EROSION OF THE ATTORNEY-CLIENT PRIVILEGE IN FIRST AND THIRD PARTY CLAIM INVESTIGATIONS

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I. Introduction

Historically, insurers have been protected from disclosure of documents generated by, or reflecting the advice of, their coverage counsel. This protection is expressed in *Aetna Cas. & Sur. Co. v. Superior Court*, 153 Cal. App. 3d 467, 474 (1984): "[C]onsultations regarding a policy of insurance between an insurance company and its attorney *prior to the time the insurance company has accepted its obligations under that policy* are protected by the attorney-client privilege vis-à-vis the person insured by the policy. Such a rule makes perfect sense, as an insurance company should be free to seek legal advice in cases where coverage is unclear without fearing that the communications necessary to obtain that advice will later become available to an insured who is dissatisfied with a decision to deny coverage." (emphasis in original).

The recent decisions by the Washington Supreme Court in *Cedell v. Farmers Ins. Co. of Washington*, 176 Wash. 2d 686, 295 P.3d 239 (2013) and *Donohue v. Fokas*, 2013 WL 6483675 (NY App. Dec. 11, 2013) erode this traditional protection by allowing discovery of communications between an insurer and its coverage attorney. *Cedell* holds that even a minimal showing of bad faith is enough to compel production of all attorney communication and work product.

The *Cedell* and *Donohue* case appear to have sparked a new trend, with numerous other jurisdictions following suit. Insurers and coverage counsel must be aware of these new cases, and prepared to deal with the potential consequences.

II. *Cedell v. Farmers Ins. Co. of Washington*

In *Cedell*, the Washington Supreme Court held that, in a bad faith action by a first-party insured, an insurance company is not entitled to standard attorney-client privilege protections. Once the insured meets an initial burden of showing facts that demonstrate bad faith, the burden shifts to the insurer to show that the privileged materials were not involved in the "investigating and evaluating, or processing of the claim." If the insurer fails to meet its burden, all materials must be produced.

A. Background Facts

Cedell, the insured, suffered a fire to his home. Cedell was not home at the time of the fire, but his girlfriend and their infant child were at the home. Although the fire

department and Farmers adjuster ultimately concluded that the fire had accidentally started from a candle, Cedell's girlfriend admitted she was using methamphetamine at the time. Two months after the loss, a Farmers adjuster estimated that the house was worth $70,000, with an additional $35,000 for the contents. A Farmers estimator later concluded that the fire-related damage only amounted to $56,498.

Farmers also hired an attorney "to assist in making a coverage determination." The attorney took examinations of Cedell and his girlfriend because the cause of the fire was allegedly in dispute. Several months after the loss, the attorney offered $30,000 to settle the loss, and included a ten-day time limit with which to respond. Cedell refused the offer and sued for bad faith. Damage was eventually valued at $115,000 with more than $16,000 in code upgrades.

In response to Cedell's discovery request in the bad faith lawsuit, Farmers produced a "heavily-redacted" claim file, relying on privilege and relevant objections. Farmers also objected, on the grounds of privilege, to interrogatories regarding the ten-day time limit on the settlement offer. Cedell moved to compel and the court agreed, stating that Cedell had "some foundation in fact to support a good faith belief" that there had been wrongful conduct that invokes the fraud exception to the attorney-client privilege. The court then reviewed the documents in camera and concluded, "[I]n the context of a claim arising from a residential fire, the insurer owes the insured a heightened duty – a fiduciary duty, which by its nature is not, and should not be, adversarial. Under such circumstances, the insured is entitled to discover the entire claims file kept by the insured without exceptions for any claims of attorney-client privilege."

The Court of Appeals granted interlocutory review and reversed, holding that – in the absence of an applicable exception to the privilege - an insurer is entitled to the attorney-cleint privilege in a bad faith action by the first-party insured. *See Cedell v. Farmers Ins. Co.*, 157 Wash. App. 267, 278, 237 P.3d 309 (2010). In a divided decision, the Washington Supreme Court reversed the holding of the court of appeals.

B. Supreme Court Analysis

The Washington Supreme Court began its analysis with the assumptions that "special considerations of first party insurance bad faith claims" require that the insured have access to the insurer's entire claim file; and that "it is a well-established principle in bad faith actions brought by an insured against an insurer under the terms of an insurance contract that the communications between the insurer and the attorney are not privileged with respect to the insured." *Cedell v. Farmers, supra,* 295 P.3d at 245.

