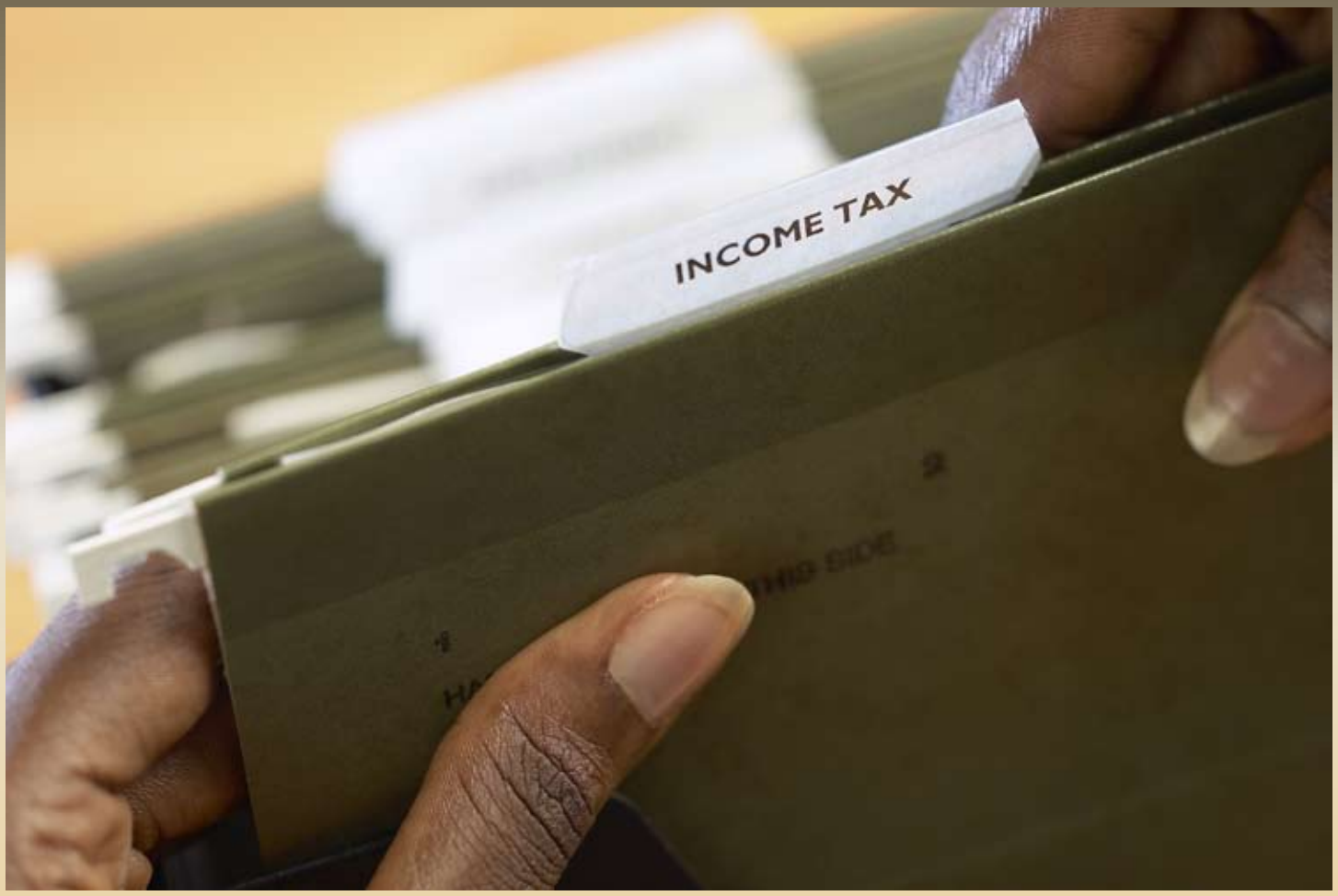
LAWYERS
RMKB
ROPERS MAJESKI KOHN BENTLEY
*A better legal system®*

# Discoverability of Insureds' Tax Returns in Disability Actions Venued in California: A Three-Step Analysis to Compel Their Disclosure

**Robert M. Forni, Jr.**




In state court actions, and diversity actions controlled by California law, discovery into the plaintiff's financial condition is appropriate under both Fed R Civ P 26(b)(1) and CCP § 2017.010, where the plaintiff's claims implicate his or her financial history. *See*, *G-K Props. v. Redevelopment Agency of San Jose*, 409 F Supp 955, 956-960 (ND Cal 1976). Such claims are implicit, if not expressly plead, in actions arising from the denial of disability benefits, in which the parties dispute occupations for which the plaintiff insured is reasonably suited in light of, among other things, his or her status in life and economic strata, as well as the nature and amount of potential off-sets to the claimed insurance benefits (including wages, tips, social security benefits and worker's compensation benefits). Thus, this article discusses the circumstances under which tax returns may be compelled under California and federal standards in such actions.

