ALERT
MARCH 15, 2013

GLOBAL INSURANCE
News Concerning
Bad Faith and Extracontractual Issues

COZEN O'CONNOR

The Washington Supreme Court Holds That in First-Party Bad Faith Litigation There Is a Presumption of No Attorney-Client Privilege

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When an insured sues an insurer for bad faith, how much of the claims file maintained by the insurer is discoverable? In a 5-4 decision, the Washington Supreme Court recently weakened insurers' ability to protect confidential communications with their attorneys in first-party claims where the insured has alleged bad faith. *Cedell v. Farmers Insurance Company of Washington*, No. 85366-5 (February 22, 2013). The court held that, in the context of a first-party claim for bad faith claim handling and processing, courts must apply a presumption that there is no applicable attorney-client privilege. The court further held that an insurer would be entitled to overcome the presumption by showing that its counsel was providing legal advice as to the insurer's potential liability and was not acting in the insurer's "quasi-fiduciary" function. Upon this showing, the insurer is entitled to an *in camera* review where the trial court will determine if the privilege applies, subject to the insured's assertions that the privilege does not apply due to an exception, including the civil fraud exception.

In *Cedell*, Farmers issued a homeowners policy to Bruce Cedell for his home, which was destroyed by a fire in November 2006 when he was not present. The fire department concluded it was "likely" accidental. Farmers' own investigator found no evidence of an incendiary origin and agreed with the fire department that a candle was a probable source of ignition. The insured's girlfriend was at the home when the fire started. Farmers' investigator found her statements consistent with the evidence found during the investigation, although she admitted that she and others "might have consumed" methamphetamine that day. The Washington Supreme Court noted that, in spite of this evidence, Farmers delayed its coverage determination on the basis that she gave inconsistent statements. In January 2007, an adjuster estimated Farmers' liability to be approximately $70,000 for the house and $35,000 for personal property. Another estimator found the damage to the home was approximately $56,498. The home was later valued at more than $115,000.

Farmers hired attorney Ryan Hall to assist in its coverage determination. Hall examined both the insured and his girlfriend under oath. In July 2007, Hall sent the insured a letter stating the fire's origin was unknown, Farmers may potentially deny coverage because of an alleged delay in reporting and based on inconsistent statements, and offered to pay the insured $30,000. The letter stated that the offer was only good for 10 days. While the insured tried to contact Farmers and Hall during this time, he was unsuccessful and his calls were not returned.

In November 2007, the insured sued Farmers alleging, in part, that Farmers acted in bad faith. In response to discovery requests, Farmers produced a redacted copy of its claim file, asserting the attorney-client privilege. The insured moved to compel. The trial court held that the insured need not make a showing of civil fraud, but merely show "some foundation [in] fact to support a good faith belief by a reasonable person that there may have been wrongful conduct which could invoke the fraud exception." The trial court concluded the facts justified production of the claims file for *in camera* review. After reviewing the file, the court concluded "[i]n the context of a residential fire, the insurer owes the insured a heightened duty — a fiduciary duty…. Under such circumstances, the insured is entitled to discover the entire claims file kept by the insured [sic] without exceptions for any claims of attorney-client privilege."

The Court of Appeals reversed, finding that a factual showing of bad faith was insufficient to trigger an *in camera* review. The appellate court also concluded, even though the trial court impliedly found that Farmers utilized Hall in furtherance of its bad faith denial, this was also not sufficient to pierce the attorney-client privilege.

In its opinion, the Supreme Court first noted that discovery is intended to be broad, but, in the context of bad faith allegations, the insured must have access to the claim file for the evidence necessary to prove his or her claim. First-party bad faith arises

from an insurer's "quasi-fiduciary duty to act in good faith," and allowing the insurer to assert a blanket privilege as to the claim file "would unreasonably obstruct discovery of meritorious claims and conceal unwarranted practices." Therefore, "the insured is entitled to access to the claims file."

The court adopted the following approach to analyze discovery of the claim file in a first-party bad faith case. First, there is a presumption that "the attorney-client and work product privileges are generally not relevant." An insurer may overcome the presumption upon a showing that its attorney was not involved in "investigating and evaluating and processing the claim," or in any other "quasi-fiduciary tasks." Instead, the insurer must show that its counsel evaluated only the insurer's potential liability, which includes a determination as to whether the claim is covered. Once the insurer has met this showing, it may seek an *in camera* review of the claim file and may seek redaction as to any communications reflecting counsel's mental impressions. However, it should be noted, to the extent that coverage counsel's "*mental impressions are directly at issue in its quasi-fiduciary responsibilities to its insured*," those impressions are not privileged and the insurer will not be entitled to redact them.

If the trial court determines the privilege applies, the insured may assert an exception to the privilege, including the civil fraud exception. If civil fraud is asserted, the trial court must engage in a two-step analysis. First, the insured must show that "a reasonable person would have a reasonable belief that an act of bad faith has occurred," whereupon the trial court will conduct an *in camera* review of claimed privileged materials. Second, after conducting its review, if the court finds the insured has a sufficient foundation for its bad faith claim, the court shall find the privilege is waived.

In applying its holding, the Supreme Court concluded that Farmers could have sought to overcome the presumed waiver to the extent that Hall gave Farmers legal advice as to the scope of coverage. However, the court concluded Hall did more than provide legal opinions; he assisted in the claim-handling process, including: (1) investigation by examining the insured and the witness under oath; and (2) adjustment, by negotiating directly with the insured to offer $30,000. The court concluded Hall performed "investigating, evaluating, negotiating, and processing" functions that, with "prompt and responsive communications with the insured," are functions where the insurer "owes a quasi-fiduciary duty."

The dissent concluded, consistent with established Washington law, that the insurer in a first-party claim is *not* a fiduciary, but is only a quasi-fiduciary and, therefore, is entitled to give equal consideration to its own interests, and "should be entitled to consult with counsel regarding its obligations under its policies." The insurer's communications with counsel should be protected by the privilege, unless an exception, such as civil fraud, applies.

The *Cedell* decision begins, first, with the presumption that in first-party bad faith claims, the attorney-client privilege is waived. The presumption can be overcome by showing that the insurer consulted counsel as to its own potential liability, as in coverage. The court held that the attorney's opinions and mental impressions would be protected, but only to the extent that they are not "directly at issue" in the insurer's "quasi-fiduciary responsibilities to its insured." This leaves open the potential that counsel's impressions regarding coverage determinations could be discoverable in some circumstances. It certainly invites policyholder counsel to try to obtain disclosure. The court omitted any discussion of the obvious factual overlap between the insurer's normal claim investigation and its ultimate coverage determination. Second, the court's decision listed several tasks that counsel engaged in which constituted the functions of the insurer, including examining the insured under oath. The court's opinion offers no recognition of the critical anti-fraud function of an examination under oath and the common necessity of involving counsel in that process.

Ultimately, the *Cedell* decision will require insurers to be more vigilant in protecting communications with counsel and in ensuring that coverage counsel's work does not involve any of the quasi-fiduciary functions of handling, investigating, evaluating, or processing a first-party policy insured's claim.

To discuss any questions you may have regarding the opinion discussed in this Alert, or how it may apply to your particular circumstances, please contact:
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