EXPANDING THE TRIPARTITE RELATIONSHIP: EXTENDING EVIDENTIARY PRIVILEGE TO FOURTH-PARTY LEGAL† AUDITS

JOHN P. KILLACKY*

Legal auditing is one of the fastest growing trends in the legal profession. Due to widely publicized abuses of the legal profession's hourly billing system and increased pressure on insurance companies to cut costs, the growth of this cottage industry noticeably affected the insurance defense industry. This note advocates extending an evidentiary privilege to information that insurers provide to the legal auditors hired to scrutinize the bills of retained defense counsel.

This note begins by outlining the origins, the nature and scope of legal auditing, and the tripartite relationship that exists between the insurer, the insured, and the legal auditor. After a thorough analysis of the policies that surround evidentiary privileges, the author assesses possible privilege models to address the concern that legal auditing waives the privilege that exists between the attorney and the client. The author recognizes that a distinction exists between insurers who choose to outsource the legal-auditing function and insurers who perform the auditing function themselves. In order to allow attorneys and insureds to maintain the type of relationship that most lawyers and clients have, the author proposes that an evidentiary privilege to fourth-party legal auditors be recognized.

I. INTRODUCTION

Since the early 1990s, attorneys have found themselves increasingly scrutinized by one of the fastest growing cottage industries in the legal profession—legal auditing.[1] This trend has most seriously impacted the

† *The outsourcing of the legal-auditing function by insurance companies is commonly referred to as "third-party" legal auditing. However, the auditor is actually a fourth party to the tripartite relationship between insurer, insured, and defense counsel. Therefore, this note uses the term "fourth-party legal audit" in order to more accurately describe the relationship and to distinguish the auditor from the insurer, who is sometimes referred to as a "third-party payor." All quotations referring to "third-party" legal audits have been changed to "[fourth]-party."*

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1. *See* Amy Stevens, *Ten Ways (Some) Lawyers (Sometimes) Fudge Bills*, WALL ST. J., Jan. 13, 1995, at B1; *see also* Andrew G. Cooley, *Audits of Attorney Bills*, FOR THE DEF., Feb. 1998, at 21. This note only addresses the evidentiary-privilege aspect of the fourth-party legal auditing argument and deals only tangentially with the ethical and professional responsibility issues raised by many state bar

insurance defense bar, dramatically decreasing the profitability of insurance defense practice.[2] In response to the onslaught of legal auditing, attorneys are fighting back with arguments highlighting the legal and ethical problems accompanying audits. These arguments include claims of conflict of interest,[3] unlicensed practice of law,[4] release of confidential information without informed consent,[5] and waiver of the attorney-client and/or work-product privileges.[6] This note will address the validity of the claim that disclosures of information to fourth-party auditing agencies waive evidentiary privilege.

The waiver argument advanced by the insurance defense bar is meritorious. This claim has found acceptance among state bar associations, many of which have issued ethics opinions forbidding the disclosure of information to fourth-party auditors.[7] However, the issue is far from settled. At least one state bar has held that such disclosures are permissible.[8] Additionally, legal auditors feel that violation of confidentiality arguments against fourth-party auditing "are too often shills for defense attorneys who don't want their bills audited . . . . Insurance companies have always audited bills . . . . All they are doing now is outsourcing this function."[9]

Recently, the courts have added to the controversy. In 1997, the First Circuit Court of Appeals decided *United States v. Massachusetts Institute of Technology* (*MIT*),[10] which addresses waiver of attorney-client

associations. The purpose of this note is to examine issues surrounding the waiver of evidentiary privilege by submission of billing statements to fourth-party auditors, a possibility that underlies many of the ethical arguments against this practice.

2. *See* Anne Berryman, *Suits Challenge Audits of Insurance Defense Bills*, FULTON CO. DAILY REP., Mar. 8, 1999, at 7; Lisa Brennan, *Driven to Defection: Fed up with Insurers' Auditors, Defense Lawyers Go to Work for Plaintiffs*, NAT'L L.J., May 18, 1998, at A1; Cooley, *supra* note 1, at 21; Hope V. Samborn, *No-frills Approach Proving Costly: Insurers' Demands to Economize Are Too Much for Some Defense Firms*, A.B.A. J., Mar. 1998, at 30; Anna Snider, *Firm Quits Client Over Outside Auditor*, 159 N.J. L.J. 198 (1999); Angela Wissman, *Insurance Defense Lawyers Feel the Squeeze*, ILL. LEGAL TIMES, Sept. 1998, at 1.

3. "In the traditional insurance-defense situation, the insurance company hires an attorney . . . to defend its insured. The insured . . . becomes the attorney's client." Claire Hamner Matturro, *Auditing Attorneys' Bills: Legal and Ethical Pitfalls of a Growing Trend*, FLA. B.J., May 1999, at 14, 18. However, when the attorney must justify a competent defense of the insured to a different party, namely the insurer or an auditor, conflicts against the interests of the true client, the insured, arise. *See id.*

4. The increased use of billing guidelines, which dictate who and how much time should be allotted to certain tasks, have been attacked as impeding the judgment of attorneys in the defense of the insured. *See* Kent D. Syverud, *The Ethics of Insurer Litigation Management Guidelines and Legal Audits*, 21 No. 7 INS. LITIG. REP. 180, 187–88 (1990), *available in* WESTLAW, TP-ALL.

5. "[T]he fact that a party has sought legal services is considered a form of client confidence or secret which the lawyer may not reveal without the client's informed consent." Cooley, *supra* note 1, at 22.

6. "In the outside audit situation, attorneys are being required to submit detailed bills containing information about client confidences and lawyer's theories to a [fourth] party." *Id.*

7. *See* Michael Booth, *State Ethics Bans on Outside Fee Audits Mounting*, 154 N.J. L.J. 93, 93 (1998).

8. *See id.*

9. *Id.* (quoting Ted Ringle, auditor at Law Audit Services).

10. 129 F.3d 681 (1st Cir. 1997).

privilege by disclosure of documents to auditors outside the insurance context. The *MIT* decision is often cited by the insurance defense bar to support their view that disclosure of billing statements to auditors waives any privilege.[11] In *In re Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedures* (*In re Rules Case*),[12] the Montana Supreme Court directly applied *MIT* to answer the question of whether disclosure of billing statements to insurer-hired auditors violates client confidentiality.[13] The court concluded fourth-party auditors do not fall within the "magic circle" of persons covered by the attorney-client privilege.[14] Additionally, a number of other suits have been filed by insurance defense lawyers seeking restrictions on the ability of insurers to review and control bills.[15]

However, the legal-audit industry claims that insurance defense lawyers are misreading *MIT*,[16] and at least one commentator has claimed that "the *MIT* decision actually supports insurers' use of outside auditors."[17] Moreover, there is a strong argument that fourth-party auditing encourages lawyers to observe higher ethical standards in billing their time and is in the best interests of the insured-client, who wants competent, efficient legal services, without paying higher insurance premium rates.[18] As existing evidentiary privileges are primarily based on public-policy justifications, the policy advantages of legal auditing may warrant an extension of privilege as well. At the core of the issue is whether insurance defense attorneys have sustainable arguments that validate their position, or whether they are merely posturing in an attempt to preserve their once-lucrative trade.[19]

This note isolates the issue of whether evidentiary privilege should be extended to information provided to fourth-parties hired by insurers to audit the bills of retained counsel. The intent of this note is to alleviate concerns regarding waiver of evidentiary privilege, thereby facilitating the procurement of informed consent from insureds with regard to

11. *See* Matturro, *supra* note 3, at 22, 24.

12. *In re* Rules of Prof'l Conduct and Insurer Imposed Billing Rules and Procedures, 2 P.3d 806 (Mont. 2000) [hereinafter *In re Rules Case*].

13. *See id.* at 818–20.

14. *Id.* at 820–21.

15. *See* Berryman, *supra* note 2, at 7; *see, e.g.*, Smith v. Law Audit Servs., No. 164549 (San Francisco Super. Ct., filed Feb. 11, 1999); Smith v. Legalgard, No. 164548 (San Francisco Sup. Ct., filed Feb. 11, 1999).

16. *See* Brennan, *supra* note 2, at A1.

17. Syverud, *supra* note 4, at 192.

18. *See id.*

19. *See, e.g.*, Ellen S. Pryor & Charles Silver, *Defense Lawyers' Professional Responsibilities: Part I-Excess Exposure*, 78 TEX. L. REV. 599, 672 (1999).

> The managed care revolution strongly suggests that many purchasers prefer saving money to spending it. There is little that ethics rules can do to prevent them from making this tradeoff. *There also is a real danger that lawyers will be the main beneficiaries of ethics-driven efforts to enhance legal services for insureds.*

Id. (emphasis added).

disclosure of attorney confidences.[20] Part II will examine the policies underlying current evidentiary privileges, particularly the attorney-client and work-product privileges, against the backdrop of the legal-auditing controversy and the scope and intensity of current auditing practices. Part III will analyze the extension of existing evidentiary privileges to fourth-party auditors through application of utilitarian, rights-based, and economic models of evidentiary privilege. Although the issue is far from resolved, part IV will propose that disclosures to fourth-party legal auditors should be protected under the same evidentiary-privilege standards applicable to the current relationship between insurers, their insureds, and retained counsel. However, this protection should not be unqualified. Therefore, a legislative approach to privilege extension is recommended. This approach should allow states to experiment with regulations governing the parameters of the auditing relationship, including auditor ethics and fee arrangements, in order to make the best use of the legal-auditing industry.

II. BACKGROUND

A. The Origins of the Legal-Auditing Controversy

Legal auditing likely originated in the application of fee-shifting statutes in civil-rights litigation,[21] under which a prevailing plaintiff must

20. The issue addressed in this note is entirely separate from the concerns regarding breach of a lawyer's duty to maintain client confidences. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 (1983); MODEL CODE OF PROFESSIONAL RESPONSIBILITY Canon 4 (1981). However, some state bar association ethics opinions do permit disclosure if informed consent of the insured is obtained. *See, e.g.*, S.C. Bar Ethics Advisory Comm., *Advisory Op. 97-22* (visited July 16, 2000) <http://www.scbar.org/ethics_advisory_opinions.htm> ("Upon receipt of informed consent from the insurer as well as the insured, a lawyer would not be ethically prohibited from submitting his bills directly to a [fourth]-party auditing firm . . . ."); Vt. Bar Ass'n Comm. on Prof'l Responsibility, *Advisory Ethics Op. 98-7* (visited July 16, 2000) <http://www.vtbar.org/AdvisoryEthicsOpinions/1998/98-07.htm> ("A lawyer retained by an insurance company to represent a policy holder may not provide billings containing confidential information to an outside auditor employed by the insurance company without the client's informed consent . . . ."). Possible waiver of the attorney-client and/or work-product privileges is an important element of informed consent. *See, e.g.*, Colo. Bar Ass'n Ethics Comm., *Formal Op. 107* (visited July 16, 2000) <http://www.cobar.org/comms/ethics/fo/fo_107.htm> ("[T]he attorney must ensure that the insured has been made aware of the risks posed by disclosure. . . . [The risks include that disclosure could] (1) result in a waiver of evidentiary privileges . . . ."); Or. St. Bar Bd. of Governors, *Formal Op. No. 1999-157* (visited July 16, 2000) <http://www.osbar.org> ("[F]ull disclosure may need to include a discussion of the risk that the submission of the detailed bills to the [fourth]-party audit service might constitute a waiver of the attorney client privilege . . . ."); S.C. Bar Ethics Advisory Comm., *Advisory Op. 97-22*, *supra* ("[Disclosure should include] the type of information which may be found in billing records, as well as the potential legal effects of releasing such information . . . . [A] lawyer contemplating the release of client billing information to [fourth] parties should carefully consider issues of waiver . . . ."). Therefore, elimination of the evidentiary-privilege issue facilitates obtaining informed consent of the insured-client. Absent the waiver concern, such consent could be easily obtained when the insured authorizes the insurer to defend them. A counterpart agreement to maintain confidentiality by the auditor would then complete the circle.

