SELF-EVALUATIVE PRIVILEGE WOULD BENEFIT INSURERS AND THEIR CUSTOMERS

by

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Our laws should protect those who play by the rules. Yet, in today’s increasingly hostile legal environment, playing by the rules is not as simple as it ought to be. Insurance companies interested in using proactive self-evaluative audits are limited by the reality that these audits may be used against them by insurance regulators, or in court — even if problems identified in the audit have been self-corrected.

According to Baltimore attorney Donald Rea, “There has been a proliferation of class-action suits” in which documents collected by federal and state regulators are made available to “sophisticated class-action lawyers” under the Freedom of Information Act. … This “troublesome” trend … sometimes violates confidentiality clauses in federal regulations.” Lew Schelman, Attorney Complains That Compliance Docs Are Used Against Lenders, NATIONAL MORTGAGE NEWS, Apr. 29, 2002.

The solution is to protect these audits by enactment of a “self-evaluative privilege,” when problems detected in the audit are corrected within a reasonable time. Currently, five states provide statutory protection for self-evaluative audits. Insurers in the rest of the country remain subject to the chilling effect created by the absence of this common-sense privilege.

What Is The Self-evaluative Privilege? The public policy underlying this privilege was set out in Bredice v. Doctors Hospital Inc,¹ which held that the minutes of medical peer review meetings were privileged so that doctors could talk freely. The court held that these meetings were intended to improve the quality of medical care, which is more important than subjecting doctor’s peer review comments to discovery. The free flow of information was outweighed by the public’s interest in improved health care.

¹50 F.R.D. 249, 250, 14 Fed R. Serv. 2d 759 (DDC, 1970). “‘The public interest may be a reason for not permitting inquiry into particular matters by discovery.’ 4 Moore, Federal *251 Practice ¶ 26.22(2) at 1287 (2d ed. 1969). As doctors have a responsibility for life and death decisions, the most up-to-date information and techniques must be available to them. There is an overwhelming public interest in having those staff meetings held on a confidential basis so that the flow of ideas and advice can continue unimpeded. Absent evidence of extraordinary circumstances, there is no good cause shown requiring disclosure of the minutes of these meetings.”

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Although this privilege has been recognized in cases since *Bredice*, an insurer can’t assume its existence. “The self-evaluative privilege is an uncertain means of protecting institutional self-analysis from discovery. Although many federal courts recognize certain criteria governing application of the privilege, the privilege has been neither universally recognized nor consistently applied. Materials previously thought protected may now be subject to disclosure.” *The Self Critical Analysis Privilege and Environmental Audit Report, 25 Environmental Law Reporter 73, 91, Winter 1995.* Although this 1995 analysis was applied to environmental audits, it remains true whether the issue is environmental, civil rights, or insurance. Legislative action is the clearest way to make this privilege certain.

This privilege has been statutorily recognized by New Jersey, Illinois, Michigan, North Dakota, and Oregon. While not identical, they have many similarities. Generally, for the privilege to apply:

1. A company must audit its practices and correct identified problems within a reasonable time.
2. If the company fails to correct the problem within a reasonable time, the privilege will not apply.
3. Audits may not be used to hide illegal or improper activity.
4. Finally, the insurance regulator may obtain audit documents to ensure that the company is following through on its findings. Failure to correct problems may result in regulatory sanctions.

The self-evaluative privilege only protects audit documents created separately from other records. It does not protect documents created in the normal course of business, and access to insurance company records would remain the same as it is today.

**Why This Privilege Is Desirable.** Generally, there are three ways to resolve problems associated with an insurer’s conduct: 1. Self-correction; 2. A regulator uncovers the problem; or 3. Litigation.

