# INSURANCE BAD FAITH:
# STRATEGIES FOR AVOIDING OR PURSUING CLAIMS

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*This paper was created for educational purposes, and to present both the insurer and policyholder perspectives on general matters. It does not constitute legal advice, and does not represent any opinions, expressed or implied, of the attorneys, their firms, or their past, current or future clients.*

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## I. BAD FAITH IN GENERAL.

"Bad faith" is the legal concept to describe a breach of the covenant of good faith and fair dealing that is implied by law in every contract. Breach of this covenant involves more than simply the breach of specific contractual duties or mistaken judgment. It signifies certain unreasonable conduct in relation to an insurance company's duties owed under a policy of insurance.

Because insurance involves both "first party" and "third party" coverages, bad faith claims exist with respect to both first party and third party insurance policies. First party coverage concerns a policyholder's claim for direct benefits under an insurance policy. Examples include homeowner's insurance, life insurance, health insurance, disability insurance, and automobile insurance. In that case, a claim for "bad faith" consists of the policyholder claiming breach of the implied covenant of good faith and fair dealing when the insurance company refuses, without proper cause, to compensate the policyholder for a loss covered by the policy or by unreasonably delaying payments due under it.

Third party coverage concerns a policyholder's claim that an insurance company has breached the implied covenant of good faith and fair dealing by mishandling a claim made by a third party against the policyholder. Examples include general liability policies or director and officer insurance policies, in which the policyholder claims the insurance company failed unreasonably to defend the policyholder against a third-party claim or that it refused to settle a claim reasonably within policy limits.

The gist of a "bad faith" claim, in either case, arises as a matter of law from the insurance policy, apart from the terms of the policy itself, namely, that the insurance company must refrain from doing anything that will injure the right of the policyholder to receive the benefits of the insurance contract, the terms and conditions of which define the duties and performance to which the policyholder is entitled. The implied covenant is that neither party will do anything which will injure the right of the other to receive the benefits of the agreement. In addition, each contracting party must do everything that the contract presupposes that the party will do to accomplish its purpose.

The rationale for these implied duties is that people buy insurance to obtain peace of mind and security in the event of a loss or claim, and that they expect to be paid promptly in the event of such a loss. Because insurance companies sell insurance policies on this basis, insurance companies are not permitted to exalt their interests over the interests of the policyholder in obtaining the protection for which they bargained. For this reason, the insurance company must give at least as much consideration to the interests of the policyholder as it does to its own.

Unreasonableness is determined on a case-by-case basis and typically involves showing that the insurance company failed or refused to discharge its contractual duties, in consideration of the contractual purposes and the reasonably justified expectations of the parties. This failure or refusal to discharge duties must be prompted not by an honest mistake, bad judgment, or negligence, but by a conscious and deliberate act that unfairly frustrates the agreed common

purposes, and disappoints the reasonable expectations of the other party thereby depriving that party of the benefits of the agreement.

Because the claim has its origin in the existence of an agreement, only persons in privity with the insurance company have standing to assert a claim for bad faith in most jurisdictions. Persons other than insureds/policyholders generally cannot sue for damages resulting from an insurance company's withholding policy benefits unless they are in privity of contract with the insurance company.

## II. BAD FAITH – FIRST PARTY CASES.

Under First Party insurance policies, an insurance company promises to indemnify its policyholder for covered losses. The implied covenant of good faith and fair dealing in those policies is that the insurance company will make a thorough and prompt investigation of the insured's claim for benefits and that it will not unreasonably delay or withhold payment of benefits. An insurance company thus breaches this covenant when it (a) fails to investigate a claim reasonably or (b) unreasonably delays or withholds payment of benefits.

### A. Failure To Investigate A Claim Reasonably.

An insurance company's duty to investigate a claim obligates it to investigate a claim *thoroughly*. In most jurisdictions, this means the insurance company must fully inquire into all possible bases that might support the policyholder's claim. Following are questions to ask that assist in determining whether an insurance company has made an adequate investigation, specifically, did the insurance company –

- Gather facts accurately?
- Focus on the right issues?
- Investigate promptly, especially when facts are fresh?
- Intimidate any witnesses or solicit false information?
- Use properly trained personnel?
- Reflect balance or bias?
- Fairly evaluate the findings?
- Handle the claim consistent with industry practice?
- Violate any state statutes or administrative regulations?
- Rely on unverified information?
- Adequately document its findings?
- Reach a decision before the investigation was concluded?
- Reach a decision based on the whole factual record, and not just isolated facts or events?
- Refuse to re-consider when presented with additional evidence?
- Refer the claim to a committee that merely rubber-stamped the decision?

The insurance company's duty to investigate includes the duty to interview witnesses with significant information. The insurance company's duty extends to whatever facts or

theories that might support coverage under the policy, even if the policyholder has not advanced all facts or theories. Moreover, the insurance company cannot sit back and wait for the policyholder to provide it with all information. If information is reasonably available to the insurance company, then the insurance company has a duty to initiate its own investigation and obtain that information.

An insurance company may have a duty to consult with an expert if its own representatives are not sufficiently knowledgeable about the subject matter of a claim. At the same time, reliance on an expert will not necessarily insulate an insurance company from a bad faith claim. If the insurance company dishonestly selected its expert, or if the expert itself acted unreasonably or failed to conduct a thorough investigation into the claim, a bad faith claim may still lie against the insurance company. A policyholder can establish this if it can prove that a reasonable investigation would have uncovered evidence to establish coverage or a potential for coverage. More egregious examples include an expert ignoring evidence submitted by the policyholder, especially if it contradicts the evidence on which the expert relied, or if the expert is found to have lied in a deposition or to the policyholder. Following are questions to consider in determining whether an insurance company reasonably relied on an expert's report to determine coverage:

- Is the report accurate or does it contain errors indicating the investigation was not conducted carefully?
- Is the report objective or does it appear biased?
- Does the report contain speculations or conclusions with no basis in fact?
- Does the report address all relevant information reasonably available to the expert?
- Does the report leave facts undeveloped and unresolved?
- Did the insurance company rely exclusively on the expert's report or did it consider information from other sources?
- Did the insurance company follow up leads from records reviewed or witnesses contacted?
- Does the expert have the appropriate qualifications to evaluate the claim?
- Did the insurance company limit any information to the expert?
- Were the policyholder's experts more qualified than those of the insurance company?

### B. <u>Unreasonable Delays Or Withholding Of Payment</u>.

To establish a claim in a First Party case that an insurance company has unreasonably delayed payment of a claim, it must be shown that the insurance company's delay was "unreasonable" or "without proper cause." In most jurisdictions, if the insurance company has made full and prompt payment, no bad faith claim can exist, no matter how egregious its conduct may have been.

Improper withholding of policy benefits may include a denial of benefits due, discontinuing ongoing benefit payments, or paying less than the amount due. Moreover, it may not withhold payments on all claims when only some are in dispute. The rationale is that such

delay impermissibly pressures the policyholder into compromising the disputed claims for the sake of obtaining the undisputed claims.

