Preventive Measures to Avoid or Minimize Bad Faith Risks

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I. Introduction

The covenant of good faith and fair dealing generally implied in an insurance contract imposes on both the insurance company and its insured "a duty that neither shall do anything which impairs the right of the other to receive the benefit of [the] agreement." *Austero v. National Cas. Co. of Detroit, Mich.*, 84 Cal. App. 3d 1, 26, 148 Cal. Rptr. 653, 669 (1978), *disapproved of on other grounds*, *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 169 Cal. Rptr. 691, 620 P.2d 141 (1979), *appeal dismissed* and *cert. denied*, 445 U.S. 912, 100 S. Ct. 1271, 63 L. Ed. 2d 597 (1980).

The essence of the implied covenant of good faith and fair dealing is reasonableness. *Guebara v. Allstate Ins. Co.*, 237 F.3d 987, 992 (9th Cir. 2001) (California law). Thus, an insurance company does not have to pay a claim while seeking information "essential to determining the merits of the claim." In addition, the insurer can resolve good faith doubts about the claim against its insured and is not prohibited from giving its own interests consideration equal to that it gives to the interests of its insureds. See *Aronson v. State Farm Ins. Co.*, 2000 WL 667285, at *9 *10 (C.D. Cal. May 11, 2000). Being reasonable does not mean being "flawless." *Aronson*, 2000 WL 667285, at *9. Consequently, an insurance company's mistake in judgment or negligence does not constitute a breach of the covenant of good faith and fair dealing, but dishonesty, fraud, and concealment may constitute such a breach, that is, bad faith. *Id.*

Bad faith involves an insurer's "deliberate or reckless failure to place on equal footing the interests of [the insurance company's] insured with its own interests… ." *Pinto v. Allstate Ins. Co.*, 221 F.3d 394, 399 (2d Cir. 2000) (New York law) [citation omitted]. As described by one court, an insurance company commits the tort of bad faith "when it affirmatively engages in dishonest, malicious, or oppressive conduct in order to avoid a just obligation to its insured." *Columbia Nat'l Ins. Co. v. Freeman*, 64 S.W.3d 720, 723 (Ark. 2002) [citation omitted]. Examples of acts held to be bad faith include an insurance agent lying by stating that there was no insurance coverage; "aggressive, abusive, and coercive conduct by a claims representative, which included conversion of the insured's wrecked car"; and the intentional alteration of insurance records to avoid a bad risk. See *id.* (citing Arkansas cases); *Cf. Jacobson v. State Farm Mut. Auto Ins. Co.*, 30 P.3d 949, 952 (Idaho 2001) (holding that delay in payment of claims resulted from insureds' refusal to provide medical releases and to submit to independent medical examinations and therefore delay did not constitute bad faith).

An insurance company's duty of good faith and fair dealing is limited to its obligations under the policy; the duty "does not exist until the policy exists" or after the policy has lapsed. Stephen S. Ashley, *Bad Faith Actions, Liability and Damages* §5:05 (Clark Boardman Callaghan 1996); See*, e.g.*, *Norman v. State Farm Mut. Auto Ins. Co.*, 33 P.3d 530, 537 (Ariz. Ct. App. 2001) (holding that, once the insurance company cancelled an auto insurance policy for nonpayment of premium and policy ceased to exist, the insurer had no contract it could breach and no obligation to its former insured under an implied covenant of good faith and fair dealing). However, the obligation of good faith and fair dealing owed by an insurer to its insured is sometimes held to continue throughout litigation between the parties. *White v. Western Title Ins. Co.*, 40 Cal. 3d 870, 221 Cal. Rptr. 509, 710 P.2d 309 (1985).

Some courts have held that bad faith claims handling can occur even if there is no coverage under the insurance policy giving rise to the claim. See*, e.g.*, *Coventry Assoc., L.P. v. American States Ins. Co.*, 961 P.2d 933, 940 (Wash. 1998) (in a case of first impression, holding that an insured may bring a first party bad faith action against its insurance company even though coverage is eventually shown to be excluded under the policy at

issue); *Cf. Cox v. Mutual of Enumclaw*, 757 P.2d 499, 502 (Wash. 1988) (concluding that insured's material fraud voided entire policy and that insured was not entitled to any recovery).

