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DISCOVERY IN BAD FAITH LITIGATION: IS THE ATTORNEY-CLIENT PRIVILEGE IN JEOPARDY

I. Opening Remarks & Introductions

The attorney-client privilege is one of the oldest privileges recognized in the American legal system. It has the important purpose of encouraging full and truthful communications between attorney and client. Recently, however, plaintiffs in insurance bad faith cases have asserted that the attorney-client privilege does not always protect communications from disclosure when the plaintiff is seeking information concerning an insurance carrier's handling of a claim. While there is no bad faith exception to attorney-client privilege, the issue of an implied waiver of the attorney-client privilege is of serious concern.

II. Overview of the Attorney-Client Privilege

A. The Tradition of the Attorney-Client Privilege

i. One of the oldest recognized privileges for confidential communications, the attorney-client privilege protects communications to and from attorneys made for the purpose of obtaining or securing legal advice. The purpose of the attorney-client privilege is "to encourage full and frank communications 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." *Upjohn Co. v. U.S.*, 449 U.S. 383, 389 (1981).

B. Burden of Establishing Privilege

i. "The party asserting the privilege has the burden of establishing its existence" and must present evidence establishing all the elements of privilege. *Asuncion v. Metropolitan Life Ins. Co.*, 493 F. Supp. 2d 716, 720 (S.D.N.Y. 2007).

ii. The following general standard is applied by most jurisdictions to determine if the privilege applies:
    1. the asserted holder of the privilege is or sought to become a client;
    2. the person to whom the communication was made:
        a. is a member of the bar of a court, or his subordinate; and
        b. in connection with his 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.

U.S. v. United Shore Machinery Corp., 89 F. Supp. 357, 358-59 (D. Mass. 1950).

C. Common Exceptions/Limitations to Privilege

A number of common exceptions and limitations to the privilege have evolved:

i. The privilege is limited to legal advice and does not apply when an attorney is acting in a **non-legal capacity**, i.e. giving business or personal advice. "The mere fact that a communication is made directly to an attorney, or an attorney is copied on a memorandum, does not mean that the communication is necessarily privileged." *U.S. Postal Serv. v. Phelps Dodge Ref. Corp.*, 852 F. Supp. 156, 160 (E.D.N.Y. 1994). "No privilege attaches to an attorney's communications when the attorney is hired to give business or personal advice, or do the work of a non-lawyer." *SR Int'l Bus. Ins. Co. v. World Trade Ctr. Props. LLC*, No. 01 Civ. 9291 (JSM), 2002 WL 1455346, *4 (S.D.N.Y. July 3, 2002).

ii. The privilege only protects legal information in the communication and does not extend to **underlying facts**. *Upjohn*, 449 U.S. at 389.

iii. Both attorneys and clients alike may **expressly waive** privilege if they **disclose privileged information** to a third party. This may be done by directly disclosing information to third parties or speaking loudly and / or publicly such that others would be able to overhear otherwise privileged communications. *Southern Bell Tel. & Tel Co. v. Deason*, 632 So. 2d 1377, 1386 (Fla. 1994) (holding that the attorney-client privilege is waived when a communication is disclosed to a third party unless the disclosure is limited to those parties that have a "need to know" of the communication).

iv. Communications between an attorney and her client are not privileged if they are made for the purpose of helping the client carry out a crime or fraud. This is called the **crime-fraud exception**. The crime-fraud exception applies if a client "made or received an otherwise privileged communication with the intent to further an unlawful or fraudulent act." *In re Sealed Case*, 107 F.3d 46, 49 (D.C. Cir. 1997). This exception also applies to communications regarding an attorney or client's efforts to cover up a crime.

v. Communications between an attorney and her client are not privileged where the client has put her communications with the attorney "at issue" in the litigation. Courts generally do now allow a client to use the privilege as a sword and a shield.

D. Determining if There is a Trend Toward Limiting Waiver in "Traditional" Litigation

i. Overall, the attorney-client privilege is becoming narrower. This is due to many factors, one of the biggest being the evolution of technology. E-mail communications, in particular, can be troublesome. Privilege applies to attorney-client communications exclusively. Where the communication is divulged to a third party, it is not privileged. In e-mail communications, then, attorneys and clients must be extraordinarily careful not to send or copy the e-mail to a third party. In-house counsel must be especially careful not to impliedly waive privilege. Jurisdictions vary on whether e-mails on which someone other than the client is copied are waived. If in-house counsel addresses an e-mail to someone other than a client, that may be waived as well. Communications shared via social media may also impliedly waive attorney client privilege.

ii. Courts have also held that communications are only privileged where an attorney is acting in a legal capacity for the purpose of rendering legal advice. If an attorney is acting as a claims adjustor, for example, communications pertaining to his role as a claims adjustor would not be privileged. If a corporate attorney also performs another role within the corporation, only communications rendering legal advice will be privileged.