## ARE THE TAX RETURNS RELEVANT?

The initial hurdle that the party seeking disclosure of tax returns must meet is establishing their relevance to the claim or defense of a party. Discovery in federal actions is generally limited to information that is not privileged, but is "relevant to the claim or defense of any party." Fed R Civ P 26(b)(1). Relevant information under this standard is information "reasonably calculated to lead to the discovery of admissible evidence." *Surfvivor Media, Inc. v. Survivor Prods*., 406 F.3d 625, 635 (9th Cir. 2005); *Brown Bag Software v. Symantec Corp*., 960 F.2d 1465, 1470 (9th Cir. 1992). Thus, to be discoverable under Fed R Civ P 26(b)(1), the information sought must be both "relevant to the claim or defense of any party," and either admissible evidence or reasonably calculated to lead to the discovery of admissible evidence.

Likewise, in state court actions, information is discoverable if it is unprivileged and is either relevant to the subject matter of the action or reasonably calculated to reveal admissible evidence. CCP § 2017.010; *see*, *Schnabel v. Superior Court*, 5 C4th 704, 711 (1993); *Valley Bank of Nevada v. Superior Court*, 15 Cal.3d 652, 655- 656 (1975). Relevancy to the subject matter is a broader standard than relevancy to the issues actually raised in litigation. *Covell v. Superior Court*, 159 Cal.App.3d 39, 42-43 (1984); *see*, *Shaffer v. Superior Court* 33 CA4th 993, 1000-1003 (1995).

The relevancy of an insured's tax returns in actions arising from the denial of disability benefits is readily apparent. In those actions, the plaintiff bears the burden of proving that he or she meets the definition of "totally disabled" under the terms of the policy and California law. *Erreca v. Western States Life Ins. Co*., 19 Cal.2d 388, 396 (1942). Under California law, total disability "is a disability which prevents the insured from 'working with reasonable continuity in his customary occupation or in any other occupation in which he might reasonably be expected to engage in view of his station and physical and mental capacity. [Citations omitted.]'" *Joyce v. United Ins. Co*., 202 Cal. App. 2d 654, 664 (1962). In light of this test, a plaintiff's sources of income, earnings history and ownership of businesses and commercial assets are discoverable under Fed. R. Civ. Pro. 26(b) and CCP § 2017.010 for a myriad of reasons, including to establish the plaintiff's salary and wage history to determine occupations for which he or she is reasonably suited; to establish income, salary and wages derived from any form of employment during the period in which the plaintiff has been allegedly "totally disabled"; to establish the extent to which the plaintiff has suffered economic harm as a result of the coverage determination; to establish the plaintiff's financial motivations for or disincentives to returning to work; and to establish the plaintiff's ability and failure to mitigate his orher alleged damages.

## IS PRODUCTION OF THE TAX RETURNS WARRANTED UNDER AN EXCEPTION TO THE STATUTORY PRIVILEGE SHIELDING TAX RETURNS?

There is no recognized federal or state constitutional right to maintain the privacy of state or federal tax returns. *See*, *Couch v. United States*, 409 U.S. 322, 336-337 (1973);

*St. Regis Paper Co. v. United States*, 368 U.S. 208, 219, 7 L. Ed. 2d 240, 82 S. Ct. 289 (1961); *Premium Service Corp*., *supra*, 511 F.2d at 229; *Saca v. J.P. Molyneux Studio Ltd*., 2008 U.S. Dist. LEXIS 3857, *5 (E.D. Cal., January 4, 2008); *Weingarten v. Superior Court*, 102 Cal. App. 4th 268, 274 (2002); *Deary v. Superior Court*, 87 Cal. App. 4th 1072, 1075, fn. 2, 1077-1078 (2001). There is no privilege for tax returns under federal law. *See*, *Premium Service Corp. v. Sperry & Hutchinson Co*., 511 F.2d 225, 229 (9th Cir. 1975); *Heathman v. United States Dist. Ct. for Cent. Dist. of Cal*., 503 F.2d 1032, 1035 (9th Cir. 1974); *Schnabel*, *supra*, 5 Cal. 4th at 719; *Crest Catering Co. v. Superior Court*, 62 Cal.2d 274, 276, fn. 1 (1965). Moreover, there is no "work product" privilege for accountants' papers analogous to the attorney's work-product privilege. *United States v. Arthur Young & Co*., 465 U.S. 805, 816 (1984). Thus, the next step in compelling the production of an insured's tax returns is establishing that they are not shielded from discovery based on any statutory privileges under state law, which state as well as federal courts exercising diversity jurisdiction are bound to apply.[1]