An insurance company may not deny a claim based on a standard it knows to be impermissible or is based on an interpretation contrary to established law. Nor may it engage in abusive or coercive tactics to avoid payment of the claim or to pressure the policyholder into accepting less than the amount owed. Even arrogance or hostility by a claims representative can constitute evidence of bad faith conduct, as can groundless accusations against the policyholder or groundless threats to rescind the policy.

The duty to act in good faith does not stop when coverage litigation commences. While the insurance company has a right to sue or defend itself in litigation regarding its coverage rights, evidence of its litigation tactics may constitute continuing evidence of its breach of the implied covenant of good faith and fair dealing. Moreover, an exceedingly low settlement offer may also be evidence of that breach.

## III. BAD FAITH – THIRD PARTY CASES.

Under Third Party insurance policies, an insurance company promises to defend and indemnity its policyholder against covered claims. The implied covenant of good faith and fair dealing in those policies is that the insurance company will provide a defense if a potential for liability exists and that it will attempt to effect a reasonable settlement of third party claims within policy limits. An insurance company thus breaches this covenant when it (a) fails to provide a defense against a third party claim when it is reasonably required to do so; or (b) fails to settle a third party claim timely or reasonably within policy limits.

### A. Failing To Provide A Defense.

In most states, and insurance company has a duty to defend any claim that is potentially covered under an insurance policy. The oft-quoted maxim is that an insurer's duty to defend is broader than an insurer's duty to indemnify. An insurer's "unreasonable" refusal to defend by itself may serve as a basis for bad faith liability. In other words, an insurance company's cavalier rejection of defense tender may constitute bad faith.

An insurance company that unreasonably delays a decision on that tender also engages in bad faith. The test of an unreasonable delay is whether the delay deprived the policyholder of benefits to which it was entitled under the policy. In the case of a pending third-party claim, such delay may be shown when the plaintiff obtains material advantages in litigation because the insurance company has not defended the policyholder timely.

Because insurance companies have a broad duty to defend policyholders against potentially covered claims, insurance companies have a duty to investigate such claims objectively and reasonably. If they fail to investigate a claim objectively and reasonably, they may be found to be acting in bad faith. The factors listed above in relation to First Party Cases are equally applicable in Third Party Cases.

### B. Failing To Settle Claims Timely Or Reasonably.

This broad duty to defend obligates insurance companies to settle third party claims reasonably. The rationale for this duty is that the insurance company has a conflict of interest when a settlement demand is made for amounts within policy limits, and when the claim might well succeed at trial for amounts in excess of policy limits. On the one hand, the insurance company has an interest in paying only amounts that it believes are reasonable, because it has assumed the risk of the claim. On the other hand, the policyholder generally has no interest in any settlement within policy limits, because it has no financial risk for those amounts. The insurance company is thus faced with the option of not settling a claim and capping its exposure at policy limits, while leaving the policyholder exposed for amounts in excess of policy limits.

This conflict of interest is underscored when the insurance company has full control over defense and settlement of a case, as policies often provide. Courts widely endorse the insurance company's full control over defense and settlement, because the insurance company is fully on the risk. They have wide discretion in controlling their risk; that discretion is limited when the policyholder comes to share in that risk.

Thus, an insurance company may be subject to a bad faith claim for refusal to settle a case reasonably when (1) the insurance company fails to accept a reasonable settlement demand by the third-party claimant for an amount within the policy's limits of liability; (2) the claimant makes a reasonable settlement offer within the policy limits and the insurance company rejects it; and (3) a monetary judgment is entered against the policyholder for an amount in excess of those policy limits.

So, what is a "reasonable settlement demand"? Generally, it is a demand for an amount that represents a figure that is within policy limits, but could well justify amounts in excess of policy limits, given the damages claimed and the probable liability of the insured. One test if whether a prudent insurance company without policy limits would have accepted the settlement demand. As a practical matter, any judgment for any amount in excess of policy limits is powerful evidence of what the risk was to the policyholder at the time of the settlement demand.

Bad faith can be found when the insurance company either rejects a reasonable settlement demand or it fails to accept it timely in accordance with the demand. Whether an insurance company has a duty to initiate settlement negotiations is unclear, but such a duty is more readily found if a third-party claimant communicated some interest in settlement and the insurance company failed to follow-up with it, or if the insurance company knew that a settlement within policy limits was feasible. Also possible is an insurance company's overly aggressive defense in which it effectively foreclosed the possibility of settlement.

Indeed, an insurance company's defensive posture can be used to justify a claim for bad faith in another respect. Some liability policies (typically D&O policies) are "burning limits" policies, meaning that defense costs are included within policy limits. In other words, an insurance company in control of the defense of a case is also in control of consuming the policyholder's available limits for settlement. If an insurance company has an opportunity to settle a case early within policy limits, but then, through litigation activity, it reduces the

amounts available under the policy to settle a case, the insurance company has effectively exposed the policyholder to excess liability unreasonably.

## IV. PREVENTING BAD FAITH ACTIONS.

The best way for insurers to prevent a bad faith accusation is to handle claims reasonably, fairly, consistently, and promptly (following all local claims handling guidelines and regulations). When policyholders believe they are being respected and heard, they are not less likely to misinterpret actions taken by an insurance company. Going the extra mile to ensure that all language used—in not only communications with the policyholder but also in internal communications—is polite, professional, and clear helps affirmatively establish good faith. Policyholders who sue for bad faith are most often the ones who feel they were mistreated by their insurance company. Keep in mind that the policyholders, who are the customers, are going through a difficult event and feel wronged. Although it is not the insurance company that caused the claim, proceed with care, mindful that those feelings might be misdirected.

Specific reminders and actions to consider include the following:

- As a precaution, assume that everything in the claim file will be discovered by the policyholder and reviewed by the court in a bad faith case. Reiterate the insurance company's paramount concern for the policyholder's interests and be sure to show your work when making careful and appropriate decisions. Maintain a written record of communications and actions taken, and avoid editorializing in ways that could be perceived as hostile toward the policyholder.

- Audit claims review guidelines with an eye toward how they would be perceived if they were presented to a jury during trial. Update any and all guidelines, training manuals, and policies to reflect the steps claims handlers should–and are–following, encouraging best practices and the individualized review of claims.

- Be mindful that some policyholders will be actively trying to "set up" a bad faith claim against the insurance company in order to leverage payment of an uncovered claim, especially when it appears that the limits purchased by the policyholder are insufficient and especially in jurisdictions where bad faith is relatively easy to establish. In these instances, resist the temptation to react defensively or prove what the policyholder is trying to do. Instead, redouble your efforts to be polite and document your reasonable efforts in hopes of diffusing the situation or at least mitigating potential damages.

- Extend reasonable courtesies and extensions of time to the policyholder if needed. Be willing to hear complaints and take action to address concerns raised. Narrow points of dispute if possible.