Whether an insurance company has acted in bad faith is often a fact-based analysis and is determined at the time the insurer was confronted with the factual situation to which it was called upon to respond. An insured cannot base a bad faith claim on "second-guessing" the insurance company's claims handling decisions after the fact. *Aronson*, 2000 WL 667285, at *9. Hindsight does not apply. *Troutt v. Colorado W. Ins. Co.*, 246 F.3d 1150, 1161 (9th Cir. 2001) (Montana law).

II. Types of Bad Faith Actions

"To students of bad faith law…, one division matters more than any other, the distinction between liability coverage and all other forms of coverage." Stephen S. Ashley, *Bad Faith Actions, Liability and Damages* §1:06, at 1-9 (1997). Thus, courts have recognized bad faith actions in cases involving liability ("third party") and nonliability ("first party") coverages.[1] Although both types of bad faith actions implicate the reasonableness of an insurance company's actions and generally provide for the same remedies—economic and noneconomic damages and, where warranted, punitive damages, see, *e.g.*, *Jones v. Secura Ins. Co.*, 638 N.W.2d 575, 580 (Wis. 2002) [citation omitted]—the two are distinguishable.

A. Liability Coverage

An insured obtains an insurance policy containing liability (or "third party") coverage for protection against claims by third parties. Liability coverage is commonly found in both consumer (*e.g.,* homeowners, automobile insurance) and commercial policies (*e.g.,* commercial general liability ("CGL") insurance; directors' and officers' insurance; errors and omissions insurance; and professional malpractice insurance). *See generally* Stephen S. Ashley, *Bad Faith Actions*, *Liability and Damages* §1:06, at 1-9 to 1-10 (1997).

Liability coverage obligates the insurance company to pay for those sums the insured becomes legally obligated to pay because of bodily injury or property damage (and in some instances personal or advertising injury) to third parties. In addition, liability coverage generally obligates the insurance company to defend its insured against lawsuits brought by third parties. The liability insurance company has a duty to carry out those obligations in good faith.

1. The duty to settle

In addition to its duties to defend and indemnify its insured, a liability insurance company has a duty to act in good faith in responding to settlement offers to resolve a third party's claim against its insured. The insurance company's failure to make an offer of settlement or to settle within the policy limits creates an issue of bad faith because the question arises as to whether the insurance company placed its own financial interests above the interests of its insured, who is consequently placed at risk for an excess judgment. *Thomas v. Atlanta Cas. Co.*, 558 S.E.2d 432, 439 (Ga. Ct. App. 2001).

Although the insurance company may have an incentive to refuse settlement and proceed to trial, its insured may prefer to settle within the policy limits, thereby avoiding the risk of trial and a verdict in excess of the policy limits, for which the insured may be personally liable. The insurance company's good faith duty to settle arises from its exclusive control over the settlement negotiations. *Haddick ex rel. Griffith v. Valor Ins.*, 735 N.E.2d 132, 134 (Ill. Ct. App. 2000), *aff'd*, 763 N.E.2d 299 (Ill. 2001). Although the insured and the third party are adversaries in the third party's case against the insured, they share a common interest in having the insured's insurance company settle the case by paying the policy limits to the third party. *See* Ashley, *supra*, at

§10:48 ("The third party has greater control over the settlement process than does the insured, but their strategies are similar: to make it so risky for the insurance company to reject a policy limits settlement offer that it has no real choice but to settle the case.").

Courts disagree on the scope of the good faith duty to settle. Some courts hold that an insurance company has a good faith duty to settle even prior to a suit's being filed by a third party. Some courts and commentators even suggest that the insurance company has an *affirmative* duty to settle where the insured's liability is clear and the third party's damages exceed the policy limits. In contrast, some jurisdictions do not find a duty to settle before a third party suit is filed. See *Haddick*, 735 N.E.2d at 135-36 (citing cases); see, *e.g.*, *Uyleman v. D.S. Rentco*, 981 P.2d 1081, 1084 (Ariz. Ct. App. 1999) ("Third-party bad faith failure-to-settle claims against an insurer do not accrue until the excess judgment against the insured becomes final and nonappealable.").