California courts have interpreted state taxation statutes as creating a statutory privilege against disclosing tax returns. *See*, *Schnabel*, *supra*, 5 Cal. 4th at 718-721; *Weingarten*, *supra*, 102 Cal. App. 4th at 274. The purpose of the privilege is to encourage voluntary filing of tax returns and truthful reporting of income, and thus to facilitate tax collection. *Weingarten*, *supra*, 102 Cal. App. 4th at 274. Ordinarily, courts of this state caution against compelled disclosure of personal tax returns "except in those rare instances where the public policy underlying the tax privilege is outweighed by other compelling public policies or where waiver principles apply." *Weingarten*, *supra*, 102 Cal. App. 4th at 276. The fact that financial records are difficult to obtain or that a tax return would be helpful, enlightening or the most efficient way to establish financial worth is not sufficient to compel their disclosure. *Ibid*.

The seminal case involving the discoverability of tax returns by private litigants is *Webb v. Standard Oil Co*., 49 Cal.2d 509 (1957). In *Webb*, the defendants in a tort case sought discovery of the plaintiffs' state and federal income tax returns. The Supreme Court interpreted Revenue and Taxation Code section 19282, which concerned that part of the code dealing with personal income tax. That section formerly provided in pertinent part that, except in tax enforcement proceedings, " '. . . it is a misdemeanor for the Franchise Tax Board, any deputy, agent, clerk, or other officer or employee, to disclose in any manner information as to the amount of income or any particulars set forth or disclosed in any report or return required under this part.'" *Webb*, *supra*, 49 Cal.2d at 512. Although, by its language, this statute appears to be directed only toward administrative officers, and does not expressly establish a privilege of the nature claimed by petitioner, the Supreme Court interpreted it to establish an implied privilege against forced disclosure in civil discovery proceedings. Because of the overlap of

1 Where a federal court's jurisdiction over an action is premised solely on diversity, and no federal questions are presented either in the complaint or counterclaim, the court must determine substantive privileges under the state law that otherwise governs the case. Fed. R. Evid. 501; *Pagano v. Oroville Hosp*., 145 F.R.D. 683, 687 (E.D. Cal. 1993) (observing privileges asserted in federal question cases shall be governed by federal law, while state privilege law should apply to purely state claims brought in federal court pursuant to diversity jurisdiction).

information contained in federal and state tax returns, the Court also held that "forcing disclosure of the information in the federal tax return would be equivalent to forcing disclosure of the state returns and would operate to defeat the purposes of the state statute." *Id* at 513-514. In reaching this conclusion, the Court noted that the purpose of the statute "is to facilitate tax enforcement by encouraging a taxpayer to make full and truthful declarations in his return, without fear that his statements will be revealed or used against him for other purposes." *Id* at 513. Thus, the Court concluded that "the privilege should not be nullified by permitting third parties to obtain the information by adopting the indirect procedure of demanding copies of the tax returns," because "[i]f the information can be secured by forcing the taxpayer to produce a copy of his return, the primary legislative purpose of the secrecy provisions will be defeated. *Id* at 513. .

**TAX RETURNS MAY BE COMPELLED (1) THE CIRCUMSTANCES INDICATE AN INTENTIONAL WAIVER OF THE PRIVILEGE; OR (2) THE LAWSUIT INVOLVES CLAIMS THAT ARE INCONSISTENT WITH THE PRIVILEGE; OR (3) A PUBLIC POLICY GREATER THAN THAT OF THE CONFIDENTIALITY OF TAX RETURNS IS INVOLVED**

The current section, Revenue and Taxation Code section 7056, is substantially similar in relevant respects to its predecessor, Revenue and Taxation Code section 19282. *See*, *Sav-On Drugs, Inc. v. Superior Court*,15 Cal.3d 1, 6 (1975). Section 7056 states in pertinent part: ". . . it is unlawful for the board or any person having an administrative duty under this part to make known in any manner whatever the business affairs, operations, or any other information pertaining to any retailer . . . required to report to the board or pay a tax pursuant to this part, or the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any return, or to permit any return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person." Although this statute, section 19282, appears to be directed only toward administrative officers, and does not expressly establish a privilege of the nature claimed by petitioner, "it does, however, manifest a clear legislative intent that disclosures made in tax returns shall not be indiscriminately exposed to public scrutiny." *Sav-On Drugs*, *supra*, 15 Cal. 3d at 6. Consequently, the privilege against forced disclosure of tax returns has been reaffirmed in a variety of situations. *Schnabel*, *supra*, 5 Cal. 4th at 723 (concluding that the corporate tax returns and the payroll tax returns regarding husband were discoverable in divorce proceedings, but that information in the payroll tax returns identifying persons other than the husband was privileged and may be withheld); *Sav-On Drugs*, *supra*, 15 Cal.3d at 3, 6-7 (holding information related to sales tax returns is privileged); *Crest Catering Co*., *supra*, 62 Cal.2d 274 (holding that employment tax returns are privileged, but the privilege was waived); *King v. Mobile Home Rent Review Bd*., 216 Cal.App.3d 1532 (1989) (finding the privilege applies in administrative proceedings); *Rifkind v. Superior Court*, 123 Cal.App.3d 1045, 1048-1049 (1981) (concluding income

