TORT LAW — LIABILITY INSURERS AND DEFENSE COSTS — SEVENTH CIRCUIT AFFIRMS DISMISSAL OF INSURER'S LEGAL MALPRACTICE SUIT. — *TIG Insurance Co. v. Giffin Winning Cohen & Bodewes, P.C.*, 444 F.3d 587 (7th Cir. 2006).

Liability insurers frequently challenge in court their obligation to pay the full legal defense costs of their policyholders.[1] They hire legal-fee auditors and submit detailed assessments of timesheets as evidence that they are not responsible for every item billed by defense firms.[2] Recently, in *TIG Insurance Co. v. Giffin Winning Cohen & Bodewes, P.C.*,[3] the Seventh Circuit blocked a liability insurer's attempt to recoup some of its policyholder's defense costs by filing a legal malpractice suit against the law firm that initially represented the policyholder. At its core, the case was about an allocation of risk between repeat players in the insurance market. Failing to address comprehensively the crux of this case, the *TIG* court missed an opportunity to force liability insurers to rely on more efficient private cost-apportionment procedures, rather than foisting malpractice claims on the courts for costly ex post review.

The malpractice claim in *TIG* arose out of Giffin Winning's failure to produce documents in an underlying lawsuit, *Varner v. Illinois State University*.[4] Giffin Winning initially represented Illinois State University (ISU) in that case, a gender discrimination class action brought by university employees.[5] As is common in such cases, ISU's liability insurer, TIG, directed and paid for most of the litigation under the terms of coverage.[6] The class action had a long, stalling history, and in late 1996, the case was stayed.[7] During that time, TIG replaced the small, Central Illinois–based Giffin Winning with the powerhouse national firm Latham & Watkins.[8] Meanwhile, the plaintiffs' attorney learned from a disgruntled former ISU employee that Giffin Winning had failed to produce three gender equity studies that the university had commissioned.[9]

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[1] *See* Posting of Marc Mayerson to Insurance Scrawl, http://www.insurancescrawl.com/archives/2005/09/defending_defen.html (Sept. 15, 2005, 12:14 EST).

[2] *See id.*

[3] 444 F.3d 587 (7th Cir. 2006).

[4] 972 F. Supp. 458 (C.D. Ill. 1997), *aff'd*, 150 F.3d 706 (7th Cir. 1998), *vacated*, 528 U.S. 1110 (2000), *remanded to* 226 F.3d 927 (7th Cir. 2000), *cert. denied*, 533 U.S. 902 (2001). As the Seventh Circuit noted in *TIG*, "[t]he case [had] a lengthy appellate history, having proceeded twice to the U.S. Supreme Court." *TIG*, 444 F.3d at 590 n.2.

[5] *TIG*, 444 F.3d at 588.

[6] *Id.*

[7] *Id.* at 588–89.

[8] *Id.* at 588; Brief of Appellees at 2, *TIG*, 444 F.3d 587 (Nos. 05-2203, 05-2447), 2005 WL 3970025.

[9] *TIG*, 444 F.3d at 589.

Once the stay was lifted, the plaintiffs filed a motion for monetary sanctions against ISU and Giffin Winning.[10] Alleging a conspiracy to hide these documents so as to conceal the existence of a damning "Planning Policy database," they also sought a default judgment as a sanction.[11] Latham, fearing the trial court judge's history of entering default judgments against defendants,[12] spent "a whopping $1.2 million, give or take" defending the motions.[13] After a four-day hearing, the trial court found that no such database ever existed and denied the request for default judgment.[14] However, it fined Giffin Winning $10,000 for discovery lapses, a sanction that was later vacated.[15] While the parties in *Varner* settled, TIG filed a tort-based malpractice claim to recover from Giffin Winning the $1.2 million that Latham had spent.[16]

The district court excluded testimony from TIG's "legal expert" after finding that it was "clear from [his] own admissions that he ha[d] simply parroted the information presented to him by" TIG.[17] The court then found that because Latham used block billing — that is, the bills showed daily fees but did not disaggregate for individual activities — TIG's estimate of the portion of ISU's legal fees attributable to Giffin Winning was "pure speculation."[18] Further, the court barred the Latham attorney who oversaw *Varner* from testifying that approximately ninety percent of the legal fees incurred were due to the defendants' negligence, dismissing this as "inadmissible speculation."[19] With no admissible evidence of damages, the district court granted Giffin Winning's motion for summary judgment.[20]

The Seventh Circuit affirmed, but on different grounds. Writing for a unanimous panel, Judge Evans[21] addressed neither the district court's holding that TIG had failed to present any admissible evidence of damages, nor Giffin Winning's broader claim that Seventh Circuit precedent precluded malpractice suits in which the only damages are

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[10] *Id.*

[11] *Id.* at 589–90.