- Examine the policy looking *for* coverage for the claim, and ensure that any annotations and notes demonstrate this.

- Document using objective terms any lack of cooperation from the policyholder, and any accusations made and/or inconsistent positions taken by the policyholder. Make note of the origin of any details being relied upon by the insurance company.

- Timely respond to all communications, especially tenders. If a policyholder asks the insurer to provide a defense, agree to do so if warranted based upon the policy and the complaint, being mindful of which state's law applies and the applicable "duty to defend" principles.

- Follow up when you say you are going to (adhering to deadlines imposed by applicable law). Make it a practice to calendar a time to follow up if you have not received a response to and inquiry, and reiterate you are waiting for a response.

- Quickly pay any undisputed portion of a First Party Claim.

- If a policyholder submits a late tender and there is a duty to defend, document all consequences from the delay, including missed opportunities and things that would have been done differently, as contemporaneous evidence prejudice resulting from the late tender.

- When the defense tender is properly denied under governing law, explain the basis or bases for the denial and invite the policyholder to contact the insurer and provide additional information that will be considered.

- If coverage issues are strong, the insurer should consider reserving specific rights based upon the issues presented and, if it is economically feasible to do so, file a declaratory judgment action to obtain a legal ruling from a court. (As the policyholder may counter-claim for bad faith and seek recovery of attorney fees, an assessment of any potential bad faith exposure should also be considered.)

- Evaluate the strength of coverage issues, including the scope of coverage provided based on the policyholder's application materials, identify potential limitations. Communicate a definitive coverage position as soon as possible, and update it as circumstances change. Instead of the policy language, provide an explanation as to why each provision referenced relates to the claim presented. Be mindful of applicable legal principles, and consult with coverage counsel familiar with the applicable state's law if there are any questions. (A quick call to experienced coverage counsel will often allow you to confirm whether it is necessary to open a file for further evaluation.)

- If coverage issues are not strong, the insurer may wish to consider providing a defense without reservation, meaning the insurer waives the right to contest coverage in exchange for the right to control the defense. If there are concerns that limits may not be not adequate but the policyholder's defenses to liability are strong, the insurer may consider assessing whether to waive limits too.

- Develop and maintain good relationships with the policyholder, defense counsel, and the policyholder's personal counsel (if any); be proactive and keep the lines of communication open. Be sure to reiterate that defense counsel and the policyholder (not the insurer) are controlling the defense if the defense is being provided under a reservation of rights. Doing so should help provide the policyholder with assurances that there has been no abandonment and that the insurer supports the policyholder's defense strategies and stands ready to make a reasonable settlement offer if warranted.

- Respond promptly to settlement demands. Acknowledge requests and ask for an extension of time and additional information if needed, and keep the file well documented. Consult with the policyholder and defense counsel and consider (and document) their views.

## VI. STRATEGIES FOR PURSUING CLAIMS AGAINST INSURANCE COMPANIES.

A policyholder intending to pursue a bad faith claim against an insurance company must be prepared and must be resolved. Insurance companies do not take lightly an accusation they have acted in bad faith and they will defend against such claims vigorously. Accordingly, the policyholder should endeavor to prevent an insurance company from acting in bad faith by offering advance warnings and demonstration. If the policyholder fails to succeed in preventing bad faith conduct, it will at least have created a useful record in support of a later claim.

Following are three general strategies to consider in preventing or developing a policyholder's claim for bad faith: (A) Justifying risk of excess policy limits damages; (B) Assignment of bad faith claim to the third-party claimant; and (C) Pursuit of bad faith litigation discovery.

### A. Justifying Risk Of Excess Policy Limits Damages.

Because an insurance company on a third-party claim has a duty to settle the case reasonably within policy limits, the policyholder's first objective is to demonstrate the reasonableness of the third-party claim. Demonstration of that claim may involve detailed analysis showing the likelihood that the third-party claim will exceed policy limits. Many policyholders are reluctant to engage in an analysis to make the case for the claimant because they are focused on defending against the claim. But that focus does not advance their interests in getting the insurance company to settle the claim. The insurance company will only be persuaded to settle a claim if it can see a realistic possibility of a judgment for the full amount of policy limits. Indeed, the policyholder is often better poised than even the claimant to make this case, because the policyholder is likely more aware of facts justifying its liability than the claimant knows. The policyholder must not be shy in articulating those facts and it should provide the insurance company with all information available to justify that position. It goes without saying that such a demonstration should be made through a meticulous paper trail, because that trail will be needed in the event the policyholder is required to prove its bad faith claim against the insurance company for refusal to settle a claim reasonably within policy limits.

In cases of "burning limits" policies, the policyholder must show that the insurance company unreasonably failed to settle a case reasonably within policy limits, less those burned by defense costs. Thus, the policyholder must take into account what is remaining on the policy in demanding that the insurance company settle the case. If the insurance company is controlling the defense and has unreasonably exhausted policy limits through defense tactics, the policyholder should be quick to describe how it has done so and to demand that the insurance company absorb such defense costs in settling the case.

Untested is what might happen when the plaintiff's settlement demand is for an amount in excess of policy limits, but where the policyholder advises the insurance company that it is willing to fund the excess amounts in order to avoid a judgment that will be far in excess of the plaintiff's demand. The same principles would seem to apply. If, with the policyholder's contribution, the insurance company had the opportunity to settle a case reasonably within policy limits and failed to do so, the insurance company should be liable for any judgment in excess of what the policyholder offered to contribute. The rationale seems readily justifiable -- but for the insurance company's refusal to contribute to the settlement, the case would have settled and the policyholder never would have been exposed to an excess policy limits judgment.

Conversely, the policyholder's financial status is irrelevant in determining the insurance company's obligation to settle a third party claim. The policyholder may be insolvent or judgment-proof and the insurance company must still honor its policy obligations. Indeed, if the policyholder is threatened with insolvency or bankruptcy from the third party claim, it should not hesitate to warn the insurance company that it will seek to hold it responsible for that insolvency if the insurance company fails to settle the claim when it reasonably should be settled.

How much time does an insurance company need to investigate and evaluate a claim? Obviously, it depends on local regulations and, in some instances, on the surrounding circumstances. The longer an insurance company has had to investigate and evaluate a claim, the less time it should need to respond to a settlement demand. Completion of discovery, or substantial completion of discovery should be one guide. Again, if the policyholder can reasonably assess excess exposure, the insurance company should be able to do so, too – even on short notice, as right before trial or during the course of trial.

Inasmuch as the policyholder should endeavor to keep the insurance company informed about the excess exposure of the claim, the policyholder should document, and point out to the insurance company when evident, the insurance company's record in investigating the claim. To some courts, the adequacy of investigation is "[a]mong the most critical factors bearing on the insurer's good faith." The reasonableness of an insurance company's refusal to settle a claim will be judged in light of the adequacy of its efforts to investigate and evaluate the claim. While the insurance company is charged as a matter of law with constructive notice of facts that it could have learned had it investigated the claim properly, it certainly helps a bad faith claim to point out what the insurance company should be investigating along the way.