21. *See* Cooley, *supra* note 1, at 21.

submit a detailed billing statement in order to recover fees.[22] Defendants often seek to challenge these fees in order to reduce recovery.[23] Litigation, which carefully scrutinizes plaintiff's attorney's bills in order to determine a reasonable fee, often occurs.[24] Specialists in the area of legal billing soon found another market for their services in the insurance industry and evolved into fourth-party legal auditors.

Legal auditing in the insurance industry was the result of several forces arising during the late 1980s and early 1990s. The most obvious of these is the public perception that attorneys widely engage in unethical billing practices.[25] Although ethical billing is the norm for the vast majority of attorneys, the entertainment industry and the media seem to highlight instances of fraudulent billing.[26] Some of the more egregious examples of overbilling include: entries for "meetings" with other attorneys, when the other attorney did not have a corresponding entry;[27] charging for heating and air conditioning services when weekend work was required;[28] billing 6.5 hours at $245 an hour for "preparing closing room," which involved "physically putting the offering documents on the table" and "[m]aking sure there was [sic] coffee and pencils in the room";[29] and a $165 entry for "ground transportation," which turned out to be a pair of shoes.[30] Legal auditors have capitalized on this perception in an effort to market their services. "A casual search on the Internet for legal auditors reveals a number of websites advertising for business. These advertisements include vague, undocumented, or unfootnoted references to surveys and studies about legal overbilling."[31] However, because the public has always questioned attorneys' ethics, the auditors' message easily catches on.

22. *See, e.g.*, 42 U.S.C. § 1988(b) (1994) (granting the trial court discretion to award attorney's fees to a prevailing party in civil-rights litigation).

23. *See, e.g.*, Dan B. Dobbs, *Reducing Attorneys' Fees for Partial Success: A Comment on* Hensley *and* Blum, 1986 WIS. L. REV. 835, 835–36 (1986) ("In the last two decades, however, litigation permitting fee awards against losing parties and against funds-in-court has increased.").

24. *See id.*

25. *See* Matturro, *supra* note 3, at 14.

26. *See id.* (citing the movie *The Firm*, in which a law firm was brought down for fraudulent billing, rather than for its connections with organized crime). The scandal involving former Justice Department official Webster Hubbell arose from unethical legal-billing practices. In the same month that Mr. Hubbell pled guilty, a Chicago attorney admitted to fraudulently obtaining $750,000 from his firm and five clients. *See* James P. Schratz, *Cross-Examining a Legal Auditor*, 20 AM. J. TRIAL ADVOC. 91, 91 (1996) (citing Matt O'Connor, *From Top Loop Law Firm to Jail: Attorney Stole $750,000 from Winston & Strawn, Clients*, CHI. TRIB., Dec. 20, 1994, at 1).

27. *See* Stevens, *supra* note 1, at B1.

28. *See id.* These charges sometimes are reported under the heading "HVAC," which stands for "heating, ventilation, and air conditioning." Although this practice is somewhat widespread, "[c]lients should balk at such charges." *Id.*

29. *Id.* "This table setter later put his 1992 law degree from Harvard to further use, at one point billing his full rate for 10 hours as he 'photocopied and distributed documents to all parties.'" *Id.*

30. *Id.*

31. Howard L. Mudrick, *No: Billing is Serious Business*, A.B.A. J., Dec. 1990, at 43; *see, e.g.*, The Devil's Advocate (visited Oct. 30, 2000) <http://www.devilsadvocate.com> (offering legal-fee management and litigation-consulting services).

Another factor contributing to the rise of legal audits is clients' awareness of the increased pressure on attorneys to exceed annual billing quotas. When firms introduced hourly billing, clients readily accepted the idea of paying for an attorney's time and expenses, rather than paying based on an arbitrary estimate of effort expended.[32] Over the years, however, the practice evolved such that the quantity of work often superseded the quality.[33] Soon, time-keeping became the "sole arbiter of billing."[34] Now, firms mandate annual billing requirements from associate attorneys and offer a "carrot and stick" approach. For the "carrot," a bonus is offered for increased hours, however, the "stick" may include poor performance evaluations, decreased opportunity for partner status, or even termination. Therefore, attorneys have a strong incentive to "pad" their billing entries.[35] Despite this phenomenon, many firms have instituted controls on billing, and partners must carefully examine billing statements before sending them to clients.[36] Yet, the perception of overbilling remains.

Perhaps the most significant change leading to an increase in auditing—and the reason why insurance defense attorneys are the most seriously affected—did not occur in the legal profession, but rather in the insurance industry.[37] Throughout the 1980s, insurance companies made lucrative investments that allowed them to pay out more in claims than they received in premiums. Most of these benefits accrued when insurance companies delayed payment of claims in order to capitalize on interest income.[38] As a result, insurers often paid attorneys to delay cases, a practice that allowed insurers to realize increased interest income and permitted attorneys to increase their number of billable hours.[39] Furthermore, the 1980s cult of greed encouraged attorneys to invest numer-

32. *See* Mudrick, *supra* note 31, at 43. Due to the individual attention required on each client's file, billing based on number of hours actually worked more accurately accounts for the cost of various services, than a flat-rate system of billing. Of course, this assumes that all attorneys are equal (an assumption partially compensated for in varying hourly rates).

33. *See id.*

34. *Id.*

35. Chief Justice Rehnquist stated, "If one is expected to bill more than two thousand hours per year, there are bound to be temptations to exaggerate the hours actually put in . . . ." William H. Rehnquist, *Dedicatory Address: The Legal Profession Today*, 62 IND. L.J. 151, 155 (1987).

36. *See* Matturro, *supra* note 3, at 14.

37. "The simple truth is that the insurance industry as we know it today . . . is embarking on a period of some of the most dramatic changes that it has ever experienced." C. David Sullivan & Patrick T. Muldowney, *Changing Times in the Insurance Industry*, FOR THE DEF., Supp. to Feb. 1998, at 2. The current challenges faced by insurers include increased competition, poor sales, low retention, increased claims, and low returns on investments. *See id.*

38. For example:

> [T]he returns were sometimes so staggering that, when an insurance company would receive a $1.00 premium, it knew that it could safely pay out $1.05 in indemnity. . . . [I]t knew that if it could delay paying . . . for at least one year, it would earn 10 or 20% interest on the premium in the interim.

Cooley, *supra* note 1, at 21.

39. "Given the numbers involved, it was cheaper to pay an attorney to defend the case than lose out on the interest income." *Id.*

ous hours "engaging in sometimes useless discovery with the goal of delaying resolution of the lawsuit."[40] However, the recession of the early 1990s made it uneconomical for insurance companies to continue to employ defense attorneys in this fashion.[41] An extremely competitive insurance market that discouraged raising premiums compounded the problem.[42] "Of the three basic components of the insurance company's income/expense picture—premiums, indemnity, and legal defense costs—the companies came to believe that the lawyers' bills were the [easiest] . . . to manage."[43] Therefore, insurers began carefully scrutinizing attorney billing statements.

Of course, clients, including insurance companies, have always performed audits of attorneys' bills.[44] However, such audits were performed internally and did not pose any of the legal or ethical problems presented by fourth-party auditing. The current environment is such that some former attorneys have embraced legal auditing as a career, generating a new cottage industry.[45] Furthermore, most legal auditors market themselves to insurance companies promising savings and requesting a contingent fee as a percentage of those savings, a practice that has drawn considerable opposition from attorneys.[46] Because the auditors' payday depends on how much fat they can trim from a bill, they have an incentive to cut as much as possible, even if that means objecting to legitimate billings.[47] Often, firms are left with no option but to acquiesce to the cuts, because it would be more costly and time-consuming to fight the auditors' decisions.[48]

The most significant effects of fourth-party legal auditing are felt by the insurance defense industry. As they are left with few economically feasible means of protest, most insurance defense firms must give in to the insurers and their auditors.[49] Additionally, "droves of once-dedicated insurance defense lawyers are switching fields."[50] Many of these attorneys actually go to work for plaintiffs' firms.[51] Some firms have seen a drastic decrease in the amount of business received from insurance com-

40. *Id.*
41. *See id.*
42. *See id.*; *see also* Sullivan & Muldowney, *supra* note 37, at 2.
43. Cooley, *supra* note 1, at 21.
44. *See id.* at 22.
45. *See* Matturro, *supra* note 3, at 14–16.
46. *See* Cooley, *supra* note 1, at 22.
47. *See id.*
48. "A billing dispute 'will cost me more in time and effort to fight than [the amount] cut,' says Shaun Baldwin, a partner with Tressler, Soderstrom, Maloney & Priess in Chicago and outgoing chair of the Defense Research Institute's insurance law committee." Samborn, *supra* note 3, at 31.
49. *See id.*
50. Brennan, *supra* note 2, at A1. "'Insurance defense just isn't a great way to make a living anymore,' says [William E.] Partridge, 49, who left Sarasota's Lutz, Webb, Partridge & Bobo to open the Sarasota office of Miami's Grossman & Roth, a prominent plaintiffs' firm." *Id.*
51. *See id.*

panies.[52] One firm even decided that it was more cost-effective to drop a client of fifteen years than to deal with further scrutiny.[53] This decision meant the loss of the firm's single largest source of income, which had kept eight attorneys employed full time. Further, the firm sent back four hundred open cases as a result of the drop.[54] Because of these devastating effects on the industry, many in the insurance defense bar have fought back.

The insurance defense industry advances several arguments in an attempt to control the proliferation of fourth-party auditing. The first two of these are somewhat intertwined: (1) that including an additional party in the tripartite (insurer-insured-attorney) relationship generates an unethical conflict of interest;[55] and (2) that increasing control over litigation by insurers, and now fourth-party auditors, amounts to the unlicensed practice of law.[56] However, the conflicts of interest arising in the tripartite relationship are not unique to the fourth-party auditor scenario.[57] A fourth-party auditor adds few problems that do not already exist within the relationship. The unlicensed practice-of-law issue is more directly related to the imposition of restrictive billing guidelines on defense counsel, which detail who and how much time may be devoted to certain tasks.[58] However, the mere potential for an audit may influence attorneys in their representation of a client.