2. Actions against the insurance company

The general rule is that "an injured third party does not have the right to bring a direct action against a wrongdoer's liability insurer." *Menefee v. Shurr*, 751 N.E.2d 757, 761 (Ind. Ct. App. 2001), *transfer denied*, 774 N.E.2d 511 (Ind. 2002) [citation omitted]; see, *e.g.*, *Messina v. Nationwide Mut. Ins. Co.*, 998 F.2d 2, 5 (D.C. Cir. 1993) (holding that, where there is no contractual relationship between the claimant and the insurance company, the implied covenant of good faith and fair dealing does not exist and "there is no doctrinal basis for holding the insurer liable in tort"); see also *Anderson ex rel. Anderson v. American Int'l Specialty Lines Ins. Co.*, 38 P.3d 240, 241 (Okla. Ct. Civ. App.), *cert. denied* (2001) ("There must be either a contractual or statutory relationship between the insurer and the party asserting the bad faith claim before the duty [to deal fairly and act in good faith] arises.") [citation omitted]; *Cf. Richards v. State Farm Mut. Auto. Ins. Co.*, 555 S.E.2d 506 (Ga. Ct. App. 2001) ("Absent an action for bad faith vested in the insured and assignment of such action to the [third party claimant], the [claimant] has no right to such an action.").

There are apparently only five states—Kentucky, Louisiana, Massachusetts, Montana, and West Virginia—that permit direct third party bad faith claims against the insured tort-feasor's insurance company. See *Menefee*, 751 N.E.2d at 761 n.2 (listing Kentucky, Louisiana, Massachusetts, and West Virginia as permitting direct third party bad faith claims); *Cf. State v. Second Judicial Dist. Court*, 783 P.2d 911 (Mont. 1989) (claimants sued insured's insurance company for statutory bad faith pursuant to Montana's Unfair Trade Practices Act).

B. Nonliability Coverages

Nonliability coverages come in a large variety of forms. Sometimes referred to as "first party" coverages, nonliability coverages include: property insurance; life, health, and disability insurance; employee dishonesty insurance; business interruption insurance; title insurance; and workers' compensation insurance. *See generally* Stephen S. Ashley, *Bad Faith Actions, Liability and Damages* §1:06, at 1-10 to 1-13 (1997); Dennis J. Wall, *Litigation and Prevention of Insurer Bad Faith*, §9.01, at 384 (2d ed. 1985).

Nonliability coverages involve only the insured and its insurance company; the insurance company has a duty to act in good faith with respect to a claim for coverage. For example, where an insured's house burns down and the insurance company unreasonably delays paying the claim, the insured may bring a bad faith claim against the insurance company for that delay.

C. Uninsured/Underinsured Motorist Coverages

We typically think of uninsured/underinsured ("UM/UIM") motorist coverage as a "first party" coverage subject to the rules applicable to first party bad faith. However, under UM/UIM insurance, the insurance company is adverse to the insured until an award or judgment because the insurer may assert the defenses

available to the uninsured/underinsured motorist, including the insured's comparative negligence. *State Farm Mut. Auto. Ins. Co. v. Shrader*, 882 P.2d 813, 827 (Wyo. 1994). Some courts have therefore held that a cause of action for bad faith does not arise until after the insured's liability has been determined. See, *e.g.*, *Quick v. State Farm Mut. Auto. Ins. Co.*, 429 So. 2d 1033, 1035 (Ala. 1983) ("The provisions of uninsured motorist insurance coverage reorder the normal postures between an insured and an insurer. Thus, until the liability of the uninsured motorist has been determined, the insurer and insured occupy an adversary position toward each other.").

In *LeFevre v. Westberry*, 590 So. 2d 154, 159 (Ala. 1991), the Alabama Supreme Court concluded that UM coverage in Alabama is a "hybrid" that contains features of both first party and third party coverage. See also *Bonenberger v. Nationwide Mut. Ins. Co.*, 791 A.2d 378, 381 (Pa. Super. Ct. 2002) ("An individual making a UIM claim is making a first party claim; however the valuation of that claim may follow traditional third party claimant concepts.").