## B. Assignment of Bad Faith Claim to Claimant.

If a policyholder has exhausted all attempts to get the insurance company to settle a Third-Party claim within policy limits, the policyholder has a fall-back option -- negotiate directly with the claimant and see if the claimant will accept an assignment of the bad faith claim against the insurance company. The claimant then steps into the shoes of the policyholder and pursues a claim directly against the insurance company. This option can be tantalizing to a claimant when the policyholder has created a good record against the insurance company, demonstrating the strong likelihood of an excess policy limits claim, and when the claimant has made a policy limits demand that the insurance company has rejected. Depending on the likelihood of that claim and the money damages available, a claimant may well wish to pursue a higher award against the insurance company. The policyholder can thus extricate itself from the suit by assigning its bad faith claim to the claimant in exchange for a covenant not to execute any judgment taken against it or to record the judgment as a lien on the policyholder's property. Such an agreement can be made without the insurance company's knowledge or consent.

Of course, the policyholder will have to establish from a clear record that the insurance company refused to accept the policy limits demand, knowing all the risks and likelihood of an excess policy limits judgment. Moreover, such an assignment will be invalid if it is the product of fraud or collusion between the claimant and the policyholder. Collusion occurs when the those parties work together to manufacture a bad faith claim against the insurance company or to inflate the claimant's recovery to artificially increase damages flowing from the policyholder's breach. Factors used in determining whether such an assignment is made in good faith:

- Any amounts the policyholder may have paid in that settlement in view of the value of the claims asserted;
- Comparison of similar awards in similar cases;
- The facts known to the policyholder at the time of settlement;
- Presence of a covenant not to execute as part of the settlement;
- Failure of the policyholder to assert viable defenses.

Strong caution should be exercised in negotiating such an agreement, because the policyholder remains subject to the cooperation clause in the policy. Every policyholder has a duty (usually expressed, implied in law, if not) to cooperate reasonably with the insurance company in defense of a claim. That duty includes such things as not making admissions or prejudicing the insurance company in the defense of the case. Because the insurance company often times remains in control of the defense of the case, the policyholder may not do anything to prejudice the defense of the case. This means the claimant must evaluate on its own whether it is worth taking the assignment in exchange for a covenant not to execute against the policyholder. In a case of clear liability or the prospect of large damages (in excess of policy limits) a claimant might eagerly take that claim without having obtained any inside information from the policyholder. The policyholder considering this option must therefore limit its contacts to paper as much as possible to prevent the insurance company from claiming that collusion had occurred. The policyholder must also consider whether it is willing to allow an adverse judgment to be entered against it, as a judgment is usually a precondition to the assignment.

### C. Pursuit Of Bad Faith Litigation Discovery.

Once the policyholder has decided to commence active litigation against an insurance company to pursue a claim for bad faith, the policyholder will need to focus discovery efforts on those facts that will support a claim for bad faith. Following are factors that assist in determining whether an insurance company has evaluated a claim properly:

- Did it weigh the facts in light of the applicable standards in the community?
- Did it consider the strengths and weaknesses of all the evidence on either side?
- Did it carefully consider the probabilities of an adverse verdict and its anticipated range?
- Did it obtain and consider past results of similar claims?
- Did it consider the experience and capabilities of counsel?
- Did it consider whether the claimant would be a sympathetic witness?
- Did it consider whether the insured and its witnesses would be sympathetic?
- Did it consider the policyholder's recommendations about the exposure and risk of loss?

In view of the above principles, the kind and extent of discovery to be undertaken against an insurance company to develop a bad faith claim should be readily apparent. Following are general categories of information and strategies to keep in mind.

#### 1. The Claims File.

Seek discovery of the claims file. This file should include all documents the insurance company prepared or reviewed in determining whether to accept or deny the claim. Sometimes it may include helpful evidence showing that the insurance company acted wrongfully in denying the claim. See if the claims examiner used marker pen to highlight only the evidence in the file supporting the denial. It will also serve to circumscribe the investigation undertaken and whether it was thorough, or objective, or sought to find a basis for coverage.

Seek discovery on why any delay to a settlement demand occurred. Evidence that the insurance company concealed its unwillingness to settle for an unreasonable period of time, knowing the delay was harmful to the policyholder, may support a bad faith finding.

Some care may need to be taken in determining the suitability of whether the claims adjustor sought reasonably qualified legal advice in the issue of settlement. An insurer's rejection of counsel's advice to settle in order to gamble on a defense verdict, if discoverable, could be evidence of bad faith.

Never settle a bad faith claim without reviewing the claims file, as it could have powerful information that could otherwise greatly enhance the strength of the bad faith claim. Indeed, if an insurance company wishes to settle before producing its claims file, chance are good the file contains good evidence.

#### 2. The Underwriting File.

Seek discovery of the underwriting file. This file will contain the information available to the insurance company when it sold the policy to the policyholder. It may well include information acknowledging that claims of the kind later denied were intended to be covered.

**3. Internal Policies, Procedures, Guidelines.**

Seek discovery of all internal policies, procedures, and guidelines of the insurance company in relation to its handling of the clam. Such information should include the insurance company's interpretation of the policy language at issue and all documents regarding its interpretation of the language. Evidence may show that the insurance company understood that the language was ambiguous, in which case it should have resolved all ambiguities in favor of the policyholder. Evidence may also be found showing that the handling of the claim was inconsistent with the insurance company's own guidelines or internal policies.

**4. Training Materials.**

Seek discovery of all materials and or training requirements the insurance company provides its representatives. Such evidence may show that the insurance company failed to train its employees properly or, alternatively, its employees failed to act in accordance with their training. Exercise of good faith includes an investigation made by persons reasonably qualified to make a decision respecting the risks involved and lack of proper training may support a finding that the claim was not handled in good faith.

**5. Advertising Materials.**

Seek discovery of all advertising documents regarding the policy at issue. Insurance companies often make sweeping promises that are useful in comparing against their actual practices of honoring claims.

**6. Pattern And Practice Discovery.**

Seek discovery on other similar acts of misconduct, by seeking discovery of all other claims or lawsuits filed against the insurance company. Such discovery is relevant in bad faith actions, because it can show that the insurance company engages in a "pattern and practice" of handling claims unreasonably. Evidence of other claims made against the insurance company may be relevant to show that the insurance company engaged in the same wrongful behavior here.

Sometimes, discovery of such claims may require the disclosure of confidential patient information. In that case, discovery may proceed by way of special notices to the other policyholders seeking authorization of their claims file information to produce in discovery, subject to a confidentiality agreement entered into between the parties. Such notices are likely to result in authorizations, because other claimants had likely encountered similar frustrations and experiences.