The second two arguments are also intertwined and involve (1) the attorney's ethical duty of confidentiality to the insured client;[59] and

52. The amount of insurance defense work handled by Williams & Montgomery in Chicago, has declined from almost 100% to only 25%. The firm has replaced some of this loss with commercial-litigation work. *See* Wissman, *supra* note 2, at 1.

53. *See* Snider, *supra* note 2, at 198.

54. *See id.*

55. *See* Veronica Bates, *Serving Two Masters: To What Extent May an Insurer Dictate a Lawyer's Defense of the Insured?*, TEX. LAW., May 17, 1999, at 27; Matturro, *supra* note 3, at 14.

56. *See* Booth, *supra* note 7, at 93; *see also* Syverud, *supra* note 4, at 184–87 (discussing the limitations on attorneys imposed by insurer-issued billing guidelines).

57. *See* Richard L. Neumeier, *Serving Two Masters: Problems Facing Insurance Defense Counsel and Some Proposed Solutions*, 77 MASS. L. REV. 66, 66–72 (1992).

58. *See generally* Connie Bauswell Saylor, *Restrictive Billing Guidelines: The Ethical Problems*, FOR THE DEF., Jan. 1998, at 32.

59. *See* Cooley, *supra* note 1, at 22. The issue of whether disclosure to fourth-party auditors violates a lawyer's duty of confidentiality is entirely separate from that of attorney-client privilege. Many state-bar ethics opinions that address the confidentiality issue recognize that they are without jurisdiction to decide the legal issue of evidentiary waiver, although most cite the possibility of waiver as an additional argument in support of a prohibition on such disclosures. *See* Ala. St. Bar, *Formal Op. RO-98-02* (visited Jan. 20, 2000) <http://www.alabar.org/Ogc/formal/fopDisplay.cfm?oneId=2> ("The question of whether disclosure of billing information to a [fourth] party auditor constitutes a waiver of confidentiality or work product is essentially a legal, as opposed to ethical, issue which the Commission has no jurisdiction to decide."); Alaska Bar Ass'n, *Ethics Op. No. 99-1* (visited Jan. 20, 2000) <http://www.alaska.net/~akctlib/eo99-1.txt> ("The Ethics Committee does not express an opinion on the waiver question; this issue must be resolved by the courts."); Colo. Bar. Ass'n Ethics Comm., *Formal Op. 107*, *supra* note 17 ("Whether particular material is privileged is a question of law and fact. . . . [T]hat analysis is beyond the scope of this opinion."); D.C. Bar Legal Ethics Comm., *Op. No. 290* (visited Jan. 20, 2000) <http://www.dcbar.org/attorney_resources/opin290.pdf> ("This is a matter of substantive law beyond the scope of the Committee's opinion."); Fla. Bar Prof'l Ethics Comm.,

(2) the waiver of evidentiary privilege through disclosure of information to a fourth-party.[60] As to the first of these propositions, again, the introduction of a fourth-party adds little to existing questions surrounding client confidentiality when an insurer is footing the bill.[61] However, the introduction of a fourth party into the tripartite relationship does have a significant effect on the scope of evidentiary privilege surrounding the relationship. Although insurers are generally included in the boundaries of evidentiary privilege in the defense of their insureds,[62] courts have not recognized a similar privilege for auditors hired by insurers. Furthermore, because courts narrowly interpret most evidentiary privileges,[63] it is likely that information provided to legal auditors would be held to be disclosed and, therefore, outside of the scope of privilege.

B. The Nature and Scope of Legal Auditing

A legal audit is more than an inspection of lawyers' bills. Therefore, an examination of the implications of evidentiary privilege for fourth-party legal auditing requires an understanding of the precise scope of such audits and their potential for disclosing information damaging to a party.

Legal audits vary in degrees of intensity and intrusion.[64] One auditor has broken down the available processes into four categories.[65] The least intrusive audit involves a "letter report that simply analyzes specific concerns or issues that can be identified from the client's billing entries or statements."[66] The second level is merely a review of billing statements, without inquiry into time sheets, prebills, work product, or other

Proposed Advisory Op. 99-2 (visited Jan. 20, 2000) <http://www.flabar.org/newflabar/images/downloads/99-02pao.pdf> ("Whether the attorney-client privilege may be waived by the disclosure is outside the scope of this Committee's review."); Idaho St. Bar, *Formal Ethics Op. No. 136, n.2* (visited Jan. 20, 2000) <http://www2.state.id.us/isb/opinion_136.htm> ("Such an interpretation of the *Idaho Rules of Evidence* is beyond the scope of this opinion."); Or. St. Bar Bd. of Governors, *supra* note 20 ("In the absence of definitive Oregon authority, whether the submission to a [fourth]-party audit service of bills containing Client's confidences and secrets waives the attorney-client privilege or work-product doctrine is a matter of substantive law beyond the scope of this opinion.").

60. *See* Cooley, *supra* note 1, at 22.

61. *See* Neumeier, *supra* note 57, at 75–76. Professor Neumeier cites circumstances such as when an insurer represents multiple individuals in a matter or when an insurer asks counsel to keep a confidence from the insured client. *See also* Eileen M. Dacey, *The Delicate Balance of the Attorney-Client Privilege in the Tripartite Relationship*, *in* INSURANCE LAW 1999: UNDERSTANDING THE ABC'S, at 199, 203–04 (PLI Litig. & Admin. Practice Course Handbook Series No. 386, 1999).

62. *See generally* Michael Keeley, *The Attorney Client Privilege and Work Product Doctrines: The Boundaries of Protected Communications Between Insureds and Insurers*, 33 TORT & INS. L.J. 1169 (1998).

63. *See id.* at 1170 (citing United States v. Nixon, 418 U.S. 683, 710 (1974) and NLRB v. Harvy, 349 F.2d 900, 907 (4th Cir. 1965) (quoting 8 J. WIGMORE, EVIDENCE § 2291 (J. McNaughton ed., rev. ed. 1961))).

64. *See* Matturro, *supra* note 3, at 16.

65. *See* Schratz, *supra* note 26, at 93.

66. *Id.* at 94.

documentation.[67] These two types of audits present little difficulty in the way of maintaining the confidentiality of privileged information. However, depending on the level of time-sheet-entry detail required by insurer-issued billing guidelines, it is possible that even these superficial reviews could result in waiver of privileged information.

The next two levels of auditing do present problems for the maintenance of evidentiary privilege. The third level of review is "a preliminary analysis based on a review of all the firm's fee and expense entries, and a review of any expense documentation, work-product, pre-bills, and time sheets that can be provided by the client, although no on-site audit is conducted."[68] This level reviews information provided "by the client." Normally this would present no problem, because the prevailing view is that evidentiary privilege belongs to the client and therefore, may be waived by the client.[69] However, in the insurance defense context, the insurer, not the insured-client, normally provides this information, thereby, giving rise to problems involving informed consent by the client.[70]

The highest level of review involves an on-site visit in which auditors scrutinize all billing statements, time sheets, prebills, and attorney work product.[71] Additionally, key personnel involved with the file may be interviewed regarding certain billing entries or work product.[72] This sort of audit is almost guaranteed to result in the disclosure of privileged information, again, without the informed consent of the insured. Furthermore, the highly intrusive nature of this audit is likely to cost firms substantial amounts of time and money to comply with the demands of such an examination. However, the pendulum swings both ways, as "[t]his on-site audit is the most expensive and time consuming, and many clients decide not to use it for those reasons."[73] But, regardless of the level and intensity of the legal audit, information subject to evidentiary privilege may be waived when it is disclosed to a fourth-party.

C. The Tripartite Relationship

Whenever an insurance company undertakes to defend one of its insured, the tripartite relationship emerges. The relationship between the insurer and insured is typically governed by a liability contract (the insurance policy).[74] That document outlines the various rights and responsibilities of each party—for the insurer: the duty to indemnify, the right

67. *See id.* at 93–94.
68. *Id.* at 93.
69. *See* Dacey, *supra* note 61, at 202–03.
70. *See* Cooley, *supra* note 1, at 22–23.
71. *See* Schratz, *supra* note 26, at 93.
72. *See id.*
73. *Id.*
74. *See* Charles Silver & Kent Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 DUKE L.J. 255, 269 (1995).

to defend, and the discretion to investigate and settle claims; for the insured: the duty to cooperate with the investigation and defense, and to refrain from settling except at the insured's own expense.[75] When a claim arises under the liability contract, an insurer will typically retain counsel pursuant to its duty to defend. An attorney hired to represent an insured will typically enter into a retainer agreement with the insurance company.[76] Thus, the existence of the liability contract and the retainer agreement create the tripartite relationship.[77]

There is considerable disagreement over the issue of whom defense counsel actually represents in the tripartite relationship. The majority view is that defense counsel represents two clients: the insurer and insured.[78] However, a minority view, which is gaining strength through proposed drafts of the *Restatement (Third) of the Law Governing Lawyers*[79] and recent cases,[80] proposes that the attorney only represents the

75. *See id.*

76. *See id.* at 270.

77. *See id.*

78. *See id.* at 273; *see also* Baker v. CNA Ins. Co., 123 F.R.D. 322, 326 (D. Mont. 1988) ("This principle . . . cannot be extrapolated to preclude an insurer from claiming the protection afforded its confidential communications with an attorney retained to protect the interests of both the insurer and the insured with respect to a claim asserted against the insured by a third party."); Gulf Ins. Co. v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone, 93 Cal. Rptr. 2d 534, 543 (Cal. Ct. App. 2000) ("Counsel retained by an insurer to defend its insured has an attorney-client relationship with the insurer."); Mobil Oil Corp. v. Maryland Cas. Co., 681 N.E.2d 552, 561 (Ill. App. Ct. 1997) ("The attorney hired by the insurer is a fiduciary of both the insurer and the insured."); Henke v. Iowa Home Mut. Cas. Co., 87 N.W.2d 920, 923 (Iowa 1958) ("[W]e hold that the district court was correct in its finding that the attorney hired by the insurer who tried the two cases did legally represent both parties in those transactions."); Central Cab Co. v. Clarke, 270 A.2d 662, 666 (Md. 1970) ("Counsel . . . represents the insured as well as the insurance carrier . . . .").

79. *See* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 215 (Proposed Final Draft No. 2, 1998) (addressing compensation by a party other than a client).

80. *See* Atlanta Int'l Ins. Co. v. Bell, 475 N.W.2d 294, 297–99 (Mich. 1991) ("[W]e approve the remedy of equitable subrogation—a less sweeping, less rigid solution than creation of an attorney-client relationship between the insurer and defense counsel . . . ."). *Bell* represented a shift away from the consensus that an attorney retained by an insurance company represents both the company and the insured. *See* Charles Silver, *Does Insurance Defense Counsel Represent the Company or the Insured?*, 72 TEX. L. REV. 1583, 1586–87 (1994); *see also* Bradt v. West, 892 S.W.2d 56, 77 (Tex. App. 1994) ("There is no attorney-client relationship between an insurer and an attorney hired by the insurer just to provide a defense to one of the insurer's insureds."); *In re Rules Case*, 2 P.3d 806, 814 (Mont. 2000) ("We hold that . . . the insured is the sole client of defense counsel.").