III. Privilege Under Attack in Insurance Bad Faith Cases

The application of the attorney-client privilege in "bad faith" insurance litigation has been under heightened scrutiny by courts in various jurisdictions due to the unique aspects of the insurer-insured relationship. Federal courts apply state law "to determine the applicability of evidentiary privileges to discovery disputes in diversity actions." Fed.R.Evid. 501; *Roehrs v. Minn. Life Ins. Co.*, 228 F.R.D. 642 (2005).

A. Unique Characteristics of First Party and Third Party Claims Lead to Trouble for the Attorney-Client Privilege

i. First Party Bad Faith Cases

1. Privilege is unique in the context of first-party bad faith cases for a couple reasons, the first being that the relationship between insurer and insured is complex. Courts in certain jurisdictions have held that that an insurer is a fiduciary, giving rise to a heightened duty of care on the part of the insurer in the eyes of the courts.
2. In addition, insurers who use counsel to analyze coverage questions are susceptible to heightened scrutiny to ensure that the attorney was not performing a claims handling or investigatory function as opposed to providing legal advice. Communications are only privileged where made for the purpose of rendering legal advice. *National Union Fire Ins. Co., et al. v. Transcanada Energy USA, Inc.*, 990 N.Y.S.2d 510, 511 (N.Y.App.(1st Dep't) 2014) (ruling trial court properly ruled that outside counsel's act of providing opinion as to whether to pay or deny claim constituted an "ordinary business activity for an insurance company" to which no privilege applied); *Electric Power Systems International Inc. v. Zurich American Ins. Co.*, 2016 WL 3997069 (E.D. Mo. July 26, 2016) (ruling in the context of the work-product privilege that "[a]n insurer's decision to decline coverage is usually the point at which ordinary course of business ends and the anticipation of litigation begins").

ii. Third-Party Bad Faith Cases

1. The defense of third-party liability claims create a tripartite relationship between the insured, insurer and counsel. Some jurisdictions consider both the insured and insurer to be a client of the attorney, in which case communications between insurer and attorney are not waived, while others have not yet recognized the insurer as a client. Often, whether or not the insurer's communications with counsel are privileged turns on whether the insurer ever had a right to control the defense in the underlying litigation.
2. Furthermore, a third-party bad faith plaintiff often has received an assignment of the insured's claims and / or rights. At least one court has held that in assigning his claim an insured implicitly waived his right to assert attorney-client privilege, although communications between an insurer and its personal attorney after the claim is filed are still protected. *Allstate Ins. Co. v. Gaughn*, 203 W. Va. 358 (1998).

3. Also, in bad faith failure to settle cases, communications between an insurer and in-house or coverage counsel may be susceptible to disclosure if the counsel's evaluation of the obligation to settle the underlying case is relied upon by the insurer in making its determination to not accept the settlement within limits offer in the underlying case.

B. What Constitutes Implied Waiver

i. The Automatic Waiver Test - The attorney-client privilege is waived where the privilege holder asserts a claim, counterclaim, or affirmative defense that raises an issue requiring examination of protected communications. *Saviano v. Luciano*, 92 So. 2d 817, 819 (Fla. 1957). In other words, "if proof of claim would require evidence of the privileged matter, then the privileged matter is discoverable." *Lee v. Progressive Express Ins. Co.*, 909 So. 2d 475, 477 (Fla. Dist. Ct. App. 2005); *Indep. Prods. Corp. v. Loew's, Inc.*, 22 F.R.D. 266, 276-77 (S.D.N.Y. 1958 (originating automatic waiver rule); *Lyons v. Johnson*, 415 F.2d 540, 542 (9th Cir. 1969). This issue most often arises in bad faith cases where an insurer asserts a defense based on the advice or judgment given to them by their attorney.

ii. The *Hearn* Relevant and Vital Test (Intermediate Approach) - In the case *Hearn v. Rhay*, the court articulated a three-prong test to determine whether an insurer had impliedly waived the attorney-client privilege. *Hearn v. Rhay*, 68 F.R.D. 574 (E.D. Wash. 1975). The test involved determining whether: 1) assertion of privilege was the result of some affirmative act, such as filing suit, by the asserting party; 2) through this affirmative act, the asserting party put the protected information at issue by making it relevant to the case; and 3) application of the privilege would have denied the opposing party access to information that is vital to its defense. *Id.* at 581. Where all three elements are satisfied, privilege has been waived. In other words, under this approach privilege is waived where the discoverable material is relevant to issues raised in the case and vital/necessary to opposing party's defense of the case. *Seneca Ins. Co. v. Western Claims, Inc.*, 774 F.3d 1272 (10th Cir. 2014) (ruling insurer waived privileged where claim note reflected settlement of underlying claim was made based on "advice of counsel"). As with the automatic waiver test, privilege is most often waived where the insurer asserts a defense based on the advice given to them by their attorney.

iii. The Restrictive Test - The privilege is waived only if the party directly puts the attorney's advice at issue. For instance by raising the advice of counsel defense in a bad faith lawsuit. *See Rhone-Poulenc Rorer, Inc. v. Home Indem. Co.*, 32 F.3d 851, 863 (3d Cir. 1994)(adopting restrictive

approach and criticizing Hearn test); *Pub. Serv. Co. of N.M. v. Lyons*, 10 P.3d 166, 173 (N.M. Ct. App. 2000).