Applying those assumptions, the Court held:

(1) An insurer may seek in camera review to overcome the presumption that its entire claim file is discoverable by demonstrating that the attorney was not engaged in any quasi-fiduciary tasks such as investigating, evaluating, or processing the claim, and that the attorney's actions were limited to counseling the insurer as to its own liability. The

court cautioned, “where an attorney is acting in more than one role, insurers may wish to set up and maintain separate files so as not to co-mingle different functions.” *Id*. at n.5.

(2) If a court concludes that the attorney did not engage in fact finding, the insured is entitled to a second in camera review by showing that “a reasonable person would have a reasonable belief that an act of bad faith tantamount to fraud has occurred.” *Id*. at 246. If, after reviewing the documents, the court determines there is foundation for a claim of bad-faith to proceed, the attorney-client privilege will be waived. *Id*. at 247.

III. Cases Adopting *Cedell*

A. Washington District Court Cases

1. *Carolina Casualty v. Omeros*

In *Carolina Casualty Ins. Co. v. Omeros Corp.*, 2013 WL 1561963 (W.D. Wash. April 12, 2013) the court stated, without discussion, that the same considerations at issue in first-party insurance bad faith claims are also present in third-party litigated claims. The court stated, “Carolina Casualty attempts to distinguish *Cedell* because it arose in the context of a bad faith claim from a first-party insured. The distinction is not persuasive. The *Cedell* court grounded its ruling in the quasi-fiduciary duty of an insurer to its insured, along with the public policy interest in regulating the business of insurance. The latter consideration is just as important in a third-party claim. As to the former, the ‘duty of good faith is applicable to both first party and third party coverage.’”

2. *Ten Talents v. Ohio Security*

In *Ten Talents Investment LLC v. Ohio Security Ins. Co.*, 2013 WL 3155379 (W.D. Wash. June 20, 2013), the court applied *Cedell* to the denial of a first-party property claim. After an in camera review, the court determined that coverage counsel only provided a legal opinion regarding whether coverage was available on a given set of facts. Pursuant to *Cedell*, however, the inquiry didn’t end there. The insured argued that it met its burden of showing bad faith based on the insurer’s failure to respond to all of the insured’s theories. Because the insurer’s coverage attorney was asked to approve the claim adjuster’s response – which did not address all theories raised by the insured – the court concluded that the attorney’s approval implicated the “advice of counsel” defense.

3. *Philadelphia Indemnity v. Olympia Early Learning*

Two weeks after *Ten Talents*, the same judge issued a decision in *Philadelphia Indemnity Ins. Co. v. Olympia Early Learning Center*, 2013 WL 3338503 (W.D. Wash. July 2, 2013). In *Olympia*, however, the court was critical of *Cedell’s* melding of the attorney-client privilege and work product doctrine. The court noted that *Cedell* had

cited the work product rule regarding materials prepared in anticipation of litigation, while specifically addressing the attorney-client privilege.

The court summarized four scenarios under *Cedell* in which an insured may discover the insurer's claim file, including work product prepared by the insurer's counsel:

(1) The insurer cannot overcome the initial presumption that the attorney-client and work product privileges are waived in a bad faith action;

(2) The insurer's attorney has engaged in "quasi fiduciary" roles such as investigation, process or evaluation of the claim;

(3) Attorney work product is "directly at issue in the quasi fiduciary responsibilities to its insured"; and

(4) There is a foundation for a bad faith claim tantamount to civil fraud.

The court concluded, "[i]f nothing else, it is now clear that the scope of discovery in first party bad faith actions is very broad, and the attorney-client privilege and work product doctrine are less difficult to overcome now than they were prior to the [*Cedell*] opinion."

4. *Palmer v. Sentinel Ins. Co.*,

In *Palmer v. Sentinel Ins. Co.*, 2013 WL3448128 (W.D. Wash. July 9, 2013), the court addressed the application of *Cedell* in situations where coverage counsel performed "mixed" duties. The insurer's attorney had investigated the insured's first-party property loss claims, interviewed witnesses, and hired experts. The attorney also provided updated exposure and coverage assessments. The insurer conceded that its attorney acted in a quasi-fiduciary manner. However, the insurer sought attorney-client and work product protection for the advice rendered by the attorney on coverage.