Although the Montana Supreme Court cites several other cases as support for the one-client view, those cases only address the subject tangentially or in dicta. *See* Continental Cas. Co. v. Pullman, Comley, Bradley & Reeves, 929 F.2d 103, 108 (2d Cir. 1991) (upholding dismissal of malpractice claim by insurer against retained counsel because amended complaint failed to show that an attorney-client relationship existed); Point Pleasant Canoe Rental, Inc. v. Tinicum Township, 110 F.R.D. 166, 170–71 (D. Pa. 1986) (refusing to allow intervention under FED. R. CIV. P. 24(a) based on allegation that insurer-retained counsel would not adequately represent the interests of intervenors); First Am. Carriers, Inc. v. Kroger Co., 787 S.W.2d 669 (Ark. 1990) (affirming disqualification of firm from representing plaintiff when firm was previously retained by defendant's insurer on behalf of the defendant); Jackson v. Trapier, 247 N.Y.S.2d 315 (1964) (stating that only one insurer-retained attorney may represent a client who carries coverage with two different insurance companies because the attorney's interests cannot be adverse). None of these authorities directly adopts the one-client view. Each of these cases merely uses the fact that the insured is, in fact, a client of an insurer-retained attorney as a

insured. This view has a serious impact on the tripartite relationship, because the privilege does not cover communications between the attorney and insurer. The one-client view also leaves little room for the extension of privilege to fourth-party auditors.

In the wake of the one-client/two-client debate, some suggest that the distinction is one not worth making.[81] Rather, the focus should remain on the documents that form the tripartite relationship—the policy and retainer agreements.[82] Because the attorney-client relationship is essentially an agency, it should be governed by an agreement between the parties and not regulated by the courts or bar association committees.[83] Furthermore, ethical rules already require an attorney to withdraw from representation if a concurrent conflict between parties arises.[84] This approach—allowing the parties themselves to define the boundaries of the relationship and relying on traditional ethics limitations to regulate attorney conduct—would allow the use of fourth-party auditors, as would the two-client approach. Even though a determination of the best approach is outside the scope of this note, recognition that the one-client approach precludes the effective use of fourth-party auditors is appropriate.

Although there is no generally recognized "insurer-insured" privilege, the attorney-client privilege is applicable to the tripartite relationship.[85] There is, necessarily, a broad and a narrow view regarding privileged communications between insurer and insured. The broad view covers all communications from an insured to the insurer, assuming that all "such communications are made for the dominant purpose of trans-

step in the analysis towards its conclusion. The notion that the insurer may also be a client is not precluded by the language of these cases.

Only *Jackson v. Trapier* directly states that "defendant is the client and *not the insurance carrier*." *Jackson*, 247 N.Y.S.2d at 316 (emphasis added). Yet, even *Jackson* suggests that an insurer-retained attorney may have loyalty to the insurer. In *Jackson*, the defendant carried dual insurance coverage and each insurance carrier retained counsel in his defense. *See id.* The plaintiffs sought to disqualify one of the retained counsel. *See id.* In affirming the disqualification, the New York Supreme Court reasoned that defendant could have only one attorney of record in order to avoid conflicts of interest among counsel. *See id.* Despite its assertion that the insurance carrier is not a client, the court's reasoning is based on the fact that attorneys retained by separate carriers may have conflicting interests. *See id.* This suggests that each attorney, in addition to representing the insured, represents the respective insurers, and even their own interests, in settling the claim. Thus, the Montana Supreme Court's reliance on these cases to support its one-client holding is tenuous.

81. *See, e.g.*, Thomas D. Morgan, *Whose Lawyer Are You Anyway?*, 23 WM. MITCHELL L. REV. 11, 40 (1997) ("When all is said and done, asking whether a lawyer retained by an insurance company represents one client or two probably is not worth the ink spent on it."); *see also* Pryor & Silver, *supra* note 19, at 607–08; Silver & Syverud, *supra* note 74, at 274.

82. *See* Silver & Syverud, *supra* note 74, at 275.

83. *See id.* Some difficulties with this approach may arise when the insured is faced with the prospect of liability in excess of the policy limits or when disputes regarding coverage arise. Professors Pryor and Silver suggest that the same principles of contract should govern, rather than allow ethics rules to interfere with effective cost-control techniques. *See generally* Pryor & Silver, *supra* note 19.

84. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7 (1999) (discussing concurrent-representation conflicts).

85. *See* John P. Ludington, Annotation, *Insured-Insurer Communications as Privileged*, 55 A.L.R.4TH 336, 340 (1987).

mission to an insurer-assigned attorney for defense of the claim."[86] Such protection would include communications regarding an incident that may potentially result in liability, but for which counsel has not been retained.[87] On the other hand, the narrow view only recognizes communications made "for the dominant purpose of the insured's defense . . . and under circumstances in which the insured has a reasonable expectation of confidentiality."[88] However, under either view, disclosure to a fourth-party may result in waiver of the privilege.[89] Thus, the attorney must be extremely careful when dealing with communications outside the tripartite relationship.

D. The Rationales Underlying Evidentiary Privilege and Its Role in the Tripartite Relationship

The common evidentiary privileges discussed in this note are the attorney-client and work-product privileges. Although recognition of privilege is contrary to the American philosophy of full discovery,[90] one commentator has noted that this is only a secondary effect of the rules.[91] The primary reason for excluding communications falling within the rules is to promote "the right to be left by the state unmolested in certain human relations."[92] This rationale was recognized in the adoption of Federal Rule of Evidence 501, which provides that "the privilege of a witness, person, government, State, or political subdivision thereof shall be governed by the principles of the common law."[93] By rejecting various proposed rules of evidence that codified existing evidentiary privileges,[94] the drafters opted out of a "definitive, static set of rules."[95] Rather, the door has been left open to extend privilege to a variety of human relationships.[96]

86. *Id.*
87. *See id.*
88. *Id.* at 341.
89. *See id.*
90. *See* David W. Louisell, *Confidentiality, Conformity and Confusion: Privileges in Federal Court Today*, 31 TUL. L. REV. 101, 110 (1956).
91. *See id.*
92. *Id.*
93. FED. R. EVID. 501.
94. The Supreme Court proposed 13 rules as Article V of the Federal Rules of Evidence that defined specific nonconstitutional privileges. *See* H.R. REP. NO. 93-650, at 8–9 (1973); S. REP. NO. 93-1277, at 11–13 (1974). The 13 rules were rejected in favor of current Federal Rule of Evidence 501. *See* H.R. CONF. REP. NO. 93-1597, at 7–8 (1974); *see also* FED. R. EVID. 502 (proposed but not enacted) (reports required by statute), 503 (proposed but not enacted) (lawyer-client), 504 (proposed but not enacted) (psychotherapist-patient), 505 (proposed but not enacted) (husband-wife), 506 (proposed but not enacted) (clergymen), 507 (proposed but not enacted) (political vote), 508 (proposed but not enacted) (trade secrets), 509 (proposed but not enacted) (secrets of state and other official information), and 510 (proposed but not enacted) (identity of informer).
95. AN EVIDENCE ANTHOLOGY 164 (Edward J. Imwinkelried & Glen Weissenberger eds., 1996).
96. *See id.*

The competing values of protected societal relationships and accurate fact-finding play heavily into the establishment of any privilege. Adopting a utilitarian view of privilege law, Wigmore set forth four fundamental conditions to the recognition of an evidentiary privilege:

> (1) The communications must originate in a *confidence* that they will not be disclosed.
>
> (2) This element of *confidentiality must be essential* to the full and satisfactory maintenance of the relation between the parties.
>
> (3) The *relation* must be one which in the opinion of the community ought to be sedulously *fostered.*
>
> (4) The *injury* that would inure to the relation by the disclosure of the communications must be *greater than the benefit* thereby gained for the correct disposal of the litigation.[97]

However, some have called this analysis into question, as some existing privileges do not fulfill all four requirements.[98] As a result, other schools of thought regarding privileges have emerged. Some suggest that a rights-based analysis, which focuses on the societal benefits arising from the recognition of privacy, is a better formula.[99] Alternatively, privileges are explained purely as a means of political expression.[100] Still, another approach is based solely on the economic benefits and burdens that accrue.[101] The extension of the tripartite relationship to include fourth-party auditors must therefore comport with one of these models in order to be justified.

In the insured-insurer relationship, privileges are often strained due to the competing interests of the parties involved.[102] Inserting a fourth-party legal auditor's request for documents and other privileged informa-

97. 8 J. WIGMORE, EVIDENCE § 2285 (J. McNaughton ed., rev. ed. 1961) (emphasis in original).

98. *See* Louisell, *supra* note 90, at 111–12 (stating, for example, that no patient-physician privilege could possibly exist under Wigmore's model).

99. *See* Thomas G. Krattenmaker, *Testimonial Privileges in Federal Courts: An Alternative to the Proposed Federal Rules of Evidence*, 62 GEO. L.J. 61, 85–87 (1973).

100. *See* Raymond F. Miller, *Creating Evidentiary Privileges: An Argument for the Judicial Approach*, 31 CONN. L. REV. 771, 782 (1999). This theory is based on the contention that evidentiary privileges are coupled with political power. *See id.* at 787–89. Two reasons for this theory exist: (1) most privileges protect persons in relatively high positions of power in society, e.g., attorneys, physicians, and clergy; (2) "the vast majority of new privileges have been created by statute, a process that certainly requires the exercise of political power." *Id.* (quoting Charles Nesson, *Modes of Analysis: The Theories and Justifications of Privileged Communications*, 98 HARV. L. REV. 1471, 1494 (1985)). However, as this model seeks to *explain* evidentiary privileges, rather than *justify* their existence, it is not an effective means of analyzing the extension of privilege to fourth-party auditors. Of course, if such a privilege were recognized, the requisite power structure (insurance company and attorney) would be consistent with the political-expression model.

101. *See* Richard D. Friedman, *Economic Analysis of Evidentiary Law: An Underused Tool, An Underplowed Field*, 19 CARDOZO L. REV. 1531, 1531–32 (1998). Friedman suggests that economic analysis is a useful but underused means of resolving various evidentiary issues. *See id.* He focuses on five basic factors: (1) the costs of producing evidence; (2) how those costs are allocated between the parties; (3) the effect of interparty transactions on evidence; (4) the extrinsic effects of adopting certain evidentiary rules; and (5) optimizing the yield of costs and benefits. *See id.* at 1532–38.

102. *See generally* Keeley, *supra* note 62, at 1169.

tion seriously disrupts "the delicate balance"[103] of the tripartite relationship. To discover legal auditing's place in the privilege arena, one must review the case law and policy surrounding attorney-client and work-product privileges.