[12] *Id.* at 592.

[13] *Id.* at 590.

[14] *Id.* at 589–90.

[15] *Id.* at 590. The plaintiffs' attorney was also fined $10,000.

[16] *See id.*

[17] TIG Ins. Co. v. Giffin, Winning, Cohen & Bodewes, P.C., No. 00 C 2737, 2005 WL 818405, at *3 (N.D. Ill. Apr. 6, 2005).

[18] *Id.* at *5.

[19] *Id.* at *4, *6.

[20] *Id.* at *5–6. The court also held that TIG was not allowed to seek damages under the collateral source rule, which permits recovery even if tort victims have received money from a nonparty. *Id.* at *6.

[21] Judges Manion and Kanne joined the opinion.

legal fees.[22] Instead, the panel held that summary judgment was appropriate because Giffin Winning's failure to produce documents was not a proximate cause of the legal expenses incurred defending the motion for default judgment.[23] The court posed the question as whether it was reasonably foreseeable that a "large law firm, apparently thinking of [the judge] as a bit trigger-happy, would jump into high gear out of fear of default judgment and launch an army of 27 attorneys, plus paralegals, . . . [to defend against sanctions for] an alleged conspiracy to hide something which does not exist."[24] Its answer was that, as a matter of law, it was not reasonably foreseeable.[25]

Searching for precedent to hang its hat on, the court cited *Abrams v. City of Chicago*,[26] which held that the city was not liable as a matter of law for failing to send an ambulance for a woman who was in labor.[27] The woman lost her baby after her friend, speeding to get her to the hospital, collided with another car.[28] Both cases, the court stated, involved similarly unforeseeable behavior.[29] It maintained that Giffin Winning could not have foreseen that its allegedly negligent document production would "spawn a million-dollar bill for attorney fees."[30] If courts expected lawyers to foresee that their minor errors would lead to massive future legal bills for their clients, then "litigation would become more of a blood sport than it already is," with lawyers growing "even more obsessive about irrelevant and tedious details."[31] The court concluded that sanctions under the Federal Rules of Civil Procedure are foreseeable for a run-of-the-mill failure to produce documents, but exorbitant attorney fees are not.[32]

Clear away the web of interrelated players, trials, and trial motions, and the essence of the case is simple: a liability insurer did not want to pay its policyholder's full legal defense costs and decided a tort claim was the best chance to recoup some of those costs. Insurers and their contracting partners often end up in court because this allows them to

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[22] *TIG*, 444 F.3d at 590. The court "deliberately skipp[ed] the larger issue of whether a malpractice claim can be based on attorney fees" — a disputed area of law — and chose instead to decide the case on the narrower grounds of proximate cause. *Id.* The court did not address why it also skipped the lower court's holding that the evidence of damages was insufficient and too speculative to survive summary judgment.

[23] *See id.*

[24] *Id.* at 592.

[25] *Id.* The court reached this decision notwithstanding the fact that, under Illinois law, proximate cause is normally an issue for the trier of fact.

[26] 811 N.E.2d 670 (Ill. 2004).

[27] *Id.* at 677.

[28] *Id.*

[29] *See TIG*, 444 F.3d at 592.

[30] *Id.*

[31] *Id.*

[32] *Id.*

shift some of their dispute resolution costs to the public.[33] However, solving these kinds of cases — those involving major liability insurers, their policyholders, and insurance defense firms — by private dispute resolution procedures agreed to ex ante would likely minimize societal costs.[34] The court's causation analysis did not explicitly address this central underlying issue. The Seventh Circuit should have crafted its analysis and holding to create a default rule directly imposing costs and burdens on liability insurers that look to courts to reallocate legal fees ex post. This would spur those insurance companies to internalize the expenses of cost reapportionment and contractually design more socially optimal solutions ex ante. As Professors Ian Ayres and Robert Gertner have noted, "[i]f it is costly for the courts to determine what the parties would have wanted, it may be efficient to choose a default rule that induces the parties to contract explicitly."[35]