### 7. Claims Personnel.

Seek discovery of all individuals who were involved in handling the claim. Then, in deposition discovery, determine (a) their training experience; (b) what they did in relation to the claim; (c) whether they handled the claim consistent with the way the company instructed them to handle it; (d) whether they were criticized or reprimanded for anything they did in relation to the claim; (e) whether the company changed the way it operates after handling the claim.

## VII. STRATEGIES FOR DEFENDING AGAINST BAD FAITH CLAIMS.

### A. Early Resolution.

As soon as bad faith litigation by the policyholder or by the claimant (directly if allowed in the jurisdiction, or by an assignment to the claimant) becomes imminent, the insurance company should explore settlement. Although it is not always feasible to raise the issue with the policyholder, it should be considered internally within the insurance company as a business decision. Factors that weigh in favor of settlement include a relatively low amount demanded, involvement of egregious claim facts that could inflame a jury even if there are no concerns with the claim handling, litigation is in an anti-insurer jurisdiction, and/or the policyholder's counsel is known as someone who is difficult and expensive to litigate against. As litigation progresses, settlement should be considered at each stage, considering not only these factors but also how litigation is going, how costly it will be to continue, and whether there is a risk of setting bad precedent.

In deciding settlement authority, consider the following (non-exclusive) factors bearing on breach of the duty to settle, and be sure to keep written records of factors considered:

- The strength of the injured claimant's case on the issues of liability and damages
- The adequacy of the insurer's investigation and evaluation
- The adequacy of the policyholder's policy limits and the consequent risk to which each party (insurer and insured) is exposed in the event of a refusal to settle
- Willingness or refusal to negotiate and the resulting "climate for settlement"
- Any other action by the insurer demonstrating greater concern for the insurer's monetary interest than for the financial risk attendant to the insured's predicament

If coverage issues are present that could impact the amount of settlement authority extended, also consider:

- Whether the insurer issued a timely and specific reservation of rights letter
- Whether the insurer attempted, through a declaratory judgment action or otherwise, to resolve the coverage issue in a way to limit the potential prejudice to the policyholder
- The substance of the coverage dispute, including the weight of legal authority on the central coverage issues
- The thoroughness of the insurer in investigating the facts relevant to the coverage issue
- Whether the insurer made efforts to settle the liability claim that were consistent with the strength of its coverage position

Also consider the general nature of the claim, including:

- The extent of injuries/damages and the egregiousness of facts
- Whether the claimant is sympathetic in a way that could motivate the court to find coverage regardless of the policy terms
- the policyholder's views on the case (whether the policyholder's strategy is to contest liability and damages, or whether the policyholder is desperate to settle), as these subjective views could motivate a policyholder to agree to an adverse judgment and an assignment of rights to the claimant

"Early resolution" does not need to mean settlement. Many clients prefer to stand by their position on principal, and not simply settle a claim to avoid the cost of litigation. But the cost of litigation often makes this difficult, inefficient, and a waste of judicial resources. Attorneys for both policyholders and insurers alike should therefore work creatively together to resolve differences of opinion in economical ways while still satisfying their client's disinclination to surrender.

More often than not, a coverage dispute does not turn on a disputed issue of fact, but rather on a disputed application of policy terms to the facts. Attorneys for either side should propose to their counterpart that the disputed issue be resolved on cross-motions for summary judgment on stipulated facts. Or if there are only one or two important disputed facts, agree to limit discovery to those few issues. It serves neither client to take a multitude of depositions, review warehouses full of old documents, and spend court time fighting motions to compel. Rather, if the facts are essentially known and undisputed, counsel should work together to identify an appropriate legal issue and stipulate to the background facts necessary to set up this issue for judicial resolution. Typically, even if the court's decision does not resolve the entire case, it will resolve enough for the parties to settle the remaining issues. This makes the practice of law more satisfying and interesting than spending hours on discovery.

Too many attorneys think they can beat their opponent into submission, but this is never true. The response is almost always in kind, yielding a war of attrition. Think of full-blown litigation instead as mutually assured destruction (MAD): something neither side wants and should avoid at all cost.

### B Forum Selection and Counterclaims.

Upon receipt of a bad faith lawsuit filed by the policyholder, the insurance company immediately assess the forum selected by the policyholder. If suit was filed in state court, consider whether diversity jurisdiction exists and, if so, whether to remove the case to federal court or, if the action is pending in federal court, whether to remand to state court. Depending on the specific jurisdiction, moving the litigation to an alternate forum less desirable to the policyholder (based upon the local bar's view of judges, jury pools, procedures, or other factors) can in the right case serve as a strong leverage point to encourage settlement of the claim.

Other considerations are whether the policy has enforceable arbitration or forum selection clauses and/or whether preconditions before suit can be filed have been satisfied, and whether there are restrictions on the timing of when suit can be filed by the policyholder.

The insurer should also assess whether to assert counterclaims against the policyholder as permitted by the applicable state's law and the facts presented. Examples include declaratory relief, rescission based upon material misstatements in the application, fraud in the submission of the claim, and, in some jurisdictions, claims for damages for the policyholder's "reverse bad faith" conduct toward the insurer.

### C. Statutory Settlement and Judgment Offers.

The widespread availability of attorney fee awards to prevailing policyholder plaintiffs in bad faith litigation often creates a disparity in bargaining power between the insurer and its policyholder, and tension between the policyholder and his or her counsel who has an incentive to work up the case. In some—but not all—jurisdictions, however, there are court rules and statutes that allow insurers to recover their prevailing party attorney fees in bad faith cases if a formal settlement offer is not accepted.

The court rules and statutes that govern offers of judgment and offers of settlement vary greatly from jurisdiction to jurisdiction. Some operate to shift fees and costs, and trigger steep interest rates. Under these rules and statutes, policyholder plaintiffs are incentivized to cease litigation and accept the offer. The impact of other types of offers of judgment and offers of settlement is to enable the insurer defendant to recover relatively minimal "costs" incurred by the policyholder from that date going forward. These latter types of offers are "toothless" in practice, and as a result offer little leverage to insurers in their effort to achieve early resolution. It is therefore imperative to determine the governing rules and practices early in litigation to assess whether an offer of judgment or an offer of settlement could be a powerful fee-shifting strategy. The governing rules applicable to the dispute must be considered at the outset of bad faith litigation.

### D. Bifurcation.

Bifurcation of coverage issues from bad faith issues, or of liability from damages, is an idea that should be considered early in the case in an effort to minimize costs and prevent the jury from hearing evidence that could taint its determinations. In the right case, it might also make sense for the insurance company to concede coverage or liability in order to have the jury solely focus on the policyholder's difficult task of proving resulting damages in isolation.

For purposes of discovery, sometimes an agreement can be reached that discovery be undertaken in phases, with discovery on bad faith permitted if, and only if, the policyholder can first prove that there is coverage. Limited discovery followed by cross motions for summary judgment is an idea that the policyholder might agree to, especially in those states that do not allow bad faith claims if the insurer's coverage determination is deemed correct. If the policyholder will not agree, then the insurer should consider whether to seek bifurcation from the court.