1. Attorney-Client Privilege

The oldest and possibly most complex of evidentiary privileges is the attorney-client privilege.[104] The policy justification underlying the privilege is to

> encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice. The privilege recognizes that sound legal advice or advocacy serves public ends and that such advice or advocacy depends upon the lawyer's being fully informed by the client.[105]

The common-law practice was rooted in the idea that requiring a lawyer to testify against his client, a person to whom he owed loyalty, would "violate the lawyer's honor as a gentleman."[106] As such, the lawyer would normally assert the privilege.[107] However, today it is widely held that the privilege belongs to the client, not the attorney.[108] In fact, there is a movement to reflect more accurately the nature of the privilege by changing its name to "client-lawyer privilege."[109]

The attorney-client privilege has several elements. The classic definition, as stated by Wigmore is

> (1) Where legal advice of any kind is sought (2) from a professional legal advisor in his capacity as such (3) the communications relating to that purpose (4) made in confidence (5) by the client (6) are at his instance permanently protected (7) from disclosure by himself or by his legal advisor (8) except when the privilege be waived.[110]

One district court put forth a more comprehensive checklist for determining whether a matter falls within the privilege.

> The privilege applies only if (1) the asserted holder of the privilege is or sought to be come [sic] a client; (2) the person to whom the communication was made (a) is a member of the bar of a court,

103. Dacey, *supra* note 61, at 210.

104. *See* EDNA SELAN EPSTEIN, THE ATTORNEY-CLIENT PRIVILEGE AND THE WORK-PRODUCT DOCTRINE 1–2 (3d ed. 1997).

105. Upjohn Co. v. United States, 449 U.S. 383, 389 (1981).

106. EPSTEIN, *supra* note 104, at 2.

107. *See id.*

108. *See id.* In fact, the privilege even survives the death of the client, as reaffirmed by the Supreme Court in a recent case involving communications between the late Deputy White House Counsel Vincent Foster and his attorneys. *See* Swidler & Berlin v. United States, 524 U.S. 399, 410 (1998).

109. *See* EPSTEIN, *supra* note 104, at 2; Dacey, *supra* note 61, at 202 (suggesting a "client-attorney" privilege).

110. Dacey, *supra* note 61, at 203 (quoting 8 J. WIGMORE, EVIDENCE § 2292 (J. McNaughton ed., rev. ed. 1961)).

> or his subordinate and (b) in connection with this communication is acting as a lawyer; (3) the communication relates to a fact of which the attorney was informed (a) by his client (b) without the presence of strangers (c) for the purpose of securing primarily either (i) an opinion on law or (ii) legal services or (iii) assistance in some legal proceeding, and not (d) for the purpose of committing a crime or tort; and (4) the privilege has been (a) claimed and (b) not waived by the client.[111]

In any event, two of the essential elements are that the client made the communication confidentially and that the client has not waived the privilege. These are the two elements threatened by the inclusion of legal auditors in the tripartite relationship.

Despite the broad policy objectives of the attorney-client privilege, courts "strictly [confine it] within the narrowest possible limits consistent with the logic of its principal."[112] The reason for this application is that the privilege is contrary to the American rule of full discovery.[113] Under this narrow interpretation, it is highly likely that courts would deem that otherwise privileged information provided to a fourth-party auditor is disclosed and no longer protected by privilege. However, the law recognizes many communications to outside parties as privileged if the party is necessary or integral to the attorney-client relationship.[114] If paying insurance defense counsel's fee is necessary for effective representation and the auditing function is integral to paying the fee, then a privilege might be recognized.[115]

The tripartite relationship has always presented an ethical problem for attorneys with regard to the duties owed to the insurer and the insured. The attorney's highest duty belongs to the insured, who is the true client.[116] However, the attorney's interests also lie with the insurer, upon whom the attorney must rely for continued business. It is likely that the attorney's relationship with the insured will only last "for the life of the claim."[117] Therefore, the attorney is in a quandary over to whom they owe loyalty. Typically, however, communications between the insurance company, insured-client, and attorney are protected by the attorney-client privilege.[118] Therefore, the question remains whether the fourth-

111. United States v. United Shoe Mach. Corp., 89 F. Supp. 357, 358–59 (D. Mass. 1950).

112. Keeley, *supra* note 62, at 1170 (quoting NLRB v. Harvy, 349 F.2d 900, 907 (4th Cir. 1965) (quoting 8 J. WIGMORE, EVIDENCE § 2291 (J. McNaughton ed., rev. ed. 1961))).

113. *See id.* at 1170.

114. *See generally* United States v. Kovel, 296 F.2d 918 (2d Cir. 1961) (accountants and, in dictum, interpreters); Cold Metal Process Co. v. Aluminum Co. of Am., 7 F.R.D. 684 (D. Mass. 1947) (attorney intraoffice communications); Lewis v. United Air Lines Trans. Corp., 32 F. Supp. 21 (D. Pa. 1940) (technical consultants).

115. *See* Ronald E. Mallen, *Looking to the Millennium: Will the Tripartite Relationship Survive?*, 66 DEF. COUNS. J. 481, 490 (1999).

116. *See* Dacey, *supra* note 61, at 204.

117. *Id.* at 204–05.

118. *See id.* at 208–09.

party legal auditor should be included under the umbrella of the tripartite, attorney-client privilege.

2. Work-Product Doctrine

Work-product protection arises out of similar considerations as the attorney-client privilege—"that a lawyer cannot provide full and adequate representation unless certain matters are kept beyond the knowledge of adversaries."[119] However, the focus of the work-product doctrine is to encourage "careful and thorough preparation by [a] lawyer"[120] for, or in anticipation of, litigation.[121] Therefore, in one sense, the scope of work-product protection is much larger than attorney-client privilege in that it encompasses more than just communications between client and attorney. Yet, at the same time the privilege is restricted to only those documents prepared in anticipation of litigation.

Hickman v. Taylor[122] is the leading case involving the work-product doctrine. The Supreme Court emphasized that a lawyer must be free to work with a certain degree of privacy, in order to assemble information, develop legal theories, and plan strategy.[123] *Hickman* can be summed up in three important points:

> (1) Material collected by counsel in the course of preparation for possible litigation is protected from disclosure in discovery.
>
> (2) That protection is qualified, in that the adversary may obtain discovery on showing sufficient need for the material.
>
> (3) The lawyer's thinking—theories, analysis, mental impressions, beliefs, and so on—is at the heart of the adversary system, and privacy is essential for the lawyer's thinking; thus, the protection is greatest, if not absolute, for materials that would reveal that part of the work product.[124]

In 1970, the work-product doctrine was codified in Federal Rule of Civil Procedure (FRCP) 26(b)(3).[125] This codification adopted generally permissive language towards discovery of attorney work product.[126] This language reflects a desire to express the true difference between the work-product doctrine and other evidentiary privileges: "The [attorney-client] privilege . . . is designed to protect confidentiality, so that disclosure outside the magic circle is inconsistent with the privilege; by contrast, work product protection is provided against 'adversaries,' so only disclosing material in a way inconsistent with keeping it from an adversary waives work

119. EPSTEIN, *supra* note 104, at 287.
120. *Id.*
121. *See* Keeley, *supra* note 62, at 1187.
122. 329 U.S. 495 (1947).
123. *See id.* at 510–11.
124. EPSTEIN, *supra* note 104, at 291.
125. FED. R. CIV. P. 26(b)(3).
126. *See id.*

product protection."[127] Thus, despite the more permissive language in FRCP 26(b)(3), the policy underlying work-product privilege would seem to provide more protection to information disclosed to fourth-party auditors by insurers.

E. United States v. Massachusetts Institute of Technology

The 1997 case of *United States v. Massachusetts Institute of Technology*[128] is commonly cited as support for the contention that providing billing statements to fourth-party auditors will result in a waiver of attorney-client and work-product privileges.[129] The case arose out of a review of the Massachusetts Institute of Technology's (MIT) tax-exempt status by the Internal Revenue Service (IRS). The IRS requested that MIT provide copies of legal bills. Although MIT supplied the documents, it redacted information claimed to be privileged.[130] However, the same legal bills had previously been submitted to the Defense Contract Audit Agency (DCAA), as required under contracts between MIT and the Department of Defense.[131] The IRS attempted to procure the documents from DCAA, but its request was refused, even though there were no promises by DCAA to MIT to keep the documents secret.[132] At most, "the regulations and practices [of DCAA] offered MIT some reason to think that indiscriminate disclosure was unlikely."[133] When DCAA and MIT refused to supply the documents, the IRS first served an administrative summons on MIT and then petitioned the U.S. District Court for the District of Massachusetts to enforce the summons.[134]

The district court held that the billings disclosed to the audit agency were no longer covered by the attorney-client privilege, while dismissing all of MIT's claims of work-product privilege.[135] MIT appealed the rul-

127. United States v. MIT, 129 F.3d 681, 687 (1st Cir. 1997) (citing 8 CHARLES A. WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE § 2291, at 368–69 (1994) (citing cases)).

128. 129 F.3d 681 (1st Cir. 1997).

129. *See* Syverud, *supra* note 4, at 191. The Bar Associations of Alabama, Alaska, Colorado, Kentucky, Mississippi, and Oregon cite to *MIT* in their ethics opinions. *See supra* note 59; Ky. Bar Ass'n, *Ethics Op. E-404* (visited Jan. 20, 2000) <http://www.uky.edu/Law/kyethics/kba404.htm>; Miss. Bar, *Op. No. 246* (visited Jan. 21, 2000) <http://www.msbar.org/opinions/246.html>; *see also* Gary Blankenship, *Ethics Opinions Address Lawyers Working for Insurance Companies*, THE FLA. B. NEWS, July 15, 1999 (visited Jan. 20, 2000) <http://www.flabar.org/newflabar/publicmediainfo/TFB News/jul15-2.html>.

130. *See MIT*, 129 F.3d at 682–83.

131. *See id.* at 683.

132. *See id.*

133. *Id.*

134. *See id.*

135. *See MIT*, 129 F.3d at 683. Three documents retained work-product privilege because the IRS could not prove that they had been disclosed. *See id.* The IRS appealed this point and the First Circuit vacated the district court ruling and remanded for further proceedings, because MIT should have carried the burden of proof to show that the documents were not disclosed, rather than the IRS having to show that they were. *See id.* at 687–88. MIT conceded that it could not carry this burden. *See id.* at 686. MIT made a similar argument on this point as it did in its attorney-client privilege claim, with similar results. *See id.* at 686–88.

ing, but the First Circuit affirmed the district court.[136] The opinion recognized "a small circle of 'others' with whom information may be shared without loss of the privilege."[137] Although MIT argued that it had a common interest with DCAA that warranted privilege—"the proper performance of MIT's defense contracts and the proper auditing and payment of MIT's bills"[138]—the court held that MIT and DCAA's interests were more conceivably characterized as adversarial.[139] Because the billings in question were incurred to deflect an antitrust investigation initiated by the Justice Department, the court found that DCAA, a governmental entity, could not share a common interest in such a matter.[140]

The First Circuit's characterization of the DCAA-MIT relationship as adversarial precludes analogy to the fourth-party auditor relationship. MIT submitted its attorney billing statements to an auditor as required by contracts between MIT and the Department of Defense.[141] The relationship between MIT and the auditor was inherently adversarial, because the purpose of the audit was to ensure that MIT was not overcharging for services.[142] The First Circuit ultimately rejected MIT's attempt to claim a common interest with the auditor.[143]

However, in most insurance defense situations, an insurer and its insured have a true common interest: escaping liability with the lowest possible cost. Likewise, an auditor hired by the insurer to review a lawyer's billings also serves the interests of the insured. Prior to the onset of litigation, auditors control insurer legal costs, which translates into lower premium rates for the insured. After an event that gives rise to a claim occurs, the auditor continues to serve the interests of the insured by encouraging retained counsel to take the most direct route to resolution.