The court stated that, when an attorney has mixed responsibilities, "the attorney-client privilege and work-product protections are likely to be waived in many, if not most cases." The court stated that *Cedell*'s suggestion of keeping separate files was not workable in many cases, because the attorneys would likely rely on their mental impressions derived from their fact-finding duties in reaching the coverage conclusion. The court thereby concluded that attorney-client privileges or work-product protections do not apply when attorneys are engaged in mixed duties.

5. *Everest v. QBE*

Everest Indem. Co. v. QBE Ins. Co., 980 F. Supp. 2d 1273 (W.D. Wash 2013) was the first insurer v. insurer dispute involving *Cedell*. Everest had sued QBE for common law bad faith, negligence, and a violation of the Insurance Fair Conduct Act (IFCA) due to QBE's denial of a defense for a construction defects action. Everest, who was

defending under a reservation of rights, alleged that QBE owed the insured a defense, and sought to depose QBE's coverage counsel.

The court allowed the deposition, ruling that the topics sought by Everest (including the attorney's experience, her clients, how she became retained by QBE, her investigation, etc) were relevant and reasonably calculated to "glean information about whether QBE/CAU acted reasonably" when it relied on its attorney's coverage analysis. In doing so, the court relied on *Cedell* for broadening "the scope of discoverable information in insurance disputes." Citing to *Carolina Casualty*, the court stated that *Cedell* is applicable to third-party bad faith actions.

6. *Woodward v. American Family*

In *Woodward v. Am. Family Mut. Ins. Co.*, 2014 WL 2198808 (W.D. Wash. May 27, 2014), the court – in its analysis – hinted that *Cedell* could apply to the production of post litigation documents as well. The court cited *Garoutte v. Am. Family Mut. Ins. Co.*, 2013 WL 5770358 (W.D. Wash. 2013), which held, "the Court is not persuaded that every document created by an insurance company after suit has commenced is protected by the work product privilege."

B. Other Ninth Circuit Cases

1. *Stewart Title Guar. Co. v. Credit Suisse*

In *Stewart Title Guar. Co. v. Credit Suisse, Cayman Islands Branch*, 2013 WL 1385264 (D. Idaho Apr. 3 2013), the District Court predicted, without discussion, that the Idaho Supreme Court would adopt the holding of *Cedell*, and would extend its holding to third-party liability situations. Credit Suisse was insured by Stewart Title for a $250 million loan to a ski resort developer. When the developer defaulted on the loan, Credit Suisse brought a foreclosure action. The developer's contractors responded with lien claims, and Stewart Title agreed to defend under a reservation of rights. It also hired coverage counsel.

The trial court ruled that most of the contractors' claims had priority over Credit Suisse's claims; one week later, Stewart Title denied coverage. In the declaratory judgment action that followed, Credit Suisse sought discovery of attorney-client documents. The court held that coverage counsel had the same mixed role as the counsel in *Cedell*, and therefore communications between the attorney and Stewart Title were not privileged.

2. *Hilborn v. Metropolitan Group*

In *Hilborn v. Metropolitan Group Prop. Cas. Ins. Co.*, 2013 WL 60555215 (D. Idaho Nov. 15, 2013) the court ordered that the insurer had to produce its entire file to the insured, including attorney-client communications. Coverage counsel had assisted with the investigation of the first-party fire loss. The court noted the similarity to *Cedell*, and held

that the attorney-client privilege did not apply because counsel had both investigated the claim and provided coverage advice.

IV. Criticism of *Cedell*

A. *MKB Constructors v. Am. Zurich Ins. Co.*

In *MKB Constructors v. Am. Zurich Ins. Co.*, 2014 WL 2526901 (W.D. Wash. 2014), the court analyzed and criticized the "new approach" adopted by the *Cedell* court. In *MKB*, American Zurich had issued MKB a Builders Risk policy. When MKB sent American Zurich notification of a ground settlement problem and related breach of contract counterclaim, American Zurich denied coverage for any claims.

MKB sued American Zurich for breach of contract, and subsequently amended its complaint to bring claims for violation of Washington's Insurance Fair Conduct Act, RCW 43.30.015, breach of the duty of good faith and fair dealing, and violation of Washington's Consumer Protection Act, RCW 19.86. MKB filed a motion to compel production of documents that American Zurich either withheld entirely, or heavily redacted, citing attorney-client privilege.