### E. Narrow the Scope of Discovery.

In addition to exploring bifurcation of discovery in phases, insurance companies should consider other ideas to narrow the scope of discovery. Policyholder counsel often do not want to expend time and resources culling through documents or traveling to take depositions, and as such may be willing to agree to prioritize targeted discovery and defer the decision of whether additional discovery might be needed until after the dynamics of the case become clearer. An early willingness to be flexible on scheduling, perhaps to stipulate to extensions of discovery deadlines, and to consider telephonic or video depositions to avoid travel is a strategy to consider to build trust and allow for a focused and more civilized litigation that will benefit all parties and counsel.

In responses to interrogatories and during depositions, it is important to continue to convey a reasonable, polite, and professional "good faith" approach. Although policyholder counsel has already agreed to take the case (meaning he or she sees value in the policyholder's claims against the insurer), each time the insurer takes a reasonable position or presents the circumstances in a reasonable and thoughtful way, the policyholder's counsel will be forced to reevaluate the initial valuation assessment.

Addressing far-reaching discovery, such as requests for the insurer's responses to all claims of a certain nature or other requests that are not readily available, the insurer should consider moving for a protective order that asks the court to prohibit such discovery or, alternatively, ask the court to order the policyholder to pay the insurer's personnel expenses required to undertake such a search. Confidentiality considerations should always be evaluated, as an insurer cannot risk exposing itself to bad faith liability to other policyholders by virtue of actions taken to comply with one policyholder's request. If it becomes absolutely necessary to produce information about other claims, confidentiality agreements should be in place that restrict the sharing of that information and any filings should be made under seal if possible.

Other general discovery considerations are to examine discovery requests closely, as many requests are worded in a way that the response is that no such documents exist. Most discovery requests are "stock" and not thoughtfully tailored to the case. As such, policyholder's counsel's level of interest in the responses can vary. Resist the temptation to interpret the "gist" of a request; give the answer that is technically requested and no more, unless there is a strategic reason to provide an explanation. If the policyholder is interested, follow up will come in supplemental written discovery or depositions.

### F. Summary Judgment.

At the outset of a case and as evidence is developing, insurance companies should focus on the legal elements the policyholder has the burden of proving. Often times, policyholder counsel evaluate and agree to take a case because there is a sympathetic policyholder who is credible and the victim of unfortunate circumstances. Even if this is true, a policyholder unable to prove the elements of bad faith cannot prevail as a matter of law. One possible way to avoid having an emotionally charged case go to a jury is to win dismissal on summary judgment.

Although reasonableness is most often a question of fact for the jury to assess based upon competing experts, consideration should be given to whether the policyholder can establish a causal link between damages and the insurer's allegedly unreasonable conduct. If, for the purposes of summary judgment only, unreasonableness is conceded, it is often difficult for the policyholder to come forward with proof of causation and resulting damages sufficient to survive summary judgment.

### G. Jury Selection and Trial Themes.

If a bad faith case is going to be tried to a jury, the selection of jurors is critically important. Policyholder counsel often use voir dire and questionnaires to incite anger against insurance companies, reminding jurors of every bad experience they have ever heard of with an insurance company. How the insurer responds to this is critical, especially in anti-insurer jurisdictions. Some techniques to consider are to embrace the rage, and ask the jurors what the insurer could have done differently—hoping to elicit actions that were done in your case. If the stories told have to do with other kinds of insurance, or circumstances along ago, it might be beneficial to distinguish the case being tried from the horror stories. Another idea is to describe the importance of insurance, focusing on the origins of fire insurance as a community benefit with origins in helpful neighbors. Before insurance, if one house burned down, the neighbors would take up a collection to help the family make repairs. Modern insurance follows the same idea, though proactively. If the wrong person tried to collect the proceeds, perhaps because he or she did not pay premiums for that type of insurance or for some other reason, then of course the neighborhood would agree that there should be no coverage. Ask a lot of questions to try and identify jurors who are able to see the other side and are suspicious of policyholders trying to take advantage of the system. Potential jurors with an anti-corporate philosophy should be questioned, as they often will view insurance companies as nameless and faceless, evil entities that can and should make payments without regard to right or wrong in any given case and often will not be shy about saying so.

Trial themes in bad faith cases depend upon the facts of the case, but should all focus on the humanity and individuality of the people who make up the insurance company. Every reasonable and polite communication should be highlighted. Every accommodation and file note that shows efforts being made to help the policyholder should be mentioned. Possible themes, depending on the case, include "we went above and beyond to help our policyholder through this tragedy" and "our policyholder suffered from this [natural disaster, vindictive lawsuit, etc.] and is, unfortunately, misdirecting his or her anger." Even if there was conduct early in the case that could be problematic, having trial counsel present the case in a reasonable and non-defensive manner can go a long way toward diffusing jury ire.

### H. Appeal.

Whether the jury's verdict is favorable or not, there is the possibility of an appeal. At this point, settlement is often discussed with abandonment of an appeal used as a bargaining chip. Before a decision is made whether to pursue (or defend) an appeal, the insurance company should give serious consideration to the strengths and weaknesses of an appeal, as they differ significantly from considerations at the trial level. In addition to the associated expenses in

paying the insurer's litigation counsel and, if the policyholder succeeds, in paying the policyholder counsel (as fees are awarded to prevailing policyholders in in most jurisdictions), insurers should consider:

- The potential broader impact on the insurance industry, obtaining a ruling that could become precedent and govern cases in the future;

- Including in the readily-accessible public record the details of the bad faith case;

- How arguments will present in writing on a cold record, without the benefits and detriments of the in-person likeability emotional factor;

- The standard of review—whether the appellate court will defer to trial court rulings on key issues, or whether issues will be addressed without deference;

- How well the trial court record has been developed and issues preserved for appeal;

- The ability of the legal issues to be simplified and persuasively explained to a three-judge panel that is unfamiliar with insurance, pressed for time, and concerned with the potential impact of legal rules on future cases (as opposed to the equities of the facts presented);

- The status of statutory and case law, and prevailing political leanings;

- The tolerability of the status quo pending appeal, which could involve the expense of posting a supersedeas bond, as the appeal could take years

## VIII. ATTORNEY-CLIENT PRIVILEGE ISSUES.

Attorney-client communications, simply speaking, are not privileged. That statement is not just for shock value, it is prudent advice.

That may surprise clients and even many lawyers. If it does, these clients have a problem: sensitive communications transmitted on the assumption of confidentiality may one day be ordered produced under a multitude of exceptions that now exist under the law. As the law has developed to erode the privilege, lawyers and clients—and especially insurance companies and their lawyers—may decide to operate on the assumption they will one day be compelled to produce their communications. They may prefer to avoid frank communication out of concern for creating written communications that could be troublesome in future litigation.