A number of courts have rejected the view of the Alabama Supreme Court. For example, in *Danner v. Auto-Owners Ins.*, 629 N.W.2d 159, 171, *reconsideration denied*, 635 N.W.2d 786 (Wis. 2001), the insurance company argued that a bad faith claim again a UIM carrier is "fundamentally different" from other first party bad faith claims. Citing the Alabama Supreme Court's rulings in *LeFevre* and *Quick*, *supra*, the carrier contended that, under UM/UIM coverage, the insurance company and the insured were adversaries unless and until an award or judgment was made in favor of the insured. In the insurance company's view, it was only after a duty to pay benefits was imposed on the insurance company that a cause of action for bad faith could arise. Consequently, a claim for bad faith could not lie against a UM/UIM carrier for the investigation, evaluation, or processing of a claim. See *Danner*, 629 N.W.2d at 171-72.

The *Danner* court rejected the insurance company's argument with respect to UIM claims, holding that a duty of good faith exists from the inception of every insurance contract. Therefore, whenever that duty is breached, including during the investigation, evaluation, and processing of a UIM claim—and the insured incurs damages as a result of the breach—"a claim for bad faith will lie." *Danner*, 629 N.W.2d at 171; see also *Ellwein v. Hartford Accident & Indem. Co.*, 15 P.3d 640, 647 (Wash. 2001), *overruled on other grounds*, *Smith v. Safeco Ins. Co.*, 78 P.3d 1274 (Wash. 2003) (holding that "the duty of good faith and fair dealing survives within the UIM relationship. This is because, although the relationship becomes adversarial, the insured still has 'the reasonable expectation that he will be dealt with fairly and in good faith by his insurer… .'") [citation omitted]; *State Farm Mut. Auto. Ins. Co. v. Shrader*, 882 P.2d 813, 827 (Wyo. 1994) (declining to adopt "hybrid" view of UM coverage urged by the insurance company and holding that, although the insurance company can assert the defense of the uninsured motorist, such "'substituted liability' does not obviate the insurer's duty of good faith and fair dealing" and therefore a UM insurance company "owes a duty of good faith and fair dealing to the insured at all times").

D. Institutional Bad Faith as Distinguished from Individual Claims Handlers' Bad Faith

Policyholder claimants' lawyers look for reasons to bring bad faith claims against the insurance company based on its procedures and practices, as distinguished from bringing claims based only on the conduct of individual claims handlers. Juries find it much easier to dislike a big bureaucracy than an individual claims handler. Former employees are frequently solicited to testify in these institutional bad faith cases and sometimes provide testimony that is very hard to overcome.

III. The First Party Insurance Company's "Right to Be Wrong"

Courts recognizing first party bad faith generally conclude that an insurance company breaches the implied covenant of good faith and fair dealing, that is, acts in bad faith, if it acts "unreasonably." See*, e.g.*, *Hollock v. Erie Ins. Exchange*, 842 A.2d 409, 416 (Pa. Super. Ct. 2004) ("Bad faith will be shown where an insurer has for a frivolous or unfounded reason refused to pay the proceeds of a policy to its insured.") [citation omitted]. Some courts find bad faith if the insurer has "unreasonably" denied a claim, see *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032 (Cal. 1973), whereas an apparent majority of courts require, in addition, the insurer's knowledge that the denial of the claim was unreasonable. See *Anderson v. Continental Ins. Co.*, 271 N.W.2d 368 (Wis. 1978).

Most jurisdictions agree that a first party insurer acting reasonably in handling an insured's claim cannot be liable for bad faith and may dismiss a bad faith claim as a matter of law on the insurance company's motion for summary judgment. In determining the reasonableness of a first party insurer's conduct, many courts have adopted a variant of a "fairly debatable" standard, not imposing bad faith liability on the insurer so long as the coverage is "fairly debatable." *Universe Life Ins. Co. v. Giles*, 950 S.W.2d 48, 54 (Tex. 1997).