**Self-correction:** A regulatory environment that encourages voluntary self-correction is in the public’s best interest, but is unlikely without the self-evaluative privilege. When enacting their privilege, the New Jersey legislature found: “…that it is in the public interest for insurance carriers in this State to conduct voluntary internal reviews and audits of their operations, practices and procedures for the purpose of discovering and correcting any operations, practices or procedures which do not comply with applicable law or regulation or which do not comply with recognized industry standards or with the insurance carrier’s own standards and for the purpose of preventing continuing and more serious violations.” NEW JERSEY CODE C.17:23C-1(a).

While self-evaluative audits provide the most desirable resolution to insurer conduct problems, the lack of a privilege guarantees that a company cannot afford the risk. “Insurers sometimes face a no-win situation when they undertake a frank examination of their own business practices. On the one hand, regulators and consumers groups are demanding that insurers monitor themselves. Insurers are even demanding it of themselves. The Insurance Marketplace Standards Association (IMSA), whose purpose is to promote ethical market conduct, makes self-assessment a condition for membership. REGULATORY AFFAIRS BULLETIN, Jan. 10, 2000. But on the other hand, regulators and consumers groups have also attempted to use the self-evaluative analysis in enforcement actions and private lawsuits.” INSURANCE COMPLIANCE WEEK, INSURANCE REGULATORY AFFAIRS BULLETIN, July 9, 2001. The New Jersey Legislature’s findings support the notion, “…if studies and reports beyond those legally required are available to third parties and other regulators and

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4Illinois does not grant administrative access to self-evaluative audits, the regulator must go to court to gain access.
potentially can result in the insurance carrier’s liability to such third parties, the insurance carrier may be discouraged from making these additional efforts and from sharing these results with regulators …” NEW JERSEY CODE C.17:23C-1(a). Without this privilege, it would be irrational for insurers to conduct self-evaluative audits.

To oppose this privilege is to stand for the proposition that it is better for regulators to catch insurers “in the act,” than for companies to correct their own mistakes. This punitive perspective denies insurers and regulators the use of a mutually useful compliance tool.

Traditional regulatory enforcement will be enhanced. Because regulators have limited resources, they are unlikely to uncover the breadth of conduct detected and corrected by these audits. Self-correction allows companies to inform a regulator of corrected conduct without fear of repercussion from the regulator, or in the courts, and is free to the taxpayer. Consequently, the privilege will allow regulators to use their limited resources more effectively. “…A legal structure that promotes self-policing programs can achieve improved compliance effectively at less cost to the State and to the insurance carriers. Voluntary compliance review, when properly conducted and implemented, results not only in improved compliance with the law, but in the adoption of procedures and policies by the insurance carriers that exceed the minimum legal requirements, and that save money by benefitting customers, lowering costs and reducing potential liabilities. Id. The Illinois Legislature also found that enacting this limited privilege would benefit consumers while encouraging voluntary and improved compliance with the insurance code. ILLINOIS CODE, 5/155.35(a).

Litigation can be a deterrent to undesirable behavior, but is the least desirable means of enforcement. Litigation is a lengthy and expensive process, which may only address the specific wrongs alleged by the plaintiff. Self-correction and regulatory oversight are capable of more immediate and comprehensive results at a much lower cost. In today’s litigious world, everyone is familiar with the image of an attorney telling a jury to “send a message” to punish the defendant. Absent a self-evaluative privilege, that attorney may use a company’s self-evaluative audit as a basis for that charge — even when the company corrected the problem before the lawsuit was filed. This is unjust, and a deterrent to responsible corporate behavior. In this scenario, only the lawyer benefits.

The obvious solution is the adoption of a self-evaluative privilege in all fifty states.

Other Privileges. Some have questioned whether the adoption of a self-evaluative privilege is necessary in light of the presence of other privileges. The only two that might apply are the lawyer/client privilege and the work product privilege. While they vary from state to state, neither provides adequate protection for self-evaluative audits.

The attorney/client privilege protects communication between lawyers and clients. Most people know that if you tell something to your lawyer in confidence it remains confidential. Review of the federal rule illustrates the limitations that an insurer would face under this privilege.