TIG was essentially about who should bear the risk that simple legal errors might have "whopping," unforeseeable consequences. In addressing this problem, the court should have focused more on the relationship of the parties. Importantly, TIG exerted substantial influence and control over Giffin Winning.[36] Insurers typically maintain control over law firms to ensure that legal expenses stay low;[37] if policyholders controlled the firms, they might needlessly incur attorney fees up to the limit of their coverage. Liability insurers choose defense counsel from a panel of firms with whom they have ongoing relationships.[38] The firms, in turn, respond to the insurers' financial directives in hopes of maintaining the business connection.[39] These cozy economic ties between insurers and defense firms have led some courts to hold insurers

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[33] *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 127–28 (1989) ("When parties fail to contract because they want to shift the ex ante transaction cost to a subsidized ex post court determination, a penalty default of non-enforcement may be appropriate.").

[34] *See id.* at 93 (noting that society benefits from penalties if it is "cheaper for the parties to negotiate a term ex ante than for the courts to estimate ex post what the parties would have wanted").

[35] *Id.*

[36] *See* Brief of Appellees, *supra* note 8, at 2. Under a duty-to-defend contract clause, which was present in the agreement between TIG and ISU, the insurer typically has "principal responsibility for choosing and compensating defense counsel." Kenneth F. Oettle & Davis J. Howard, *D&O Insurance: Judicially Transforming a "Duty To Pay" Policy into a "Duty To Defend" Policy*, 22 TORT & INS. L.J. 337, 339 (1987).

[37] *See* Douglas R. Richmond, *Liability Insurers Right To Defend Their Insureds*, 35 CREIGHTON L. REV. 115, 129 (2001).

[38] *See* Robert H. Jerry, II & Douglas R. Richmond, *The Insurance Aspects of* Damages, 2004 J. DISP. RESOL. 107, 110.

[39] *See* Richmond, *supra* note 37, at 132; *see also* David B. Wilkins, *Who Should Regulate Lawyers?*, 105 HARV. L. REV. 799, 826 (1992) ("[T]he heightened monitoring capabilities of corporations are likely to make the law firm as a whole more concerned with satisfying client desires . . . .").

vicariously liable for a defense firm's negligence.[40] Ironically, as the effective employer of Giffin Winning, TIG may have been responsible under this theory for Giffin Winning's alleged negligence.

In general, when the market is working properly, courts should not intervene on behalf of a liability insurer to reallocate costs ex post.[41] The question then is whether the market was working properly in *TIG*. More precisely, since TIG was left with the full legal bill, was it in fact the "superior risk bearer?"[42] The answer is yes. Unlike a party unfamiliar with the legal system and in a poor position to observe its attorney, TIG did not merit consumer protection from the tort system. In fact, TIG had leverage over Giffin Winning; it effectively controlled and monitored the firm; it had sufficient motivation to assure that it received quality legal services; and, as an insurance company, it was more than capable of anticipating the business risk.[43] Thus, although the court ultimately ruled against TIG, it should have done so on these grounds. Such a holding would have provided a strong incentive for liability insurers in TIG's position to rely on private risk allocation and dispute resolution procedures instead of coming to the courts for ex post reimbursement.

For similar reasons, the *TIG* court should have explicitly refused the onerous task of examining the evidence of damages. Disputes over policyholders' legal bills often center on damages,[44] and both parties in their briefs and the lower court in *TIG* focused on this issue.[45] To

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[40] *See, e.g.*, Boyd Bros. Transp. Co. v. Fireman's Fund Ins. Cos., 729 F.2d 1407, 1409–11 (11th Cir. 1984); Pac. Employers Ins. Co. v. P.B. Hoidale Co., 789 F. Supp. 1117, 1122–23 (D. Kan. 1992).

[41] Contract law is generally preferable to tort law unless it cannot be used or the market is not working properly and needs the regulatory strength of tort law. *See* William Powers, Jr., *Border Wars*, 72 TEX. L. REV. 1209, 1224 (1994) ("Tort law waits in the background to step in and resolve the disputes that occur when no contractual relationship is present."); *see also* E. River S.S. Corp. v. Transamerica Delaval, Inc., 476 U.S. 858, 873 (1986) (noting that when the commercial market operates properly, there is "no reason [for courts] to intrude into the parties' allocation of the risk").

[42] *See* Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83, 90 (1977). The superior risk bearer is the party that at the time of contracting was in the best position to prevent the risk from materializing or to insure against the risk. *Id.* at 90–91. The factors used to determine which party is the superior risk bearer include the parties' "risk-appraisal costs" and "transaction costs." *Id.* at 91.