Only in a situation where the insured may be subject to excess liability or denial of coverage could the auditor be characterized as an adversary. In such a case, the insurer would also be an adversary, and it would be prudent for the insured to obtain separate counsel anyway, whether or not an auditor was involved. Because a fourth-party auditor does not independently affect the characterization of the insurer-insured relationship, the auditor-insured relationship is not inherently adversarial. Therefore, *MIT* cannot govern fourth-party auditor situations.

MIT can also be distinguished on the grounds that MIT was not merely outsourcing an audit function that it could have performed in-

136. *See id.* at 683, 688.
137. *Id.* at 684.
138. *MIT*, 129 F.3d at 686.
139. *See id.*
140. *See id.; see also* Syverud, *supra* note 4, at 192 (citing the Appendix to the Brief of Respondent-Appellant/Cross-Appellee at 28–29 that described "the bills and redactions made from MIT board minutes regarding the same legal services").
141. *See MIT*, 129 F.3d at 683.
142. *See id.*
143. *See id.* at 686.

house. Instead, it disclosed the billing statements for purposes unrelated to its own determination of whether the bills were reasonable—that is, to ensure that its defense contracts continued.[144] Although this distinction is a corollary to the adversary argument discussed previously, it teases out the role of the fourth-party auditor. An insurer uses a fourth-party auditor to review the reasonableness of bills—a function that it could perform on its own. However, it is dramatically more efficient to outsource this function to an auditor specializing in legal-billing review. MIT, on the other hand, could not have performed the same function in-house. The institution's defense contracts required it to submit billings to the government auditor.[145] Therefore, a direct analogy between the two cases would effectively limit the means that *all* clients could employ to determine whether their legal expenses are appropriate. This issue is well outside the scope of that which the First Circuit addressed.

Finally, although the court did not directly address the existence of fourth-party auditors, it did make clear that the case was distinct from one where disclosure occurs "among separate parties similarly aligned in a case or consultation ([e.g.,] codefendants, *insurer and insured*, patentee and licensee)."[146] One commentator has suggested that "the *MIT* decision actually supports insurers' use of outside auditors, because disclosure of billing information is necessary to facilitate the insured's representation and because the insurer and insured have a common interest in efficient, cost-effective and appropriate representations."[147] Therefore, the *MIT* decision should not govern the fourth-party auditor situation.

F. In re Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedures

Nonetheless, the insurance defense bar's reading of *MIT* received a boost from the Montana Supreme Court when it decided the *In re Rules Case*[148] in April of 2000. Brought in 1998 on an original application to the Supreme Court for a declaratory judgment, the *In re Rules Case* petitioners sought a ruling that insurer control of defense attorneys violated the Montana Rules of Professional Conduct.[149] The Court accepted jurisdiction to address two questions: (1) "May an attorney licensed to practice law in Montana, or admitted pro hac vice, agree to abide by an insurer's billing and practice rules which impose conditions limiting or directing the scope and extent of the representation of his or her client, the insured?"; and (2) "May an attorney . . . be required to submit detailed descriptions of professional services to outside persons or entities without

144. *See id.* at 683.
145. *See id.*
146. *Id.* at 685 (emphasis added).
147. Syverud, *supra* note 4, at 192.
148. 2 P.3d 806 (Mont. 2000).
149. *See id*. at 807.

first obtaining the informed consent of his or her client and do so without violating client confidentiality?"[150]

In resolving the first question, the court held that an insurer-retained attorney represents only the insured.[151] As previously discussed, adherence to the one-client view all but precludes the ability to recognize an attorney-client privilege between retained counsel and the insurer, much less a fourth-party auditor.[152] Predictably, therefore, the court found that fourth-party auditors do not fall within the "magic circle" recognized in *MIT*.[153]

In reaching its conclusion, the court focused on the lack of a common *legal* interest between the insured and the fourth-party auditor and the fact that insureds do not seek *legal* advice from auditors.[154] "This asserted common interest in keeping litigation costs and premiums down is not sufficient to bring third-party auditors within the magic circle."[155] The court determined that auditors were not necessary to the functioning of the representation, and therefore, disclosure of information constitutes waiver.[156]

As discussed below, however, the traditional models for justifying evidentiary privileges do not focus on the distinction between legal and other interests. Moreover, the court's finding that auditors are not necessary to the representation is fairly conclusory. Therefore, this note seeks to evaluate the extension of the privilege against the backdrop of various privilege models.

III. ANALYSIS

A. Policies Surrounding the Fourth-Party Auditor

The fourth-party auditor serves as a control on the attorney-insurer-insured relationship. As previously discussed, unchecked employment of insurance defense attorneys resulted in abuses of the system and condoned inefficiency.[157] Although in the attorney's mind, working without restrictions may be the ideal situation, "unmonitored and unrestricted legal services inure to no one's benefit."[158] Because litigation costs consume the largest percentage of insurer expenditures (fifty-five percent),[159]

150. *Id.* at 807–08.

151. *See id.* at 814; *cf. supra* note 80 (addressing the viability of the Montana Supreme Court's conclusion on this point).

152. *See supra* notes 78–85 and accompanying text.

153. *See In re Rules Case*, 2 P.3d at 820.

154. *See id.* at 819–21.

155. *Id.* at 821.

156. *See id.*

157. *See supra* notes 21–36 and accompanying text.

158. Syverud, *supra* note 4, at 192–93.

159. *See id.* Nearly 55% of every claim dollar is consumed by defense costs. *See* Sullivan & Muldowney, *supra* note 37, at 3.

increases in such costs will have a large impact on insurance premiums. "It is manifestly in the interest of policyholders, who ultimately bear the costs of defense through their premium rates, to contain the escalation of legal defense costs through appropriate cost-containment measures . . . ."[160]

Insurance companies audited attorneys' bills long before the current controversy came into being.[161] However, as in many industries, outsourcing of noncore competencies results in more efficient use of scarce resources. In short, insurance companies should concentrate on providing insurance products. Bringing the auditing function back in-house in order to avoid the superficial legal pitfalls associated with outsourcing would substantially increase costs.[162] This reasoning substantially undermines the argument that disclosure of legal-billing statements to fourth-party auditors is against the best interests of the insured. To the contrary, such disclosure is likely to bestow more benefit than detriment to insureds. The insureds are likely to perceive that their best interests are served by relieving the pressure on their pocket book caused by high premium rates.

However, the policy interest in lower premium rates is only half of the argument. Once a lawsuit is filed against insureds, they become unconcerned with premium rates. However, they are intensely interested in resolving the dispute within their own policy limits. Here, the auditor serves the valid function of controlling defense-litigation costs, not so as to detract from defense counsel's representation, but to ensure efficient resolution. The interests of the insured are thus served by avoiding the long, protracted discovery and frivolous legal wrangling that marked insurance defense practice in the 1980s.[163] Through efficient dispute resolution, the insured may rest easy without the excessive invasion of privacy or ongoing threat of excess exposure liability that is typical of extended insurance defense litigation.

Another concern associated with forbidding disclosure of information to fourth-party auditors arises from the very nature of the tripartite relationship. By refusing to extend the privilege, a jurisdiction could unintentionally back itself into the more consistent "one-client"[164] view.[165] This is a minority view and "would erode completely the traditional view that the sharing of information as between the defense lawyer, the insurer and the insured is privileged."[166] Rather, the parties themselves should be allowed to structure their relationship by agreement.[167]

160. Syverud, *supra* note 4, at 193.
161. *See supra* note 44 and accompanying text.
162. *See* Syverud, *supra* note 4, at 192.
163. *See supra* notes 37–40 and accompanying text.
164. *See supra* notes 79–80 and accompanying text.
165. *See* Syverud, *supra* note 4, at 193.
166. *Id.*
167. *See supra* notes 81–84 and accompanying text.

Finally, the use of fourth-party auditors is merely a more effective means for insurers to review the reasonableness of legal billings. Any client is entitled to monitor attorney performance and conduct regarding fees. However, as discussed when distinguishing the *MIT* case, a client should not be absolutely barred from assistance in this endeavor.[168] Limited means should be permitted, without penalty, that allow clients to control their legal costs by holding attorneys accountable. Fourth-party auditors serve this function in the tripartite relationship. Denial of an extension of privilege to fourth-party auditors would preclude all clients from holding their attorneys accountable using external means.

However, there remain many arguments *against* disclosing information to fourth-party auditors. First, an attorney owes his client a duty of confidentiality.[169] Although this duty is strained by the existence of the tripartite relationship, inclusion of a fourth-party auditor would arguably remove all meaning from the duty to keep client confidences confidential. Second, the legal intricacies of various evidentiary privileges are such that obtaining blanket informed consent is difficult. Additionally, the existence of fourth-party auditing creates huge disincentives for attorneys to enter insurance defense practice.[170] The flight of attorneys from the defense bar seriously undermines the ability of insureds to obtain adequate legal representation under their policies. Finally, the overarching argument that evidentiary privilege precludes full and frank discovery of the facts is ever present in this dispute.[171] However, these arguments are somewhat overdramatized efforts to maintain an inefficient status quo and eliminate attorney accountability.

B. The Fourth-Party Auditor Privilege Under Evidentiary Analyses

In order to analyze whether communications to a fourth-party auditor should be covered by evidentiary privilege, the relationship will be analyzed against the backdrop of the various evidentiary models discussed previously.

168. *See supra* notes 141–42 and accompanying text.

169. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 (1999) (discussing client confidentiality).

170. *See supra* notes 49–54 and accompanying text. Surveys show that personal-injury defense attorneys already earn less per hour than personal-injury plaintiff's attorneys, increasing the incentives to enter plaintiff's practice. A few examples of the spread are: 1994 Ohio—PI Plaintiffs: $100/hr, PI Defense: $87/hr; 1992 Texas—PI Plaintiffs: $125/hr, PI Defense: $110/hr; 1994 Michigan—PI Plaintiffs: $125/hr, PI Defense: $95/hr. *See* Herbert M. Kritzer, *The Wages of Risk: The Returns of Contingency Fee Legal Practice*, 47 DEPAUL L. REV. 267, 279 tbl.3 (1998).

171. *See* Keeley, *supra* note 62, at 1170.