### A. Confidence in Confidentiality Is the Cornerstone of the Privilege and Necessary to Achieve Its Purpose.

Distrust in the attorney-client privilege guts its purpose. The purpose of the attorney-client 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.

But this purpose cannot be achieved if the participants do not have full confidence that confidentiality will be preserved. The free-flow of information and the twin tributary of advice are the hallmarks of the privilege. For all of this to occur, there must be a zone of safety for each to participate without apprehension that such sensitive information and advice would be shared with others without their consent.

When attorneys and clients lack confidence in the privilege, the value dissipates. They simply will not engage in the desired full and frank communications if the law creates a realistic possibility that a court will one day force disclosure. When the law reaches the point where the risk of disclosure makes frank communication too dangerous, lawyers and clients will operate on the assumption that the communication will be produced. Many lawyers have already concluded that it is no longer safe to count on the attorney-client privilege.

### B. Attorney-Client Communications, Without More, Are Not Privileged

Many regard the strict confidentiality of attorney-client communications as a truism, a mantra repeated in television legal drama, higher education, and even in the highest courts of the land. The attorney-client privilege is the oldest of the privileges for confidential communications known to the common law. So the assumption that these communications are privileged is sensible and justified.

But that assumption is still wrong, or at least imprudent. The attorney-client privilege is often narrowly defined, riddled with exceptions, and subject to continuing criticism. Grand as the privilege stands in our legal lexicon, it is nonetheless narrowly defined by both scholars and the courts. The attorney-client privilege is not given broad, unfettered latitude to every communication with a lawyer, but is to be narrowly construed to meet this narrowest of missions.

Under the California Evidence Code, for example, a communication between an attorney and client, without more, satisfies only the first three of six elements required to establish the privilege. The party claiming privilege must show:

(1) Attorney: a person authorized to practice law;

(2) Client: a person who consults a lawyer to secure legal service;

(3) Information transmitted between a client and lawyer;

(4) In the course of that relationship;

(5) In confidence by a means which discloses the information to no third persons, and

(6) Includes a legal opinion formed and the advice given by the lawyer.

If any of the last three conditions are not satisfied, the attorney-client communication is not privileged. And even if all six conditions are satisfied, parties seeking production of the communication have a multitude of waiver theories at their disposal.

### C. Insurance Companies in Particular Face Hurdles in Preserving the Privilege

Insurance lawyers and clients should be especially concerned with the erosion of the attorney-client privilege due to three common situations that lead to production of their communications: (1) the "at issue" waiver, e.g., when the insurance company seeks to defend a bad-faith claim by asserting that they reasonably relied on the advice of counsel; (2) the implied waiver, i.e., when a court finds that merely denying bad faith (or general assertions that the claim was handled properly under the law) automatically puts the attorney's advice at issue; and (3) when the attorney is not serving in the role of an attorney as defined by the last three legal elements, e.g., when they conduct a factual investigation or offer guidance on company policy or give business advice, rather than legal advice.

Insurance companies and their lawyers can take steps to increase the likelihood of preserving the privilege, as discussed further below. But, despite best efforts, the law does not give sufficient clarity and certitude in the ultimate confidentiality sufficient to justify the risk of frank communication. They are thus tempted to take the safer route of assuming disclosure. This article addresses each of these situations and recommends steps to help preserve the privilege, but nevertheless recognizes that the law is, in certain contexts, too inconclusive to give the confidence necessary to serve the purpose of the privilege.

### D. The "At Issue" Waiver: Advice of Counsel Defense

The attorney-client privilege is waived when the client puts the privileged communication at issue in litigation. For example, a client can be held to have waived the privilege when it alleges that it relied on the advice of counsel, misunderstood terms of an agreement, or diligently investigated a claim with the assistance of counsel.

Courts generally apply a three-part test to determine whether a party has put the advice at issue: (1) a party asserting privilege must take an affirmative act that (2) makes the protected information relevant to the case, and (3) application of the privilege would deny the opposing party access to information vital to defending against the affirmative assertion.9

Other courts say this "relevance" standard is too broad, and require that the party asserting the privilege specifically rely on privileged communications for a claim or defense or as an element of a claim or defense.

Either way, merely denying an allegation should not result in an "at issue" waiver under this rule. Where the opponent injects attorney-client communication into the case, the privilege has not been waived.

For insurance companies, at-issue waiver occurs most commonly when the company argues that it had a good-faith reason to deny coverage because it reasonably relied on the advice of its counsel. Ideally, the company would decide at the outset of the claim whether to assert the defense, and hire counsel specifically for this purpose, rather than hiring the attorneys it intends to use for future coverage litigation. Under this scenario, both attorneys and clients can conduct their communications with full recognition of the likely disclosure.

However, even if this decision is not made at the outset, attorneys and clients must always recognize the possibility that circumstances may arise in the future to justify assertion of this defense. Indeed, a lack of care in these communications during the claim may limit the client's future options in asserting this defense. Accordingly, clients and lawyers are well-advised to assume throughout the claim process that the communications will be released.

### E. Implied Waiver: Some Jurisdictions Find that Simply Opposing a Claim of Bad Faith Waives Privilege

The most significant erosion of the attorney-client privilege over the last twenty years arises from the implied-waiver doctrine. Courts in Ohio, Delaware, and Arizona hold that insurance companies can waive the privilege even without asserting the advice-of-counsel defense.

In *Tackett v. State Farm*, 653 A.2d 254, 259 (Del. 1995), State Farm denied that there was "any unreasonable justification for denying" coverage. The Delaware Supreme Court ruled that State Farm's denial put the privileged communications at issue, as counsel's advice could lead a jury to find against State Farm on its "assertion" (i.e., its denial of the allegation).

Where, however, an insurer makes factual assertions in defense of a claim which incorporate, expressly or implicitly, the advice and judgment of its counsel, it cannot deny an opposing party an opportunity to uncover the foundation for those assertions in order to contradict them.

In *Boone v. Vanliner and Moskovitz v. Mt. Sinai Medical Center*, 744 N.E. 2D 154 (Ohio 2001), the Supreme Court of Ohio ruled that the attorney-client privilege did not protect communications if they were conducted in the context of claims handling and could be used to show bad faith: "Documents and other things showing the lack of a good faith effort to settle by a party or the attorneys acting on his or her behalf are wholly unworthy of the protections afforded by any claimed privilege." Thus, "neither the attorney-client privilege nor the so-called work production exception precludes discovery of the contents of an insurer's claims file."

In *Boone*, the Ohio Supreme Court clarified that the doctrine applies to pre-denial communications: "[W]e hold that in an action alleging bad faith denial of insurance coverage, the insured is entitled to discover claims file materials containing attorney-client communications related to the issue of coverage that were created prior to the denial of coverage."