[43] *See* Martin C. McWilliams, Jr., *Who Bears the Costs of Lawyers' Mistakes? — Against Limited Liability*, 36 ARIZ. ST. L.J. 885, 918 (2004) (noting that law firms' clients that match the stated criteria may be "superior risk bearers").

[44] *See* Marc S. Mayerson, *Insurance Recovery of Litigation Costs: A Primer for Policyholders and Their Counsel*, 30 TORT & INS. L.J. 997, 1003 (1995) ("Disputes over defense cost 'damages' are increasing in coverage litigation involving larger claims, as insurers seek to reduce their own loss by chipping away at the amounts they are required to pay as part of the duty to defend.").

[45] *See* TIG Ins. Co. v. Giffin, Winning, Cohen & Bodewes, P.C., No. 00 C 2737, 2005 WL 818405, at *3–6 (N.D. Ill. Apr. 6, 2005); Brief of Appellees, *supra* note 8, at 17–46; Brief of Plain-

meet their burden of proof, liability insurers have hired legal auditors to testify as experts and have inundated the courts with stacks of legal bills that purport to show excessive spending.[46] In step with this trend, TIG offered an auditor as a witness and a plethora of timesheets, with the attorneys who billed the hours willing to take the stand, so that the court could "break down . . . which tasks were devoted to responding to the sanctions motion."[47] This in turn would give the court "a basis for the computation of damages with a fair degree of probability."[48] TIG's exhausting description of the steps necessary to calculate damages highlights the Achilles' heel of its request: listening to this testimony and poring over the bills squanders judicial resources.[49] As Judge Posner observed in a case similar to *TIG*, "there is no occasion for a painstaking judicial review" of legal bills in a well-working market.[50] In *TIG*, the superior risk bearer in the transaction — the liability insurer — properly absorbed the costs. Thus, there was no need for judicial intervention. The *TIG* court should have followed the lower court's lead in unequivocally disallowing the testimony from TIG's legal auditor and refusing to review the legal bills as evidence of damages.

This is not to say that courts should always rebuff liability insurers that seek to recoup defense costs. If the parties allocate risk contractually, then the courts may need to redistribute costs in the insurer's favor if it is left paying more than its agreed upon share. More importantly, the courts need to create default rules that force parties in situations such as these to apportion costs efficiently through ex ante agreements. There are myriad ways that insurers and defense firms

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tiff-Appellant TIG Insurance Co. at 32–50, *TIG*, 444 F.3d 587 (Nos. 05-2203, 05-2447), 2005 WL 3970028.

46 Financial auditors must adhere to strict, generally accepted standards. However, legal auditors need not meet those standards. They are generally former lawyers hired to serve as "mouthpieces" for the insurance companies. *See* Posting of Marc Mayerson to Insurance Scrawl, *supra* note 1.

47 Brief of Plaintiff-Appellant TIG Insurance Co., *supra* note 45, at 38.

48 *Id.* at 35–36.

49 *See* Brief of Appellees, *supra* note 8, at 10–11 ("TIG's 'damages,' if any, are buried somewhere in some 650 block-bills, which also record — without differentiation — an enormous quantum of legal work which could never constitute 'damages.'").

50 *See* Taco Bell Corp. v. Cont'l Cas. Co., 388 F.3d 1069, 1076 (7th Cir. 2004). The United States District Court for the District of Massachusetts followed suit in *Liberty Mutual Insurance Co. v. Black & Decker Corp.*, 383 F. Supp. 2d 200 (D. Mass. 2004). In that case, the insurer sought to recoup some of its policyholder's legal defense fees by arguing that the billing practices were unreasonable. The court chastised the insurer for not controlling the costs ex ante: "Having declined to involve itself in the insured's conduct of the litigation . . . , [the insurer] is in no position *ex post* to complain that the insured's billing and litigation management policies do not meet its private criteria." *Id.* at 210. Although that case involved billing rates, the damages issue was similar to that in *TIG*; in neither scenario should courts have to pore over legal bills for liability insurers when the market is working properly.