1. Wigmore's Utilitarian Model and the Attorney-Client Privilege

Wigmore's model is based on the protection of relationships in society, balanced against the truth-seeking function of the judicial system.[172] The four factors set forth in his treatise reflect this balancing of interests; the first two stress confidentiality as necessary to the communication and the relationship, while the latter two focus on the place of the relationship in the community and the resulting harm from recognition of the privilege.[173] The primary criticism of this approach is that "few lay people are aware of protected relationships" such that they modify their behavior to take advantage of them.[174] Another criticism leveled at Wigmore is that his factors "are sometimes highly conjectural and defy scientific validation," resulting in the recognition of privileges based on pure speculation of how people might act.[175] Despite these criticisms, Wigmore's approach remains an important consideration in the recognition of new privileges,[176] and it is a valuable model to analyze the extension of the attorney-client privilege to fourth-party auditors.

A pure behavior-modification analysis of the fourth-party auditor relationship reveals little need to recognize a privilege. The insured-client communicates with the attorney under the ambit of the attorney-client privilege; extension of privilege to a fourth-party auditor would have little effect on whether the insured communicated confidences to the attorney, without the knowledge, in advance, that those communications would be provided to an outside auditor. One could also argue that only the most astute insured-client would take steps to ensure that privileged information was not revealed to an auditor so as to waive the initial attorney-client privilege. Therefore, the fourth-party auditor relationship is a perfect example of the criticisms raised against Wigmore's approach.

a. Communication Must Be Made in Confidence

When Wigmore's factors are balanced against one another, a strong case for privilege can be made. First, the insured-client communicates

172. *See* WIGMORE, *supra* note 97, § 2285; *see also* Miller, *supra* note 100, at 782–83.

173. *See* WIGMORE, *supra* note 97, § 2285.

174. Miller, *supra* note 100, at 783. "Empirical studies confirm this observation, but also indicate that people have a dramatically lower likelihood to communicate if they are informed that a conversation is not privileged." *Id.*

175. Louisell, *supra* note 90, at 111–12. Wigmore responds to this criticism in the following manner: "If the counsellors were compellable to disclose, 'no man . . . of a noble or elevated mind would stoop to such an employment.' Certainly the position of the legal adviser would be a difficult and disagreeable one . . . . This double minded attitude would create an unhealthy moral state in the practitioner. . . . If only for the sake of the peace of mind of the counsellor, it is better that the privilege should exist." *Id.* at 112 (quoting 8 J. WIGMORE EVIDENCE § 2291 (J. McNaughton ed., rev. ed. 1961)).

176. *See* Miller, *supra* note 100, at 783–84 (citing Jaffe v. Redmond, 518 U.S. 1 (1996) and "indicat[ing] that courts incorporate traditional Wigmore criteria in assessing a new privilege").

with the attorney with the understanding that those communications will be held in confidence under the attorney-client privilege. Generally in the tripartite relationship, when the insured-client communicates a confidence, the client does so to both the attorney and the insurer. Extending the privilege to the fourth-party auditor changes nothing about the confidential nature of the existing attorney-client relationship and communications made therein. The client understands that his communication is confidential and will not be disclosed outside of that relationship. Thus, the structure of the agreement made by the parties through the liability policy, retainer agreement, and audit agreement will determine whether Wigmore's first factor is satisfied.

b. Confidentiality Necessary to the Relationship

It is fundamental that if the fourth-party auditor is included in the tripartite relationship, confidentiality is "*essential* to the full and satisfactory maintenance of the relation between the parties."[177] Although an argument may be made regarding client ambivalence to confidential communications, it is more likely that an insured faced with a lawsuit will be very concerned with the scope of disclosure and will likely consult with defense counsel to ensure confidentiality. Therefore, the client will be reluctant to disclose information with the knowledge that his insurer and attorney will waive privilege through disclosure to an auditor. Conversely, the insured will be equally unwilling to pay higher premium rates in order to maintain a privilege that he does not foresee asserting. Likewise, the attorney will be unwilling to represent the insured or insurer when faced with the prospect of waiving the client's confidences or not getting paid. Insurers will be required to bring auditing activities in-house, resulting in increased premium prices[178] and decreased impartiality in attorney-billing reviews. Therefore, Wigmore's second factor weighs heavily in favor of privilege.

c. Societal Recognition of the Relationship and Utilitarian Balancing

The third and fourth factors in the utilitarian analysis present a greater obstacle to the extension of the attorney-client privilege to outside auditors. They depend, in large part, on whether society is willing to recognize the validity of the outside auditing function in the attorney-client relationship. On the one hand, the presence of an auditor may tend to affect how an attorney performs in defense of the insured-client, and unscrupulous auditors may search for ways to justify their own existence. However, an outside auditor should only have the same effect on

177. WIGMORE, *supra* note 97, § 2285.
178. *See* Syverud, *supra* note 4, at 192.

attorney performance as insurers who perform their own in-house audit, or a careful client who closely scrutinizes every bill. Furthermore, although the early effects of the auditing cottage industry have yielded some unscrupulous behavior,[179] eventually the market should equalize, as insurers are faced with losing competent defense counsel[180] or keeping their unsavory audit agency.

On the other hand, auditors help insurance companies to keep premium rates low and serve as a check on otherwise unmonitored defense-attorney practice. If a privilege is not recognized, two things could happen: (1) insurers would disclose information to auditors anyway, if the cost-savings realized by using auditors were greater than the liability incurred by revealing client information; or (2) insurers would bring the auditing function back in-house and pass the resulting costs onto their insureds. Either result is undesirable. Essentially, the question boils down to whether the fourth-party auditor is integral to the tripartite relationship.[181] Despite the arguments of the insurance defense bar,[182] efficient attorney practice, affordable insurance coverage, and protection of confidences are desirable public-policy goals. The presence of an auditor in the tripartite relationship promotes the first two of these goals. The absence of an auditor promotes the protection of client confidences. However, as evidenced by prior experience,[183] this comes at the expense of the first two objectives. The disclosure of information to a professional who promotes the best interests of the client should not result in a loss of privilege. Such a result would lead to an arbitrary waiver of evidentiary privilege for insureds, dependent only upon whether their particular insurer has chosen to outsource the auditing function.

2. The Rights-Based Approach

The rights-based approach to evidentiary privileges focuses on privacy.[184] All that is considered is the privilege claimant's fundamental right to privacy; no attention is paid to the societal benefit realized by recognizing a relationship as privileged.[185] The rights-based approach "serves to promote and protect personal autonomy and self-

179. *See supra* notes 46–49 and accompanying text.

180. *See supra* notes 50–54 and accompanying text.

181. *See* United States v. Kovel, 296 F.2d 918, 921 (2d Cir. 1961) ("[T]he complexities of modern existence prevent attorneys from effectively handling clients' affairs without the help of others . . . ."); Mallen, *supra* note 115, at 490.

182. *See supra* notes 55–63 and accompanying text.

183. *See supra* notes 26–41 and accompanying text.

184. *See* Thomas G. Krattenmaker, *Interpersonal Testimonial Privileges Under the* Federal Rules of Evidence*: A Suggested Approach*, 64 GEO. L.J. 613, 647–48 (1976). Prof. Krattenmaker defines privacy as a "*voluntary* and *secure* control that a person possesses over communication about oneself." *Id.* at 648 (emphasis added).

185. *See* Miller, *supra* note 100, at 784–85.

development,"[186] "provides a context for necessary emotional release"[187] and allows a person "'to integrate his experiences into a meaningful pattern and to exert his individuality on events.'"[188] The focus in the privacy analysis is how the deprivation of privilege will impact the individual.[189]

The application of the privacy model is fundamental to the attorney-client privilege[190] and it is also the basis of attorney work-product protection.[191] Although the client is the interested party in the first privilege, the attorney's right to privacy is implicated in the latter. Both parties rely on the respective privileges in order to foster full disclosure of client confidences and effective representation in litigation. Therefore, waiver of the privileges would seriously impact the core attorney-client relationship. Also, it is important to note that disclosure to an outside auditor is not a *voluntary* act[192] by either the insured or defense counsel, but rather a mandated one by another party—the insurer. The fact that a particular insurer chooses to outsource the auditing function should not impact on the core attorney-client relationship. Waiver of privilege based upon the business decision of a third-party payor would arbitrarily undermine the core attorney-client relationship. Rather, extension of privilege to fourth-party auditors would protect the existing core attorney-client relationship.

186. Krattenmaker, *supra* note 184, at 649. "In democratic societies there is a fundamental belief in the uniqueness of the individual, in his basic dignity and worth as a creature of God and a human being, and in the need to maintain social processes that safeguard his sacred individuality." *Id.* (citing ALAN F. WESTIN, PRIVACY AND FREEDOM 33 (1970)).

187. Krattenmaker, *supra* note 184, at 649.

> Privacy enables people to 'let their hair down,' to engage in perfectly lawful conduct not encumbered by peer group pressures, to partake of '[f]ree discourse . . . [that] may be frivolous or serious, humble or defiant, reactionary or revolutionary, profane or in good taste,' or to take comfort in time of sorrow.

Id. at 649–50 (quoting United States v. White, 401 U.S. 745, 762 (1971) (Douglas, J., dissenting)).

188. Krattenmaker, *supra* note 184, at 650 (quoting ALAN F. WESTIN, PRIVACY AND FREEDOM 36 (1970)).

> Privacy provides the essential setting for people to reflect upon the world about them—to think through the mass of data and ideas that impinge upon them daily, to evolve personal responses to those worldly demands, and to contemplate the morality of their behavior and the utility of their ideas.

Id.

189. *See* Miller, *supra* note 100, at 786; *see also* Jaffee v. Redmond, 518 U.S. 1 (1996) (recognizing psychotherapist-patient privilege). "Because of the sensitive nature of the problems for which individuals consult psychotherapists, disclosure of confidential communications made during counseling sessions may cause embarrassment or disgrace. For this reason, the mere possibility of disclosure may impede development of the confidential relationship necessary for successful treatment." *Id.* at 10.

190. *See* EPSTEIN, *supra* note 104, at 4–5.

191. *See id.* at 290 (citing Hickman v. Taylor, 329 U.S. 495, 510–11 (1947)).

> A lawyer, as an officer of the court, is bound to work for the advancement of justice while faithfully protecting the rightful interests of his or her clients. In performing various duties, however, it is essential that a lawyer work with a certain degree of privacy, free from unnecessary intrusion . . . . Proper preparation of a client's case demands that the lawyer assemble information, sift what the lawyer considers to be the relevant from the irrelevant facts, prepare legal theories, and plan strategies without undue and needless interference. That is the historical and necessary way in which lawyers act . . . .

Id.

192. *See* Krattenmaker, *supra* note 184, at 648.

Of course, insureds who value their privacy could choose to deal only with insurers who perform legal bill auditing in-house. This way, insureds would pay for privacy in the form of higher insurance premiums reflecting increased insurer costs. However, not only is this an inefficient means of operating, but also it is unlikely that the large majority of insureds would be so aware of their legal rights to consider shopping around for such a term. The result would be an arbitrary deprivation of rights based on an obscure decision by the insurer.