(b) General Rule of Privilege. A client has a privilege to refuse to disclose and to prevent any other person from disclosing confidential communications made for the purpose of facilitating the rendition of professional legal services to the client, (1) between himself or his representative and his lawyer or his lawyer's representative, or (2) between his lawyer and the lawyer's representative, or (3) by him or his lawyer to a lawyer representing another in a matter of common interest, or (4) between representatives of the client or between the client and a representative of the client, or (5) between lawyers representing the client.

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5The use of litigation as a deterrent to improper conduct is, at best, the use of a blunt instrument when more refined tools are available. However, this is a separate debate, which could completely obscure the focus of this paper.

6Because these privileges have developed differently in the states as common law doctrines, it is not possible to discuss this exhaustively; therefore, we will discuss them in their most common form, and cite the federal rule. There may be a state where one of the privileges would protect a self-evaluative audit. If that is the case, it is an anomaly.
For the privilege to apply to a company, the communications must be between the lawyer and individuals in the corporation who qualify as the client. ATTORNEY-CLIENT PRIVILEGE AND THE WORK-PRODUCT DOCTRINE CORPORATE APPLICATIONS, BNA Corporate Practice Series, 22-3 § 1. Communications between a lawyer and someone within the company structure deemed by a court not to be a client would not be protected by the privilege. *Id.*

Applying this privilege to self-evaluative audits would require a company to adapt the audit process to the limitations of the privilege. “To use attorney-client privilege, … it is critical that a lender's compliance system be under the direct control of the firm's in-house counsel, and that all communication with that office by persons reporting loan-specific information is clearly made for obtaining legal advice.” Lew Schelman, *Attorney Complains That Compliance Docs Are Used Against Lenders*, NATIONAL MORTGAGE NEWS, Apr. 29, 2002. The same is true for insurance companies.

The primary problem would be proving that the advice sought was legal. While a self-evaluative audit may identify and correct legal issues, it must also address business practices and solutions. To remain within the privilege, anyone participating in the audit would have to function as agents of a lawyer. This may well exceed the scope of the privilege, leaving the information unprotected.

Another concern is that a company may only reveal information to “clients.” The United States Supreme Court has held that disclosure to someone in a company who is not a client constitutes waiver of the attorney client privilege. *Upjohn Co. v. United States*, 449 U.S. 383 (1981). It is unclear whether the insurer could inform enough people within the company so that inappropriate practices can be corrected. Or, put another way, it is unclear if a company could inform all of the people necessary so that the practice in question can be corrected.

Companies attempting to conduct these audits under the auspices of the attorney/client privilege would have to alter and limit their efforts. This does not have much appeal for a company wishing to perform critical self-audits.

*The work product privilege* is even more restrictive. One standard requirement is that work product documents must be prepared by an attorney in anticipation of litigation. The self-evaluative audit is intended to promote good business practices, preventing litigation. Because self-evaluative audits should be prepared proactively to avoid problems, it is unlikely that this privilege would protect them.

**Conclusion.** Companies wanting to proactively identify and eliminate improper conduct should be given all the tools necessary. One critically important tool is the self-evaluative audit privilege. This privilege is narrowly tailored so that it only protects the audit, and only if problems cited are corrected within a reasonable time. It does not protect other documents created in the normal course of business, nor does it provide protection for fraud or criminal activity. The smoking gun will still be discoverable.

Absent this privilege, good corporate citizens face fines and punitive sanctions from individual plaintiffs for proactively cleaning house — this is bad public policy. It is hard to understand how this privilege does not exist in all fifty states.

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7For an excellent definition of the work product privilege, see NORTH DAKOTA CODE 44-04-19.1(3). See also FRCP 26(b)(3), which states in part that “the court shall protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation.” See also, Lew Schelman, *Attorney Complains That Compliance Docs Are Used Against Lenders*, NATIONAL MORTGAGE NEWS, Apr. 29, 2002.