In *State Farm v. Lee*, 13 P.3d 1169 (Ariz. 2000), State Farm argued that it was acting on its good-faith understanding of the law, but it did not argue that it was relying on its lawyer's advice. The Arizona Supreme Court found the two arguments inseparable: a client's reliance on its understanding of the law puts at issue its attorney's advice on that law. The Arizona Supreme Court did not purport to apply the implied waiver theory: "We also agree that mere denial of the allegations in the complaint, or an assertion that the denial was in good faith, is not an implied waiver."

Yet implied waiver was, in effect, the consequence:

> But as our cases have shown, a litigant's affirmative disavowal of express reliance on the privileged communication is not enough to prevent a finding of waiver. When a litigant seeks to establish its mental state by asserting that it acted after investigating the law and reaching a well-founded belief that the law permitted the action it took, then the extent of its investigation and the basis for its subjective evaluation are called into question. Thus, the advice received from counsel as part of its investigation and evaluation is not only relevant but, on an issue such as this, inextricably intertwined with the court's truth-seeking functions.

The Arizona Supreme Court's finding in *Lee* makes sense in theory, but in practice it puts the insurance company in a precarious situation as to what it might say in litigation that a court could find puts counsel's advice at issue. An insurance company cannot know in advance whether a court might apply Lee to find a waiver in a multitude of circumstances: if an adjuster testifies in deposition that she sought guidance from the legal department before denying; if she testifies about the company's reasoned practice in interpreting and applying a policy exclusion; or if she testifies that she conducted a full claim investigation. At the time of the communication, the attorney and client have no idea what future statement might be made in litigation that could be construed as a waiver under this rule.

Whereas the "at issue" waiver doctrine brings certitude at least at the time the insurance company decides to assert the defense, the implied waiver doctrine offers little certitude at any point. For any insurance companies handling claims in states that follow some version of the implied-waiver doctrine, attorneys and clients, to be safe, may simply assume that their communications in claims handling will not be kept confidential.

### F. Lawyer Playing the Role of a Lawyer

While the first two situations discussed are focused on attorneys involved in the underlying claims-handling process, both claims and litigation counsel may lose privilege to the extent they take actions that do not appear connected with legal advice.

As noted above, to be privileged, an attorney-client communication must also meet three additional requirements. The communication must be in the course of that relationship, in confidence by a means which discloses the information to no third persons, and include a legal opinion formed and the advice given by the lawyer.

These elements leave substantial ambiguity concerning how any one jurisdiction might apply them in a particular case.

In some jurisdictions, coverage counsel's communications with its insurance company client are only protected by the attorney-client privilege if the attorney is providing legal advice about the insurer's potential liability. If counsel is "acting as an adjuster," then the communications are not protected in some jurisdictions. In an abundance of caution, insurance companies should, as a matter of course, segregate and separately label communications with counsel that address legal advice about the insurer's potential liability, and communicate about investigatory and claim processing matters with the expectation that the policyholder and the court will see them at some point.

- Limit the scope of representation and communications to evaluations of the insurer's potential liability

- Avoid communications that could be misinterpreted as if counsel were "investigating and evaluating and processing the claim" that the insured may be entitled to discover if bad faith is alleged

- In the event counsel is needed to assist with claims handling tasks, such tasks and communications should be segregated to facilitate disclosure, if required, while maintaining protections for communications that address evaluations of the insurer's potential liability

For example, any communication that appears primarily factual, and not intertwined with legal advice, is at risk. Purely factual documents prepared and sent to a lawyer may be held not to be privileged because facts alone are not privileged. Likewise, a lawyer's interview memorandum in an investigation was held not privileged because no groundwork was laid with the witnesses to ensure confidentiality. Counsel's memoranda that simply transmitted factual information might not be privileged because the lawyer is merely acting as a conduit for factual data.

But if the same documents stated that the factual information was prepared in order to seek or give legal advice, ideally framing or answering a specific legal question in the document itself, it should be preserved as a privileged attorney-client communication. Factual investigations performed by attorneys as attorneys fall comfortably within the privilege.

It can be difficult to predict where a court will draw the distinction between simply factual information and factual information tied to legal advice. As courts have drawn sometimes subtle distinctions, attorneys and clients have little choice but to err on the side of safety by drafting such communications on the assumption it will be produced.

Similar problems arise when legal advice is distributed broadly. Privilege is not waived just because non-lawyers forward the attorney's legal advice to other non-lawyers, but all recipients must be among those that "need to know" the legal strategy. Otherwise, sharing privileged information too broadly within the company or with people that do not "need to

know" defeats or waives the privilege, as it suggests the speakers did not consider the communication to be confidential in the first place. How a court might determine who "needs to know" the advice in any particular case creates uncertainty that further undercuts the purpose of the privilege.

A larger problem occurs when the distinction between legal advice and business advice is blurred. Business advice or statements of corporate policy are not privileged.

There is general agreement that the protection of the privilege applies only if the primary or predominate purpose of the attorney-client consultations is to seek legal advice or assistance. There are substantial policy reasons for holding that business documents submitted for attorney review are not by that virtue automatically exempt as privileged or work product protected communications.

This distinction between business and legal advice is especially difficult for insurance companies because their business requires them to interpret and apply contract terms. In effect, insurance companies are in the business of legal interpretation. Insurance lawyers and clients cannot predict easily whether advice on interpretation of an insurance policy constitutes legal advice or business advice. The attorney can best protect himself by taking extra steps to establish privilege, e.g., by citing case law and expressly characterizing the analysis as a legal opinion.

In-house counsel for insurance companies faces extra scrutiny. The law recognizes a "presumption" that "communications to outside counsel" primarily relate "to legal advice," under *Diversified v. Meridith*, 572 F.2d 596 (8th Cir. 1977). But the *Diversified* presumption is not "applied to in-house counsel." Though costly, hiring outside counsel automatically increases the likelihood of attorney-client protection.

These cases offer guidance on how corporations can best preserve the attorney-client privilege. In summary, attorneys and clients should do whatever possible to emphasize that the attorney is acting in his or her role as attorney, by asking for and giving legal advice expressly and treating the communications confidentially. However, it is often difficult to know at the time of the communications what precautions will be sufficient, or if any precaution will be sufficient. Therefore, even when taking these precautions, attorneys and clients may choose to assume the worst—that the documents will be produced—and structure their communications accordingly.

These concerns are not merely theoretical. Some insurance attorneys already have resolved not to put any sensitive advice in writing. The risk of future production is too great.

## IX. CONCLUSION.

Bad faith claims can create a number of complex legal problems, whether you are approaching them as counsel for the policyholder or the insurer. Often, the line between acting in good or bad faith can seem unclear when coverage of a claim is delayed or denied. Insurers face legal action stemming from bad faith claims if the policyholder believes the insurer did not handle the investigation, discovery and litigation of coverage adequately and ethically. The above discussion is intended to provide insight regarding an insurance company's obligation to

act in good faith with its policyholder, and a policyholder's remedies when its insurance carrier does not. As guidelines and regulations vary from jurisdiction to jurisdiction, counsel must always consult applicable law and become familiar local practices in order to properly evaluate the issues set forth herein.

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