tax returns of a law corporation and three partnerships of which husband was a member are privileged in a marriage dissolution proceeding); *Sammut v. Sammut*, 103 Cal.App.3d 557, 562 (1980) (observing privilege applies to "discovery of income tax returns in litigation between former spouses in spousal support modification proceedings"); *In re Marriage of Brown*, 99 Cal.App.3d 702, 707-709 (1979) (finding privilege applies to income tax records of new spouse in litigation between former spouses involving child support payments); *Brown v. Superior Court*, 71 Cal.App.3d 141 (1977) (finding privilege applies to W-2 forms).

Even so, this statutory privilege is limited and not absolute. *Weingarten*, *supra*, 102 Cal. App. 4th at 274; *Schnabel*, *supra*, 5 Cal. 4th 704, 721 (1993). Under California law, the court has broad discretion in determining the applicability of this privilege. *Weingarten*, *supra*, 102 Cal. App. 4th at 274; *National Football League Properties, Inc. v. Superior Court*, 65 Cal. App. 4th 100, 106-107 (1998). The privilege against disclosing tax returns protects tax returns, and nothing else. *Deary*, *supra*, 87 Cal. App. 4th at 1082. It does not apply to communications between the insured and his or her accountant or tax preparer; nor does it apply any materials on which the accountant or tax preparer relied to prepare the returns.

Moreover, the privilege is subject to a number of exceptions. Tax returns may be compelled (1) the circumstances indicate an intentional waiver of the privilege; *or* (2) the lawsuit involves claims that are inconsistent with the privilege; *or* (3) a public policy greater than that of the confidentiality of tax returns is involved. *Weingarten*, *supra*, 102 Cal. App. 4th at 274; *Schnabel*, *supra*, 5 Cal. 4th at 721. If any one of these exceptions apply, the disclosure of tax returns may be compelled.

**THE COURT MAY FIND THAT THE INSURED HAS WAIVED ANY CLAIM THAT RECORDS REGARDING THE INSURED'S ECONOMIC CONDITION, EMPLOYMENT ACTIVITIES AND WAGE HISTORY, SUCH AS TAX RETURNS, ARE PRIVATE, PRIVILEGED OR OTHERWISE SHIELDED FROM DISCOVERY IN PLACING THOSE MATTERS IN ISSUE, AT LEAST FOR THE PERIOD WHEN THE INSURED ALLEGES THAT HE OR SHE HAS BEEN "TOTALLY DISABLED."**

## ESTABLISHING THAT THE INSURED HAS WAIVED THE PRIVILEGE

Waiver is the intentional relinquishment of a known right after knowledge of the facts. *Waller v. Truck Ins. Exch.*, 11 Cal. 4th 1, 31 (1995). The burden is on the party claiming a waiver of a right to prove it by clear and convincing evidence that does not leave the matter to speculation. *Id.* Doubtful cases will be decided against a finding of waiver. *Id.* Waiver may be either express, based on the words of the waiving party, or implied, based on conduct indicating an intent to relinquish the right. *Id.*

Rare is the occasion when the plaintiff has expressly waived any right to object to the production of his or her tax returns. However, where the plaintiff has been timely served notice of a subpoena compelling the production of his or her tax returns, and has not moved to quash the subpoena, the plaintiff may be found to have impliedly waived any objection to the release of tax records responsive to the subpoena, thus obligating the

witness to comply with it. Fed. R. Civ. Pro. 45(d)(1); *see*, *In re Flat Glass Antitrust Litigation*, 288 F.3d 83, 90 (3rd Cir. 2002). Likewise, the court may find that the insured has waived any claim that records regarding the insured's economic condition, employment activities and wage history, such as tax returns, are private, privileged or otherwise shielded from discovery in placing those matters in issue, at least for the period when the insured alleges that he or she has been "totally disabled." *See*, *Young v. United States*, 149 F.R.D. 199, 205 (S.D. Cal. 1993) (finding plaintiff waives any tax return privilege to the extent a plaintiff places tax records in issue by making a claim for lost income); *see also*, *Britt v. Superior Court*, 20 Cal. 3d 844, 849 (1978) (observing that, in seeking recovery for physical and mental injuries, the plaintiffs waived their physician-patient and psychotherapist-patient privileges as to all information concerning the medical conditions which they put in issue).