can structure their agreements to allocate risk as they see fit.[51] For example, TIG, which had great leverage over the firm that would represent its policyholder and the conditions of the firm's service,[52] could have assigned Giffin Winning responsibility for all costs stemming from its negligence, no matter how routine. Alternatively, if TIG were intent on ensuring that the public court system remained a welcoming option, it could have arranged a contract with Giffin Winning that would have reduced its burden of proof at trial.[53] Under such an agreement, perhaps TIG's speculative damages estimate would have proved sufficient in the lower court. Whatever the contract specifications between the insurer and defense firm, the insurer would have to absorb some of the costs of a more receptive court system by compensating the insured for the advantageous terms during negotiations. If those costs are sufficiently great, the insurer may opt instead to create private dispute resolution procedures, such as arbitration[54] — a likely option since procedures agreed to ex ante are often more cost-effective than ex post enforcement by courts.[55] Regardless of what the insurer ultimately decides, the bottom line is that, by internalizing these dispute resolution costs, the insurer is more likely to choose a system that maximizes social welfare.

Notably, close business relationships exist between other large businesses and their outside legal counsel beyond the insurance liability context of *TIG*. Why then limit the analysis suggested above to liability insurers and their defense firms? Three potential justifications are worth emphasizing. First, insurers engage in pure risk management as their core business, while the primary function of a typical corporation is to produce goods and services.[56] Second, as an empirical matter, liability insurers deal with substantially more litigation

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[51] *See* David Rosenberg, *Joint and Several Liability for Toxic Torts*, 15 J. HAZARDOUS MATERIALS 219, 229 (1987) (noting that parties can apportion liability through contract, "result[ing] in the efficient and fair allocation of liability"). It is important to note that liability insurers have long been sophisticated at drafting contracts. *See* John Fabian Witt, *Toward a New History of American Accident Law: Classical Tort Law and the Cooperative First-Party Insurance Movement*, 114 HARV. L. REV 690, 829 (2001) ("By the 1880s and 1890s, commercial life insurance companies had become extremely sophisticated in drafting life insurance policies.").

[52] *See* Brief of Appellees, *supra* note 8, at 54–55.

[53] *See* Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814, 857–58 (2006) (commenting that courts will enforce "reasonable contractual burden of proof provisions").

[54] *See id.* at 856 ("It is now common for parties to agree to have disputes resolved by arbitration rather than by litigation . . . .").

[55] *See id.* ("In many of these cases, the parties' ex ante agreement as to procedure improves the cost-effectiveness of their prospective enforcement mechanism.").

[56] *See* Francis J. Mootz III, *Holding Liability Insurers Accountable for Bad Faith Litigation Tactics with the Tort of Abuse of Process*, 9 CONN. INS. L.J. 467, 519 n.136 (2003) ("[I]t is appropriate to distinguish insurers from other corporate entities because the very nature of the business of insurance implicates the public policy favoring compensation of injured parties . . . .").

than do other businesses.[57] Thus, they have greater expertise with litigation, and they can spread their risk over a larger caseload to better meet unanticipated legal costs.[58] Finally, there is precedent for viewing insurers as distinct from other corporate entities. Courts have long treated insurance policies differently from commercial contracts.[59] The extent to which jurists should adhere to this distinction is a topic for a different article. The point here is that, given liability insurers' strengths and sophisticated business connections with defense firms, courts should push insurers to arrange socially preferable dispute resolution procedures ex ante.

If the *TIG* court had analyzed the problem as suggested, it would have sent a clear message to liability insurers: they should consider the taxing standards they will face in court when designing private dispute resolution procedures and allocating risk ex ante. Cases like *TIG* are attractive candidates for ex ante contract solutions because they involve sophisticated, repeat players with close business ties within a well-working market.[60] Moreover, when conflicts arise between these parties, it is costly to transfer to the courts the task of calculating potential damages. Liability insurers seeking to avoid paying their policyholders' full legal defense costs have abused the court system with their repeated pleas for ex post cost reallocation. If courts forced insurers to consider and internalize more fully their dispute resolution costs ex ante, social welfare would increase. By not recognizing this overtly, the Seventh Circuit missed an opportunity to declare that the courts will not be receptive to liability insurers looking for a subsidized ex post reallocation of their policyholders' legal fees.

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[57] *See id.*

[58] *See id.* (noting liability insurers' litigation "expertise and their ability to spread risks over thousands of cases each year").

[59] *See id.* ("[T]he judiciary has always regarded the business of insurance to be distinct from ordinary commercial activity.").

[60] *See* Rosenberg, *supra* note 51, at 230 ("If there are competitive markets for the products and services of each firm, then the contracts each will make with the others will minimize their respective costs by allocating future liability on the basis of the relative causal contributions of each to the loss.").