Claims®

Inside: Your Premiere Issue of COMMERCIAL CLAIMS

APRIL 1995

LITIGATION MANAGEMENT

Bad Faith For Legal Work? Your Insurer May Be Liable for Mishandling Its Lawyers

By Jim Schratz

By James P. Schratz

BAD FAITH FOR LEGAL WORK?

Your Insurer May Be Liable for Mishandling Its Lawyers

Bad faith lawsuits against insurance companies for improper claims handling have been in existence for some time. Most of these cases however, focus on the insurer's failure or delay in paying claims. However, as insurers have responded to dramatic changes in the market by imposing (or sharing) more of the risk of loss with the insured, insureds have begun to challenge the insurer's inadequate supervision of litigation which has resulted in higher premiums. This article briefly describes some of the more well-known risk sharing policies, analyzes the various case law which has greatly expanded insured's rights in this area and then questions whether some insurance companies are adequately protecting the insured's rights in controlling defenses costs.

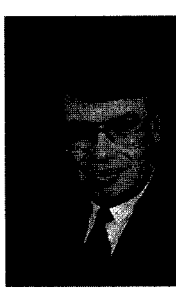
Risk-sharing mechanisms

As dramatic changes in the insurance market have occurred, various risk management tools have been developed, especially among sophisticated, commercial insureds. These insureds utilize insurance to transfer or reduce the uncertainty of loss by substituting payment of relatively certain insurance premiums.

These "alternative market" variations include:

a. Fronting, whereby a policy of insurance is issued, but the insured is often left to administer all claims and agrees to reimburse the insurer for all payments it must make. Essentially, the insurer functions as a surety for the insured's ability to pay claims.

b. Claims administration agreements, or unbundled services, whereby the insured retains all of the risk of loss and, perhaps, some decision-making authority, but utilizes an insurer to administer and adjust claims.



Jim Schratz, an attorney, is president of Jim Schratz and Associates, a litigation management consulting firm located in Santa Rosa, Calif.

c. Retrospective premium arrangements, whereby the risk is insured, but the premium is determined partially by the claim experience. The arrangements commonly provide for payment by the insured of more than the amount actually paid out, the excess being an allowance for claim handling expenses. This means that the insurer might be able to profit by skimping on claim adjustment and inflating claim payments, or in the alternative, by not controlling legal expense.

d. The policy may provide that the insured retains the risk of loss up to some amount (commonly referred to as a "self-insured retention" or "SIR") and that the insurer's liability attaches only with respect to larger amounts.

e. Self liquidating policies. In most policies, the carrier owes the insured a duty to defend a lawsuit brought against the insured and a duty to indemnify the insured against a loss covered by the policy. Costs of defense are not included within policy limits and in many cases can be many times more than the policy limits. Insurers have responded by writ-

ing self-liquidating policies where the cost of defense is included within coverage limits. The result is that as defense costs rise, there is an ever decreasing amount of money available to pay the claim.

In this situation the insurance company sometimes has little incentive to control defense costs, especially in cases where the insured's liability is relatively clear and is much greater than the policy limits.

One element common to many of these policies is the insurer's "service fee," although it is described under numerous rubrics. This fee is based on a percentage of the indemnity payment and legal fees expended. Under these circumstances, the insurance company has a dis-incentive to control legal costs.

Insurer's duty beyond traditional claims handling

Over the past 25 years, courts have begun to recognize the various duties insurance companies have in connection with these alternative risk sharing arrangements.

"There are certain clues that an insured can look for to determine if the attorney is overbilling and if the insurance company has failed to adequately monitor these bills."

These cases usually focus on one or more of the following claims related activities:

a) failure to set adequate reserves, i.e. over-reserving claims;

b) failure to adequately investigate claims;

c) overpaying claims; and

d) failure to pay claims promptly.

For example, in *Deerfield Plastics v. Hartford Insurance Co.*, 536 N.E.2d 322 (Mass. 1989), the court held that once evidence of negligent investigation and settlement of a claim under a retrospective premium policy has been presented, the insurer bears the burden of proving the reasonableness of the settlement.