The court began its analysis by focusing on the history of the attorney-client privilege. It noted that the attorney-client privilege has been recognized as the oldest of the privileges for confidential communications known to the common law. The court also noted the importance of full and frank communication between an attorney and its client. The court continued:

> A recent Washington Supreme Court opinion [*Cedell*] has significantly altered the application of both the attorney-client privilege and the work product doctrine in the context of first-party bad faith insurance claims in Washington State. Unfortunately, as another federal district court has noted, the opinion creates rather than alleviates confusion about what must be produced, and under what circumstances. Nevertheless, in *Cedell*, the Washington Supreme Court adopts a new approach for determining when first-party insurers may assert the attorney-client privilege and the work product doctrine, and it requires trial courts to conduct in camera reviews at two points during this determination.

The court acknowledged that *Cedell* creates a presumption that no attorney-client privilege exists in claims between an insured and insurer. It also highlighted the problems with the two-step in camera review, noting that "even if the insurer demonstrates (either in camera or otherwise) that the attorney was not serving in a quasi-fiduciary role, the insured may still be able to pierce the insurer's assertion of attorney-client privilege or protection under the work product doctrine" through the use of the second in camera review to establish a presumption of bad faith.

The court continued by clarifying what amounts to "bad faith" under Washington law. The court stated:

> For a civil fraud exception to apply, so that a communication is stripped of its attorney-client privilege, the party seeking discovery must show that (1) its opponent was engaged in or planning a fraud at the time the privileged communication was made, and (2) the communication was made in furtherance of that activity.

Furthermore, "allegations making out a prima facie case of bad faith or a Consumer Protection Act violation" do not, in and of themselves, constitute a "good faith belief" that the insurer committed fraud. Thus, the court held, an insured's allegation of bad faith alone, even when sufficiently supported by the record to establish a prima facie case, is not enough to waive the attorney-client privilege; instead, something more than bad faith is required.

The court also commented on *Cedell*'s two-step in camera review, and noted that, pursuant to *Erie*, the federal court retains its discretion over whether to conduct an in camera inspection of documents, because such an inspection is procedural in nature. Further, the court commented that the *Cedell* analysis is inapplicable where an insurer withholds documents pursuant to the work product doctrine in Federal court.

V. New York Cases

A. *Donohue v. Fokas*

In *Donohue v. Fokas*, 2013 WL 6483675 (NY App. Dec. 11, 2013), the Appellate Division of the New York Supreme Court analyzed whether plaintiff was entitled to the claims file associated with the defendant/insured's first-party property claim arising out of the same incident. The court held that, because the first-party property claim file was not prepared in anticipation of litigation, it was not entitled to the protection of New York's work-product statute, CPLR 3101(d)(2). In its decision, the court quoted a prior statement by the appellate division in interpreting the statute, *Bombard v. Amica Mut. Ins. Co.*, 738 N.Y.S. 2d 85 (NY App. 204):

> [T]he payment or rejection of claims is a part of the regular business of an insurance company. Consequently, reports which aid it in the process of deciding which of the two indicated actions to pursue are made in the regular course of business. Reports prepared by insurance investigators, adjustors, or attorneys before the decision is made to pay or reject a claim are thus not privileged and are discoverable, even when those reports are mixed/multi-purpose reports, motivated in part by the potential for litigation with the insured.

B. *Melworm v. Encompass*

One week after *Donohue*, the same department of the Appellate Division issued an opinion in *Melworm v. Encompass Indemnity Co.*, 2013 WL 6642679 (NY App. Dec. 18, 2013), that dealt more directly with attorney-client communications. *Melworm* was an insurance breach of contract action for denial of a claim for vandalism to a boat. The insured sought reports by coverage counsel, who had investigated the claim on behalf of the insurer, and whose reports were prepared pre-denial. Again relying on *Bombard*, the court concluded that the insurer had not met its burden of showing that the reports were protected by the attorney-client privilege.

VI. Conclusion

The current trend appears to be a continued erosion of the attorney-client privilege in first and third party coverage claims. Insurers and coverage counsel can, however, take steps to protect themselves from production of attorney-client communications. These steps include, but are not limited to, the following:

(1) Set up separate claim files for investigation versus legal coverage analysis;

(2) Consider separate coverage counsel;

(3) Utilize independent adjusters; and

(4) As counsel, segregate files, and specifically label all *Cedell* privileged communications and materials.

Although coverage counsel needs to be aware of the facts to render legal advice, counsel should separate themselves from the actual investigation of the clam to protect the attorney-client privilege.