**THE INSURED MAY PLACE HIS OR HER INCOME AT ISSUE IN CONTENDING THAT HE OR SHE SUFFERED "ECONOMIC HARDSHIP" AS A RESULT OF THE INSURER'S TERMINATION OF HIS OR HER CLAIM FOR DISABILITY BENEFITS**

For instance, the court found the privilege was waived in *Crest Catering Co. v. Superior Court*, 62 Cal.2d 274 (1965). In that case, the employer had promised in a union-employer trust agreement to "furnish all necessary information upon demand" regarding its payroll. However, all of its books and records were destroyed in a fire, leaving the employer's tax returns as the only source of the required information. In an action brought by the union, the Supreme Court held that by promising to provide payroll information, the employer had relinquished its claim of privilege in tax returns that showed all of the promised information. *Id*. at 278.

Likewise, the Court found that a husband had waived any privilege in his tax returns in *In re Marriage of Parks*, 138 Cal. App. 3d 346 (1982). In that case, the husband had executed a stipulated judgment of dissolution, in which each spouse agreed, " 'on the demand of the other, to execute or deliver any instrument, furnish any information, or perform any other act reasonably necessary to carry out the provisions of this agreement without undue delay or expense.' " The court determined that his W-2 forms were necessary to the wife's determination of her half-interest in his retirement pay, and were therefore discoverable. *Id*. at 349.

However, a tax return that has been produced under court order is not a voluntary relinquishment, and does not, therefore, effect a waiver of the privilege. *Fortunato v. Superior Court*, 114 Cal. App. 4th 475, 481 (2003); *Thomas B. v. Superior Court*, 175 Cal. App. 3d 255, 263 (1985).) Likewise, submitting personal tax returns with a loan application to a bank for the purpose of obtaining a loan is not a voluntary relinquishment over the returns, and therefore will not effect a waiver of the privilege. *Fortunato*, *supra*, 114 Cal. App. 4th at 481.

## ESTABLISHING THAT THE INSURED HAS PLACED HIS OR HER INCOME AT ISSUE

The plaintiff may implicate his or her tax returns through any number of claims. The insured may place his

or her income at issue in contending that he or she suffered "economic hardship" as a result of the insurer's termination of his or her claim for disability benefits. *See*, *Wilson v. Superior Court*, 63 Cal.App.3d 825, 829 (1976) (finding assertion of the tax return privilege inconsistent with the gravamen of the lawsuit where plaintiff sued his accountant for faulty tax advice); *Newson v. City of Oakland*, 37 Cal. App.3d 1050, 1055 (1974) (finding assertion of the tax return privilege inconsistent with claims of lost income). In addition, the insured places her sources of income (e.g., wages, salaries and tips) and ownership, operation and control of business property at issue in contending that he or she has been continuously and totally unable to work at the very time he or she reportedly owned and controlled a business. Tax records documenting the insured's ownership or control of a business are also relevant and material to establishing any claim that the insured lacks the functional capacity to work in her own or any other occupation for which he or she is reasonably suited based on his or her background, training and experience. Tax records also affect the benefits the plaintiff could receive if they show he or she was receiving income from working. Under these circumstances, the assertion of the privilege against disclosing the tax returns would be inconsistent with, and deprive the defendant insurer a reasonably opportunity to evaluate, the gravamen of the insured's claim that he or she is "totally disabled."

**ESTABLISHING THE APPLICABILITY OF THE "PUBLIC POLICY" EXCEPTION REQUIRES A MORE COMPELLING SHOWING, WHICH MAY NOT BE NECESSARY OR EVEN ADVISABLE WHERE THE INSURER CAN CLEARLY PREVAIL UNDER ANOTHER EXCEPTION**

## ESTABLISHING THAT DISCLOSURE IS NECESSARY TO FURTHER A GREATER PUBLIC POLICY

Establishing the applicability of the "public policy" exception requires a more compelling showing, which may not be necessary or even advisable where the insurer can clearly prevail under another exception. Under the "public policy" exception, tax returns are subject to disclosure on the grounds that the state's interest in ascertaining the truth in legal proceedings outweighs the plaintiff's privilege against disclosing tax returns. *Weingarten*, *supra*, 102 Cal. App. 4th at 274. The "public policy" exception is narrow and only applies "when warranted by a legislatively declared public policy." *Schnabel*, *supra*, 5 Cal. 4th at 721; *see*, *Fortunato v. Superior Court*, 114 Cal. App. 4th 475, 483 (2003); *Deary*, *supra*, 87 Cal. App. 4th at 1080. Further, the public policy must be a compelling one, and exceptions on this ground will be declared only rarely. *Fortunato*, *supra*, 114 Cal. App. 4th at 483; *Weingarten*, *supra*, 102 Cal.App.4th at 276. One such public policy that California has long recognized is "the historically important state interest of facilitating the ascertainment of truth in connection with legal proceedings." *Britt*, *supra*, 20 Cal.3d at 857. However, public policy favoring discovery in civil litigation is not, by itself, sufficiently compelling to overcome the privilege. *Fortunato*, *supra*, 114 Cal. App. 4th at 483; *Weingarten*, *supra*, 102 Cal.App.4th at 275–276. Indeed, such an exception would swallow the rule. *Fortunato*, *supra*, 114