In *National Surety Corp. v. Fast Motor Service, Inc.*, 572 N.E.2d 1083 (Ill. App. 1991), the court held that a cause of action exists when an insured sues his insurer for a breach of duty for unreasonably settling claims under a policy which provides for retrospective premiums.

In *Security Officers Service, Inc. v. State Compensation Insurance Fund*, 17 Cal. App. 4th 887 (1993), the court held that under an insurance policy in which the insured's annual claims experience inexorably influences its premiums, the insurer may be liable if it processes claims and sets reserves without good faith regard for their impact on the insured's premiums and potential dividends.

See also *Tricor California Inc. v. State Compensation Insurance Fund*, 30 Cal.App. 4th 230 (1994).

Bad faith failure to monitor legal costs

Over the past few years, the subject of abusive billing practices by attorneys has received an increasing amount of attention. One study found that 38 percent of the private practitioners believe that lawyers "occasionally" inflate their hours. Based on his survey, the author concluded that there is no support for the proposition that the vast majority of lawyers bill ethically and accurately.

Each year the insurance industry spends billions of dollars in legal fees defending insureds. It is probable that a significant portion of these fees were not actually incurred by the attorneys. Furthermore, these costs often are passed onto the insured through the various mechanisms discussed above. Under the rationale discussed in the cases above, a carrier's failure to control these costs could be construed as bad faith.

For insureds who currently have one of the alternative risk sharing mechanisms described above or who are contemplating entering into such an arrangement, the insurer should be carefully scrutinized as to its ability to control legal costs. Conversely, carriers should carefully monitor their litigation management programs to assure they are adequately protecting the insured's interests.

Look for signs of control

There are some key items an insured should look for to determine if its carrier is adequately controlling legal costs. These include:

1) Has the carrier established proper billing guidelines, clearly setting forth what are acceptable billing practices?

2) Has the carrier required periodic budget estimates from the attorney and compared them to actual invoices?

3) Has the carrier explored alternative billing methods such as fixed fee or reverse contingency agreements?

4) Has the carrier periodically audited the legal bills either through in-house audits or outside independent legal audits?

Although legal bills are often times almost indecipherable to anyone but the lawyer who drafted them, there are certain clues that an insured can look for to determine 1) if the attorney is overbilling and 2) if the insurance company has failed to adequately monitor these bills and instead is merely passing the cost on to the insured. For example, any bills which contain the following are prime suspects for overbilling:

1) Initials only — the bills should contain the names, and not just initials, of all people who billed to the file;

2) Overstaffing — too many people billing to the file;

3) Excessive intra-office conferencing;

4) Excessive time spent reviewing and/or analyzing;

5) Minimal billing increments — some firms charge a minimum of 15 minutes when the phone call only lasted 2 or 3 minutes;

6) Charging for clerical or secretarial work; and

7) Excessive photocopying costs.

In conclusion, insureds need to be much more vigilant in determining if their carrier is adequately managing litigation, and insurance companies have an opportunity to clearly demonstrate to insureds and potential insureds their ability to control litigation costs. CC

RESOURCES

William T. Barker, "Combining Insurance and Self-Insurance: Issues for Handling Claims," *Defense Counsel Journal*, 352 (July 1994)

Reed, "How Did We Get To Where We Are — And What Are We Going To Do About It," *Beyond the Billable Hour: An Anthology of Alternative Billing Methods* (R.Read ed. 1989).

Greenfield, "What Law School Never Taught You," *California Lawyer* 53 (1992).

Ross, "The Ethics of Hourly Billing By Attorneys," *Rutgers Law Review* 1 (Fall, 1991).

Pitulla, "Truth in Billing," *ABA Journal* 120 (December 1992).

Schratz, "Resolving the Cumis Quandary: Guidelines for Reasonable Fees," *Insurance Litigation Reporter* (June 1992).