Under California's version of the "fairly debatable" standard, the so-called "genuine dispute" doctrine, "where there is a *genuine issue* as to the insurer's liability under the policy for the claim asserted by the insured, there can be no bad faith liability imposed on the insurer for advancing its side of that dispute." *Chateau Chamberay Homeowners Ass'n v. Associated Int'l Ins. Co*., 90 Cal. App. 4th 335, 347, 108 Cal. Rptr. 2d 776, 784 (2 Dist. 2001) [court's emphasis]; see also *Anderson v. Nationwide Ins. Enters.*, 187 F. Supp. 2d 447, 458 (W.D. Pa. 2002) ("We note that in many instances, bad faith allegations arise out of insurance claims having incomplete or unclear facts, and these cases have frequently been resolved in favor of insurers at the summary judgment stage.").

Although courts in the various jurisdictions have articulated somewhat different standards for "reasonableness," the basic rationale is the same: bad faith liability cannot be based on "a legitimate, arguable, or fairly debatable reason" for denying (or delaying payment of) a claim. Douglas G. Houser, *Good Faith as a Matter of Law: The Insurance Company's Right to Be Wrong*, 27 Tort & Ins. L.J. 665, 667 (1992); *see generally* Douglas G. Houser, Ronald J. Clark, & Linda M. Bolduan, *Good Faith as a Matter of Law: An Update on the Insurance Company's "Right to Be Wrong,"* 39:4 Tort Trial & Ins. Practice L. J. 1045 (Summer 2004) (includes Appendix—First-Party Bad Faith Standards: State-by-State Summary).

IV. Minimizing Bad Faith Claims

There are a number of steps that an insurance company can take to minimize bad faith claims. The insurance company should adopt fair claims handling procedures and ensure that claims personnel know those procedures and adhere to them. Stephen S. Ashley, *Bad Faith Actions, Liability and Damages* §10:59 (Clark Boardman Callaghan 1996). The person handling a claim must make sure that the insurance company has followed the rules and that the claims file demonstrates that the insurance company has conformed to the law. Moreover, claims handlers should consider the effect on a potential jury of every document that is included in the file and how that document is going to affect the jury's opinion of the insurance company. As one commentator has noted, "[i]nsurance bad faith cases are won or lost on the contents of the insurance company's claims file." *See* Ashley, *supra*, §10:60, at 111.

Maintaining an adequate claim file is the first, but not the last, step toward minimizing bad faith risks. Avoiding delays and "passive" claims handling is another positive step toward building a claim decision that can be defended. This usually requires that the claims handler have some form of "tickle system" to ensure that claims do not languish.

It goes without saying that the claim file should also reflect a work product that is devoid of any appearance of bias or prejudgment. The claims handler should follow the factual evidence where it leads until the factual background is sufficient to make a decision regarding coverage. Indicia that a factual investigation has been "steered" toward a determination that results in no coverage will be a source of attack for a policyholder's lawyer.

V. Defending Bad Faith Claims–The Claims File: We Have Met the Enemy, and He Is Us

When a bad faith claim is filed against an insurance company, one of the most important discovery issues is production of the insurance company's claims file. An insurance company's claims file contains a wealth of information about a particular claim, the insurance company's standard practices, and whether those practices were followed in the case at issue. Several legal doctrines may protect sensitive portions of the claims file from disclosure.

A. Attorney-Client Privilege

The attorney-client privilege applies to protect the discovery of confidential communications between attorney and client. *In re Grand Jury Matter*, 147 F.R.D. 82, 84 (E.D. Pa. 1992). The privilege extends to others who are advised of the confidential information at the direction of the attorney, including to an insurance company's investigator taking an insured's statement to assist the insurance company's lawyer in defending claims against the insured. *State ex rel. Medical Assur. of W. Va., Inc. v. Recht*, 583 S.E.2d 80, 88-89 (W. Va. 2003) [citations omitted] (holding that privileged communications between attorney and his client remained privileged even if shared with client's liability insurer).

