information typically does not constitute a waiver of the privilege in Illinois pursuant to *Waste Management*, 144 Ill. 2d at 194, an insurer's disclosure of privileged information to a party that is not part of the legal defense team, such as a third-party auditor, may constitute a waiver of the privilege. *See In re Rules of Prof'l Conduct & Insurer Imposed Billing Rules & Procedures*, 2 P.3d at 820-21 (holding disclosure of confidential information contained in billing invoices to third-party auditor may result in waiver of attorney-client privilege or work-product protection). Because such disclosures could lead to a privilege waiver, an attorney must obtain the informed consent of the insured before sending bills to a third-party fee auditor. *See* ABA Op. 01-421, *supra*, at 5-6 (stating "[a] majority of jurisdictions have concluded that it is not ethically proper for a lawyer to disclose billing information to a third-party billing review company at the request of an insurance company unless he has obtained the client's consent.")

Conclusion

Insureds should review litigation guidelines carefully with their defense counsel and attempt to negotiate an agreement with the insurer and defense counsel regarding acceptable billing practices before the attorney begins work on the file. Ultimately, however, it is the defense attorney who must ensure that litigation guidelines do not interfere with the duties imposed by the Illinois Rules of Professional Conduct. Negotiating a mutually-agreeable billing agreement with the insurer early in the defense of the case will help to ensure that defense counsel's ability to represent the insured effectively is not compromised materially by the insurer's litigation guidelines, that the insurer does not breach its duty to provide a full defense, and that neither the insured nor the defense attorney will end up having to shoulder any portion of the fees that should be covered by insurance. Moreover, insureds should advise their insurers that they do not consent to having their attorneys' billing invoices reviewed by third-party auditors in light of the risk the disclosure of billing invoices to an auditor could result in the inadvertent waiver of the attorney-client privilege.