Cal. App. 4th at 483

The seminal case on the public policy exception is *Miller v. Superior Court*, 71 Cal.App.3d 145 (1977), in which the court held that public policy mandated an exception to the privilege against forced disclosure of tax returns. In *Miller*, the petitioner claimed he was unable to pay child support, but asserted the privilege. Relying on specific statutes that allowed public agencies access to certain tax information,[2] the court concluded that the "policy favoring the confidentiality of tax returns must give way to the greater public policy of enforcing child support obligations." *Id*. at 149. Under those unique circumstances, the court stressed that its "decision is limited to the narrow issue of the assertion of the privilege of nondisclosure of income tax returns in the context of proceedings to enforce child support obligations. In that context, we hold that the privilege does not apply." *Ibid*.

However, subsequent courts have observed that, although the public policy favoring the confidentiality of tax returns does not give way merely because the information is relevant, the balance tips in favor of disclosure when a party, without a valid basis, refuses to comply with legitimate discovery requests and court orders compelling the disclosure of alternative sources of the party's financial information. *See*, *Weingarten*, *supra*, 102 Cal. App. 4th at 276. For instance, in *Weingarten v. Superior Court*, the trial court ordered the defendant's tax returns disclosed based on the third exception, finding that a public policy "greater than confidentiality of the tax return [was] involved . . . ." *Weingarten*, *supra*, 102 Cal. App. 4th at 274. The defendant challenged this finding, arguing that although tax returns may be a useful source to establish her financial condition and thus to prove the proper punitive damage amount, the mere fact that her tax returns would be relevant to punitive damage issues did not warrant abrogating the privilege. *Ibid*.

The Court of Appeal agreed that "the fact that a complaint contains a punitive damages allegation or a fact finder has found a basis for imposing punitive damages does not, standing alone, constitute a basis for compelling the disclosure of tax return information." *Weingarten*, *supra*, 102 Cal. App. 4th at 275. However, the court found disclosure was warranted under the public policy exception based on the defendant's repeated refusal to produce relevant financial information in response to the plaintiff's previous discovery requests, which necessitated the production of her tax returns. Before trial, the defendant refused the plaintiffs' requests to inspect corporate books and records, withheld significant information regarding sales in the residential development at issue in the action, asserted unsupported privilege claims in response to a document request, attempted to evade and improperly limit her deposition, and refused to comply with a court-ordered accounting until the plaintiffs filed a sanctions motion. *Weingarten*, *supra*, 102 Cal. App. 4th at 275-276. Then, in response to the trial court's pretrial order requiring the defendant to identify relevant witnesses and documents pertaining to her financial condition, she produced only an unverified and incomplete financial

2 The court in *Miller* "had a legislative enactment directing its path to a conclusion that in child support cases, public policy favored disclosure of income tax records." *Sammut*, *supra*, 103 Cal.App.3d at 562.

statement. After the court found the defendant liable for punitive damages, the court provided her a second chance to properly comply with the plaintiffs' financial discovery by treating their proposed order as a document request. The Court of Appeal noted that, had the defendant produced the type of conventional financial documents requested by the plaintiffs, (such as bank, investment, and real estate records), the compelled production of tax returns would not have been warranted. However, instead of producing these standard documents, the defendant continued to refuse to produce any credible financial information and instead claimed she had already disclosed all information relevant to her current financial condition, relying on her admittedly outdated financial statement. By so acting, the court found that "[the defendant] intentionally interfered with plaintiffs' ability to obtain relevant information through legitimate means, and then sought to hide behind the tax return privilege to ensure no relevant information would be revealed to plaintiffs." *Weingarten*, *supra*, 102 Cal. App. 4th at 275. Consequently, under these circumstances, the Court of Appeal held that the trial court acted within its discretion in ordering the disclosure of the tax returns because public policy favoring "an ordered process designed to uncover the truth," coupled with the plaintiffs' demonstrated need for the tax returns to prove their case, outweighed the defendant's right to claim the tax return privilege as a basis to refuse to produce highly relevant evidence of her financial condition. *Weingarten*, *supra*, 102 Cal. App. 4th at 276.