A Majority of jurisdictions follow:

iv. The Hearn Test (Intermediate Approach) - *State Farm v. Lee*, 199 Ariz. 52 (2000); *Frontier Ref., Inc. v. Gorman-Rupp Co.*, 136 F.3d 695 (10th Cir. 1998); *Home Indem. Co. v. Lane*, 43 F.3d 1322 (9th Cir. 1995); *Pyramid Controls, Inc. v. Siemens Indus. Automations, Inc.*, 176 F.R.D. 269 (N.D. Ill. 1997).

v. **Note:** The rationale behind all three tests is that insurers should not be able to manipulate attorney-client privilege such that it acts as an impenetrable shield, and if they attempt to do so, insureds can use it against them. Because there is always a possibility that privilege may be impliedly waived,

C. Status of the Law – Sampling of Different Jurisdictions

i. Several jurisdictions have severely limited the application of attorney-client privilege in the insurance context:

1. Ohio – *Boone v. Vanliner Ins. Co.*, 91 Ohio St. 3d 209 (Ohio 2001) (holding the insured can discover claim file materials containing attorney-client communications created prior to denial of coverage; mere filing of a bad faith case entitles court to in camera review of claims file).
2. Delaware – *Tackett v. State Farm Fire & Cas. Ins. Co.*, 653 A.2d 254, 257-59 (Del. 1995) (insurer impliedly waived privilege where it stated that it had engaged in "routine claim handling; "waiver of the attorney-client privilege may be implicit, even if contrary to the party's actual intent").
3. Washington – *Cedell v. Farmers Ins. Co. of Washington*, 295 P.2d 239, 246 (2013) (holding that in bad faith claims the claimant is presumptively entitled to discovery of the entire claims file).
4. Idaho – *Stewart Title Guaranty Co. v. Credit Suisse, Cayman Islands Branch*, No. 1:11-CV-227-BLW, 2013 WL 1385264 (D. Idaho 2013) (holding that Idaho's joint client privilege exception applies to bad faith claims).
5. New York / Missouri are two of the jurisdictions that have recently recognized that outside counsel providing legal advice as to whether to accept or deny a claim constitutes a "business function" done in the ordinary course of an insurance company's business and therefore not protected by the attorney-client or work product privileges. *National Union*, 990 N.Y.S.2d at 511; *Electric Power Systems Int'l, Inc.*, 2016 WL 3997069 *4.

6. Arizona follows the intermediate approach, however, in practice waiver is regularly found in the insurance bad faith context. A showing of bad faith in Arizona requires 1) that the insurer acted unreasonably toward its insured, and (objective prong) (2) that the insurer acted knowing that it was acting unreasonably or acted with such reckless disregard that such knowledge may be imputed to it (subjective prong). Insurers must either give up their right to defend against the subjective prong of bad faith or waive their right to assert privilege regarding communications with its counsel. *See State Farm v. Lee*, 199 Ariz. 52, 56 (2000)(holding that if "the litigant claiming the privilege relies on and advances as a claim or defense a subjective and allegedly reasonable evaluation of the law—but an evaluation that necessarily incorporates what the litigant learned from its lawyer—the communication is discoverable and admissible." *Id.* at 58; *but see Everest Indem. Ins. Co. v. Rea*, 342 P.3d 417 (Ariz. Ct. App. 2015)(holding insurer did not assert a defense that it depended on the advice of counsel in forming subjective belief and did not waive the privilege).

IV. Best Practices to Maintain the Privilege

A. Attorneys retained to evaluate coverage and/or investigate a claim should explicitly state on any written reports that the communication is protected by the attorney-client privilege and that the report contains evaluation of any legal issues relevant to the investigation.
B. Prepare any coverage position letter under the insurer letterhead and not from law firm.
C. Avoid, if possible, raising "advice of counsel" as a defense so that the client does not impliedly or otherwise waive the attorney-client privilege.
D. Avoid, if possible, indicating in claim notes that decisions were made "on advice of counsel."
E. Retain separate counsel for claims investigation and coverage determinations, and clearly specify the purpose for which each is retained.
F. Use the telephone. Try to avoid providing written evaluations until after the evaluation of coverage is discussed verbally.
G. Limit disclosure of documents to essential individuals and avoid disclosure to individuals involved in the underlying third-party claim/litigation.
H. "Split the file" on third-party liability claims and ensure that counsel providing advice as to coverage or possible bad faith exposure takes steps to preserve the privilege.
I. Attempt to stay discovery on a bad faith claim until the underlying action is resolved.