3. Economic Analysis of Privileges

One of the newer models proposed for analysis of evidentiary law arises out of the law and economics movement.[193] This approach essentially applies a cost-benefit calculation to determine the best resolution,[194] broken down into five general factors: (1) costs of producing evidence; (2) how those costs are allocated between the parties; (3) the effect of interparty transactions on evidence; (4) the extrinsic effects of adopting certain evidentiary rules; and (5) optimization of the yield between costs and benefits.[195] Because of the inherent efficiency involved with outsourcing, the issue of privilege and fourth-party legal audits fits well within this economic model.

The costs involved in not recognizing a privilege are fairly simple to identify: insurers will be forced to audit in-house, passing the expense on to their insureds. Further, legal auditing will effectively cease to exist.[196] The only winners in this situation would be *unscrupulous* insurance defense attorneys, which represent a small percentage of the overall bar. However, recognition of a privilege puts a burden on many defense attorneys who find that legal auditing has made the insurance defense practice unprofitable.[197] Yet, in time, the problems associated with legal auditing should abate as the industry becomes more competitive and fee arrangements with insurers become more standardized.[198] Furthermore, as proposed in part IV, legislatures could develop certain controls to regulate the legal-auditing industry.[199] A potentially useful resource for insurers and insureds should not be exterminated merely because there are current abuses not unlike those associated with the spawning of any cottage industry.[200] Therefore, the burdening of many—insurers, in-

193. *See* Friedman, *supra* note 101, at 1531–32.

194. *See generally id.*

195. *See id.* at 1532–37.

196. Many may argue that this is a highly worthy goal to which to aspire.

197. *See supra* notes 49–54 and accompanying text.

198. For example, if auditors were prohibited from charging based on a percentage of billings cut from attorneys' bills, the incentive to short-shrift defense attorneys would go away, leading to a more objective analysis of billing statements.

199. *See infra* Part IV.

200. *See, e.g.*, Theodore C. Hirt, *A Second Look at Amended Rule 11*, 48 AM. U. L. REV. 1007, 1010 (1999) (citing critics of FED. R. CIV. P. 11 and its associated "'cottage industry' of sanctions prac-

sureds, and auditors—does not justify the benefit to the few attorneys who take advantage of the insurance billing system.

Nonextension of privileges would have many transactional and extrinsic effects on the current tripartite relationship. Within the relationship, the contours of the attorney-client relationship would be dramatically redefined, as the client could no longer be sure at the outset that his communications would be privileged. Nor could attorneys generate work product free of concern. Rather, the determination of whether evidence is privileged would be made ex parte, when the insurer decides to submit billings to auditors. Even then, depending on the level of audit involved,[201] the privilege would be in question. The extrinsic effects would be an arbitrary recognition of privilege and a windfall to opposing counsel, dependent solely upon an insurer's decision to outsource. This is a result that cannot be logically justified.

Of course, the economic approach to evidentiary law has been met with "a rather restrained reception."[202] One of the major criticisms of economic analysis is that it is premised on the idea "that people are rational agents who optimize their decisions within constraints placed on them by their environment."[203] Furthermore, it is suggested that the law and economics approach does not reflect the way that the law, and the world, should operate.[204] However, such concerns are minimized when considering an extension of privilege to fourth-party auditors. First, the party choosing to outsource—the insurer—is most likely a rational actor who does make decisions based on a cost-benefit analysis. Because only the inclusion of the auditor is sought to be justified by an economic model and the underlying privileges exist in their own right, the decision to outsource is independent of irrational behavior by the attorney or insured. Rather, it is the product of reasoned analysis by the insurer. Second, recognition of evidentiary privilege after disclosure to a fourth-party auditor yields a result worthy of approval. The issues are unlike those

tice"); A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 948–49 (1999) (discussing abuses by plaintiffs' attorneys in the market-class-action cottage industry).

201. *See supra* notes 64–73 and accompanying text.

202. Myrna S. Raeder, *Cost-Benefit Analysis, Unintended Consequences, and Evidentiary Policy: A Critique and a Rethinking of the Application of a Single Set of Evidence Rules to Civil and Criminal Cases*, 19 CARDOZO L. REV. 1585, 1588 (1998) (describing the response to an attempt to justify attorney work-product privilege under an economic model to the Evidence Section of the American Association of Law Schools).

203. *Id.* at 1591. A prime example of irrational behavior occurs in the negotiation context. "When subjects were asked to choose between a sure gain of $240 and a 25% chance at a gain of $1,000, 84% selected the sure payment, even though the expected value of the chance (25% [times] $1,000) is $10 higher." Russell Korobkin & Chris Guthrie, *Psychological Barriers to Litigation Settlement: An Experimental Approach*, 93 MICH. L. REV. 107, 130 (1994). The opposite result occurred when subjects were faced with either a sure loss or a chance loss. *See* JOHN S. MURRAY ET AL., PROCESSES OF DISPUTE RESOLUTION 82 (2d ed. 1996).

204. *See* Raeder, *supra* note 202, at 1590 ("Who among us would not find it a true challenge to defend a corporation, in a case involving serious personal injury or death, by telling a jury that a cost-benefit analysis of the missing safety device demonstrated its economic infeasibility?").

involved when a corporation deems the cost of liability to be less than that of implementing a safety measure.[205] Rather, the law should not operate such that mere technicalities—such as an insurer's choice to outsource—waives the spectrum of privileges that would otherwise apply, creating a windfall for opposing counsel. In other words, whereas efficiency is less valued in certain choices, e.g., whether to install safety devices, the choice to outsource certain functions is *primarily* a question of efficiency.

Thus, an optimization of the costs and benefits associated with fourth-party auditors recognizes their value to the tripartite relationship, despite some detrimental effects incurred during the genesis of the industry. Extension of privilege to outside auditors is the only way to effectively take advantage of the benefits offered.

IV. RESOLUTION

An extension of evidentiary privilege to fourth-party, legal-billing auditors should be recognized. Although contrary to the American rule of complete discovery, such recognition would not expand the scope of information covered by existing evidentiary privileges. Rather, it would only remove the differentiation between those insurers who choose to outsource the auditing function and those who do not. In the end, attorneys and insureds could act as most lawyers and clients do, assured in advance that confidences and work product are protected. The alternative is a scenario where attorneys and insureds must modify their relationship based on an ex parte decision made by the insurer. This goes against the fundamental policies surrounding the underlying privileges.[206]

Of course, such an extension should not be entirely unqualified. Just as the current tripartite relationship depends upon the insurance policy and retainer agreement to outline each party's rights and responsibilities,[207] the addition of an outside auditor should be carefully controlled by an agreement between the insurer and auditor. Such an agreement should include, of course, an agreement to keep information confidential. To give effect to this confidentiality clause, the auditor should agree to indemnify the insurer, attorney, and insured for any liability resulting from an unauthorized disclosure by the auditor. Likewise, insureds and attorneys should agree to terms in their respective agreements regarding the use of outside auditors.

The preferred method of recognizing a privilege would be through the legislature, which could add to the regulation of the relationship. Despite the many benefits of the judicial approach to privilege recogni-

205. *See id.*
206. *See supra* notes 112 and 119–21 and accompanying text.
207. *See supra* notes 74–77 and accompanying text.

tion,[208] a new privilege is not being created. Rather, existing privileges are merely being extended to a new entity.

The benefits of legislative enactment in this situation are many. First, the legislative process is more responsive to current developments.[209] The legislature is better able to grant privileged status in an immediate and wholesale fashion, rather than the gradual, piecemeal process characteristic of judicial recognition.[210] Second, the power imbalances normally inherent in the legislative process are largely irrelevant in this context.[211] The primary players in this conflict are auditors, insurers, and defense counsel; the interests of the insureds are represented by the insurers who aspire to protect insureds' confidences while providing the most efficient legal representation. No party seriously lacks a voice in the political process. Third, a legislative enactment could avoid much (though, of course, not all) of the theoretical dueling associated with judicial decisions, as demonstrated following the *MIT* decision.[212]

Most importantly, the legislatures in each state may experiment with the industry to develop certain controls that will equalize the playing field and end abuse. For example, the legislature could decline privileged status to insurer-auditor agreements where the fee arrangement is contingent on the amount of money the auditor cuts from the audited bill. Regulations could also be enacted limiting the number of auditors permitted to be employed by a single insurer or prohibiting the use of more than one auditor for a single client, in order to limit disclosures and prevent conflicts. Legislatures could also require auditing decisions to be made ex ante, so that insureds and attorneys are aware that disclosures will be made. The legislative approach provides the most expeditious and tailored response to the extension of evidentiary privilege to fourth-party auditors.

V. CONCLUSION

The widely publicized abuses of the hourly billing system and increased pressure on insurance companies to cut costs resulted in the growth of a cottage industry in legal auditing. In response, insurance de-

208. *See generally* Miller, *supra* note 100 (identifying such benefits to include insulation from the influence of political power, flexibility, and selectivity).

209. *See id.* at 780. "During the past two decades, the majority of new state evidentiary privileges have been introduced by statute. 'The development of [state] judge-made privileges [has] virtually halted.'" *Id.* (quoting CHARLES T. MCCORMICK, MCCORMICK ON EVIDENCE 156 (4th ed. 1992)).

210. This is not to say that the gradual, piecemeal method is inappropriate or subordinate. For the creation of new privileges, the judicial approach is better able to flush out the nuances of the relationship and balance them against social policies. *See generally* Miller, *supra* note 100. But here, where the judiciary has already performed this function as to the underlying privileges, a legislative extension is better.

211. *See id.* at 781–82.

212. *See supra* notes 128–47 and accompanying text.

fense attorneys struck back with various legal and ethical arguments against mandates that they disclose billing statements and client information to legal auditors hired by insurers. Fueled by the holding in *United States v. MIT*, many state bar associations and the Montana Supreme Court ruled that disclosure of confidential client information without informed consent is unethical and may result in a waiver of evidentiary privilege. However, application of the *MIT* decision to the fourth-party auditor relationship is flawed, and an extension of existing evidentiary privileges is justified by various existing models of privilege recognition. No new privilege is proposed to be created. Rather, existing privileges should be protected from extinction due to an unrelated decision of an insurer to increase efficiency.

If legislatures protect information disclosed to outside auditors while simultaneously regulating the legal-auditing industry, a balance of interests in the tripartite relationship can be achieved. Because the complexities of evidentiary privilege will not be implicated in such disclosure, it will be easier for attorneys and insurers to obtain informed consent from insureds without violating standards of professional conduct. Additionally, controls can be implemented that will ensure that competent and efficient counsel do not flee the insurance defense industry for lack of profitability. Otherwise, the continued viability of the tripartite relationship, and the ability of insurers to defend their insureds, is threatened. Because many people rely on insurance companies to wage their legal battles, harm to the relationship would have a serious detrimental effect on society as a whole. Such an effect should not be the result of an arbitrary distinction between insurers who outsource and those who do not.