Thus, far from being limited to cases in which the Legislature has expressed an explicit policy favoring the disclosure of financial information, an insured's tax returns may be compelled under the public policy exception where the insurer establishes that the insured's refusal to produce his or her tax returns not only interfered with the insurer's ability to prove its case, but also undermined the discovery process and the judicial system's ability to ensure an ordered process designed to uncover the truth. *See*, *Weingarten*, *supra*, 102 Cal. App. 4th at 276. To meet this burden, the insurer must establish (1) the insured has previously refused to produce relevant nonprivileged financial records or has produced only meaningless and unreliable financial information in response to the insurer's discovery; (2) the insured has engaged in a pattern of improperly obstructing efforts to obtain financial records through means that do not implicate the privilege and it is reasonable to assume this pattern of conduct will continue; and (3) less intrusive methods to obtain the insured's financial records have been unsuccessful. *See*, *Weingarten*, *supra*, 102 Cal. App. 4th at 276-277.

## DOES THE INSURER'S NEED FOR THE TAX RETURNS OUTWEIGH THE INSURED'S RIGHT OF PRIVACY?

The insured's limited right of privacy in his or her tax returns under article I, section 1 of the California Constitution presents one last obstacle to obtaining them. That section provides:

> All people are by nature free and independent and have inalienable rights. Among these are enjoying and defending life and liberty, acquiring, possessing, and protecting property, and pursuing and obtaining safety, happiness, and privacy.

Cal Const, Art. I, § 1.[3] Individual insureds have no absolute constitutional right to maintain the privacy of their earnings and income history under article I, section 1 of the California Constitution. *Weingarten*, *supra*, 102 Cal. App. 4th at 274. Although a limited right of privacy in California extends to financial privacy in litigation, it is "subject to balancing the needs of the litigation with the sensitivity of the information/records sought." *Davis v. Leal*, 43 F. Supp. 2d 1102, 1110 (E.D. Cal. 1999) (citing, *Valley Bank of Nevada v. Superior Court*, 15 Cal.3d 652, 657 (1975)). Likewise, "[b]alancing of competing interests is underscored by the overall balancing provisions contained within Rule 26(b), Federal Rules of Civil Procedure. This Rule allows the court on its own initiative to limit discovery based, *inter alia*, on the needs of the case, the importance of the issues at stake, and undue burden." *Pagano v. Oroville Hosp.*, 145 F.R.D. 683, 698 (E.D. Cal. 1993).

**INDIVIDUAL INSUREDS HAVE NO ABSOLUTE CONSTITUTIONAL RIGHT TO MAINTAIN THE PRIVACY OF THEIR EARNINGS AND INCOME HISTORY UNDER ARTICLE I, SECTION 1 OF THE CALIFORNIA CONSTITUTION**

The balance tips in favor of disclosing tax returns where the insured maintains that he or she is "totally disabled" in that he or she is unable to work with reasonable continuity in his or her own occupation or in any other occupation for which he is reasonably suited. In that instance, tax returns are reasonably necessary to establish the insured's sources of income, employment history and functional capacity during the period he or she was allegedly "totally disabled." Tax returns may also shed light on the extent to which the plaintiff sustained any economic harm or could have mitigated his or her alleged damages. Under such circumstances, the insurer's need for the insured's returns may outweigh his or her privacy interests in them. *Saca*, *supra*, 2008 U.S. Dist. LEXIS 3857, *13-14.

The fact that the insured may have filed his or tax returns jointly with his or her spouse or domestic partner does not necessarily preclude their production. Under California law, all property acquired by a married person during marriage is presumed to be community property, and a party claiming separate property has the burden of rebutting the presumption by clear and convincing evidence. Cal. Fam. Code, § 760; *Gagan v. Gouyd*, 73 Cal. App. 4th 835, 843 (1999). Thus, where an insured fails to meet the burden of showing that he or she has no interest in a spouse's property, joint tax returns may still be compelled. *Weingarten*, *supra*, 102 Cal. App. 4th at 277.

However, the production of joint tax returns do implicate the privacy rights of the insured's spouse or domestic partner, with whom the insured filed the joint tax returns, assuming the spouse is still alive. The insured may

---

3 This provision only protects the privacy rights of people. *Hecht, Solberg, Robinson, Goldberg & Bagley LLP v. Superior Court*, 137 Cal. App. 4th 579, 594 (2006). Corporations do not have a right to privacy under article I, section 1 of the California Constitution. *Saca v. J.P. Molyneux Studio Ltd.*, 2008 U.S. Dist. LEXIS 3857, *12 (E.D. Cal. Jan. 3, 2008); *see*, *Zurich American Ins. Co. v. Superior Court*, 155 Cal.App.4th 1485, 1504 (2007); *Roberts v. Gulf Oil Corp.*, 147 Cal.App.3d 770, 795 (1983). Insofar as privacy rights are accorded other business entities, they depend on the circumstances, are subject to a balancing test to weigh competing interests, and may be outweighed by a substantial need for disclosure. *Hecht, Solberg, Robinson, Goldberg & Bagley*, *supra*, 137 Cal. App. 4th at 594 (affirming order compelling partnership to produce documents that were discoverable under relevancy standards).

assert the privacy rights of his or her spouse or partner. *See*, *Valley Bank of Nevada v. Superior Court*, 15 Cal. 3d 652, 657 (1975); *Weingarten*, *supra*, 102 Cal. App. 4th at 278. Thus, in the event that joint tax returns are sought, the third-party spouse has a right to notice and an opportunity to be heard. *Valley Bank of Nevada*, supra, 15 Cal. 3d at 658; *Weingarten*, *supra*, 102 Cal. App. 4th at 278.

