Is the Attorney-Client Privilege Bulletproof

When Insurance Companies Use it to Disguise Bad Faith Claim-Handling?

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When policyholders challenge their insurance companies' claims-handling practices, insurance companies often play a game of Russian roulette, using attorney-client privilege to shield their factual claim investigations from disclosure and policyholder criticism. By claiming that an attorney performed the claims-handling function, the insurance company may waive the privilege and blow the top off its putative protection, exposing the facts (good and bad) underlying a coverage denial to the cold light of day.

Insurance companies take another deadly spin in the game of chance when they invoke the advice of counsel defense. This occurs when an insurance company — usually unwillingly — claims that its coverage denial was based on the advice of coverage counsel and therefore reasonable, for purposes of defending against allegations of bad faith. Once the insurance company places its attorney's advice at issue, however, the privilege may be waived.

When conducting discovery in coverage litigation, a policyholder should not be deterred when John Doe, Esq., instead of John Doe, claims department representative, writes the denial letter. Nor should a policyholder assume that attorney activity on a privilege — or claims — log, or involvement of an attorney in internal communications regarding coverage, will automatically be protected from disclosure. Determining whether an attorney is acting as a claims handler or legal advisor is a fact inquiry

that looks to the dominant purpose of the attorney's function.

There are many reasons why an insurance company would pass off its claims-handling function to an attorney: experience, knowledge, the desire to protect sensitive information, reliance

on the advice of counsel defense in bad faith litigation, or simply protecting a claims employee from being deposed. Indeed, a recent insurance industry publication tailored to claims adjusters characterized a deposition as a "Maalox moment that may be about as much fun as a root canal."

The Lawyer in the Claims-Handling Function

Insurers cannot shield claims files from disclosure on the basis of the work-product privilege by having lawyers handle claims. For the work-product doctrine to apply, the investigation must be outside of standard claims-handling process. For attorney-client privilege to apply, the attorney must provide legal advice and not conduct a factual investigation.

> *"Before the coverage dispute, the lawyer is acting as claims adjuster who investigates the claims, analyzes them and determines whether payment should be made and, if so, at what amount."*

Insurance companies commonly use lawyers for two primary purposes: 1) to perform the business function of address coverage issues (adjusting claims, supervising the claims process or monitoring the investigation of claims); or 2) to be the litigator litigating a coverage dispute. Before the coverage dispute, the lawyer is acting as claims adjuster who investigates the claims, analyzes them and determines whether payment should be made and, if so, at what amount. At some point, the lawyer turns into a coverage lawyer who does not make such business decisions. If the matter could be handled by a layperson just as easily as a lawyer, the matter may not be privileged.

Under the same rationale, documents in a claims file created by or for an insurance company as part of its ordinary course of business, are not afforded work-product protection, even if prepared by a lawyer. Courts often presume that documents prepared by or for an insurer prior to a coverage determination are prepared in the ordinary course of the insurer's business and are not afforded work-product protection.

Similarly, documents created after the insurance company's retention of counsel are not necessarily afforded work-product protection where the insurance company continues to investigate the claim without denying coverage — the hiring of outside counsel does not, by itself, indicate a determination to litigate. Therefore, insurance companies cannot claim that investigative documents are privileged because they were prepared in anticipation of litigation before a coverage denial, because claims investigations often continue after outside counsel is hired.

The Insurance Industry Recognizes Waiver in Investigatory Circumstances

Even the insurance industry affirms this challenge to the privilege that is traditionally raised by policyholders. Recently, AIU, an insurance company similarly situated to a policyholder in coverage litigation, sued its reinsurer, TIG, alleging that TIG had breached the reinsurance contracts at issue by failing to indemnify AIU for its share of settlement payments in an underlying matter. In an attempt to compel TIG's claims files and challenge TIG's assertion of the attorney-client and work-product privileges, AIU argued (in the same manner that a policyholder would argue in bad faith litigation against an insurance company) that TIG's counsel was acting solely in an investigatory function, and not as a lawyer.

Ultimately, on a motion to reconsider, the AIU court found that certain documents were, in fact, privileged, but it was only after a detailed and fact-intensive inquiry into the nature of the claimed privileges and documents at issue. Nonetheless, this case is noteworthy because it

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highlights the insurance industry's recognition of this challenge to the privilege.

Uncovering Bad Faith

To prove bad faith, a policyholder must show how the insurance company processed the claim, how the claim was considered and why the insurance company took the action that it did. Once it has made this factual inquiry, the policyholder must also show the absence of a reasonable basis for denying benefits of the policy and the insurance company's knowledge or reckless disregard, or the lack of a reasonable basis for denying the claim. An insurance company's intentional denial, failure to process or failure to pay a claim without a reasonable basis can give rise to a bad faith lawsuit. Therefore, some courts find that an insured's claim of bad faith may also be the basis for disclosure of privileged insurance company communications, in what is referred to as the bad faith exception.

> *"Do not be fooled by the involvement of the insurance company's lawyer in handling or litigating a claim. As a policyholder, you are entitled to discovery to prove your bad faith claim."*

In these jurisdictions, the policyholder's need for the claims file is found to be "overwhelming" because it is a unique, contemporaneously prepared history of the company's handling of the claim.

The Advice of Counsel as Shield

An insurance company in bad faith litigation can also waive the attorney-client privilege when it asserts its good faith due to its reliance on its counsel's advice. Insurance companies commonly defend bad faith or malicious claim handling allegations giving rise to punitive damages by providing evidence that the insurance company relied on the advice of competent counsel. This is an implied waiver, whereby the insurance company voluntarily puts its state of mind and attorney advice at issue. In such circumstances, the policyholder is entitled to discover communications between the lawyer and insurance company, which relate to the advice on denial of coverage.

When an insurance company makes factual assertions in defense of a claim, which incorporate the advice and judgment of counsel, it cannot deny a policyholder the opportunity to uncover the foundation for those assertions in order to contradict them. The policyholder should be entitled to test the reasonableness of the attorney's opinion and the insurance company's reliance on the opinion.

What to Do

Do not be fooled by the involvement of the insurance company's lawyer in handling or litigating a claim. As a policyholder, you are entitled to discovery to prove your bad faith claim. If an attorney was involved in the insurance company's investigation of the claim, push for the information and shift the burden to the insurance company to tell you why the information is privileged.

Do ask for: the underwriting file, claims file (including all documents regarding the processing, payment and/or denial of the claim, and investigative reports regarding the claim), loss reserves, underwriting manuals and guidelines, communications with the insurance broker, document retention policy, reinsurance information (including reinsurance policy and communications with reinsurer[s]) and marketing materials concerning the coverage purchased. ▲