To discharge this obligation, the insurer seeking the returns must formally notify the spouse or domestic partner with whom the insured filed the joint return of any motion or proceeding seeking their disclosure, and afford the spouse or domestic partner a fair opportunity to assert his or her interests in the joint returns. *Weingarten*, *supra*, 102 Cal. App. 4th at 278. To assert his or interests, in turn, the spouse or partner must object to the disclosure of the joint returns; identify his or her separate property and prove that it is his or her separate property; or assert alternative ways to protect his or her privacy rights. *Ibid*. Once the insured or spouse/domestic partner establish that any property disclosed in the joint returns is truly separate, then the court should examine the tax returns in chambers and redact any information that relates solely to the separate property of the spouse or partner. *Ibid*.

**THE FACT THAT THE INSURED MAY HAVE FILED HIS OR TAX RETURNS JOINTLY WITH HIS OR HER SPOUSE OR DOMESTIC PARTNER DOES NOT NECESSARILY PRECLUDE THEIR PRODUCTION**

## CONCLUSION

Under California and federal discovery standards, an insured's tax returns should be discoverable in actions arising from the denial of disability insurance benefits wherein the insured alleges that he or she is, or has been, "totally disabled." The returns are relevant to establish the nature and amount the insured's reported income derived from working, as well as the amount of past due and future benefits in light of any income, government benefits or other sources of potential off-sets identified in the returns. Moreover, tax returns are not shielded from discovery under an absolute right of privacy or privilege. Insofar as the returns themselves are private or privileged, they may still be compelled based on the insurer's reasonable need to evaluate the insured's alleged inability to work and resulting damages, because such allegations place at issue his or her sources of income at least for the period of his or her alleged "total disability."

Robert M. Forni, Jr. is a senior associate in the firm's Redwood City office. He specializes in the representation of insurance carriers in bad faith and coverage litigation. He has also provided services as insurer-selected counsel for insureds, and independent representation of insureds as *Cumis* counsel. His practice includes representing employee welfare plans, claims administrators and insurers in ERISA litigation, as well as insurers, insurance agents and brokers in contract and tort disputes involving fraud and breach of fiduciary duty claims, general commercial litigation, unfair business practice cases, and NASD arbitrations. He has a special interest in assisting insurers and employee welfare plans in the handling of claims and cases in which insurance fraud is suspected. He is experienced in representing insurers in the litigation of declaratory relief and bad faith actions in both state and federal courts, as well as preparing comprehensive coverage opinions and providing coverage advice throughout the claims process. His expertise extends to personal and commercial lines of insurance, including disability, liability, property, and automobile insurance. Comments and inquiries may be directed to him at rforni@rmkb.com.

L A W Y E R S

# RMKB

ROPERS MAJESKI KOHN BENTLEY

*A better legal system®*

**In California, the firm has long maintained a reputation as one of the state's most outstanding trial firms. The addition of a New York office in 1999 and the newest office in Boston this year has allowed RMKB to expand the wide variety of services available to our clients and has allowed the firm to represent clients on a national basis. The attorneys at RMKB have extensive experience in the areas of business litigation; catastrophic injury litigation; class actions; construction defect litigation; corporate law; directors and officers liability; employment counseling and litigation; entertainment law; environmental and toxic tort liability; fidelity and surety bonds; insurance coverage, bad faith, ERISA, fraud and regulation; intellectual property; litigation management, cost control and fee disputes; mergers and acquisitions; product liability; professional negligence; real estate; and reinsurance. The firm's appellate practice has an outstanding track record and has more than 350 published decisions.**

**San Francisco**
201 Spear Street
Suite 1000
San Francisco, CA 94105
ph (415) 543-4800
fax (415) 972-6301

**Los Angeles**
515 South Flower Street
Suite 1100
Los Angeles, CA 90071
ph (213) 312-2000
fax (213) 312-2001

**San Jose**
50 W. San Fernando Street
Suite 1400
San Jose, CA 95113
ph (408) 287-6262
fax (408) 918-4501

**Redwood City**
1001 Marshall Street
Suite 300
Redwood City, CA 94063
ph (650) 364-8200
fax (650) 780-1701

**New York**
17 State Street
Suite 2400
New York, NY 10004
ph (212) 668-5927
fax (212) 668-5929

**Boston**
60 State Street
Suite 700
Boston, MA 02109
ph (617) 973-5720
fax (617) 973-5721

**www.rmkb.com**