The attorney-client privilege may be asserted to protect certain information in an insurance company's claims file. In the context of bad faith claims, courts have disagreed as to when the privilege applies.

1. Failure to settle within the policy limits

In a bad faith action by an insured against a liability insurance company for failure to settle within the policy limits, the general rule is that the attorney-client privilege does not apply. *Baker v. CNA Ins. Co.*, 123 F.R.D. 322, 326 (D. Mont. 1988); see also *Hodges v. Southern Farm Bur. Cas. Ins. Co.*, 433 So. 2d 125, 131 (La. 1983) (holding that insured could discover work product of his own attorney, reasoning that attorney was hired by insurance company to represent both insured and insurance company, and therefore, attorney's legal opinions or theories concerning liability claim at issue benefitted both parties); *Cf. Yurick ex rel. Yurick v. Liberty Mut. Ins. Co.*, 201 F.R.D. 465, 474 (D. Ariz. 2001) (noting that, in bad faith actions by an excess carrier against a primary carrier, courts have held that the attorney-client and work-product privileges "do not attach to communications between the insurance company and its attorney because the duty owed to the excess carrier by the primary carrier is identical to that owed to the insured") (citing cases).

The same rule—that the attorney-client privilege does not apply to claims alleging failure to settle within policy limits—generally applies in bad faith actions brought by third party claimants. For example, in *Dunn v. National Security Fire & Casualty Co.*, 631 So. 2d 1103 (Fla. Ct. App. 1993), a case involving an automobile liability insurer, the court opined:

> Discovery of the insurer's claim file and litigation file is allowed in a bad faith case over the objections of the insurer that production of the file would violate the work product or attor-

> ney/client privilege… . The rationale… is because the injured third party "stands in the shoes" of the insured party… and the insurer owes a fiduciary duty to its insured.

Dunn, 631 So. 2d at 1109 [citations omitted].

The *Dunn* court noted, however, that the insured could overcome the work-product privilege only "by a showing of need and undue hardship in obtaining substantially equivalent information by other means." *Id.* (citing Fla. R. Civ. P. 1.280). The court further noted that the attorney-client privilege, although "absolute," could be overcome, but only by an *in camera* inspection: "An *in camera* inspection of these files would have established whether they contained privileged attorney-client communications and, if so, whether redaction would have been feasible. In the absence of such an inspection, the trial court's [discovery] order violates the attorney-client privilege." *Dunn*, 705 So. 2d at 608.

In *State ex rel. Allstate Insurance Co. v. Gaughan*, 508 S.E.2d 75 (W. Va. 1998), however, the West Virginia Supreme Court rejected *Dunn* as "unsound," recognizing instead what it called a "quasi attorney-client privilege" with respect to claims by third parties for failure to settle. The court held that, "where an insured has signed a release of his/her claim file to a third party litigant, an insurer may raise a quasi attorney-client privilege to communication in the insured's claim file. The quasi attorney-client privilege belongs to the insurer, not the insured, and may be waived only by the insurer." *Gaughan*, 508 S.E.2d at 89.

2. Special UIM rule

In a case involving underinsured motorist ("UIM") claims, the Washington Court of Appeals has held that the attorney-client privilege applies to bar discovery of privileged material in claims files. In *Barry v. USAA*, 989 P.2d 1172 (Wash. Ct. App. 1999), the insured was involved in an automobile accident. After the tort-feasor's insurance company paid its policy limits, the insured sought UIM benefits under her own policy. The insured hired her own attorney to pursue her claim. The insured eventually brought a bad faith case against her insurance company, alleging bad faith failure to process her claim. Pursuant to the lawsuit, the insured sought discovery of reports from the claims adjuster and correspondence from the insurance company's attorney who had handled the UIM claim. The court held that the attorney-client privilege applied to bar discovery.

In reaching its decision, the court noted that, in a typical case, the attorney represents both the insurance company and the insured, and, in such a case, the communications between the insurance company and its attorney are not privileged with respect to the insured. However, under Washington law, the UIM insurance company stands in the shoes of the underinsured motorist/tort-feasor to the extent of the carrier's policy limits. As a consequence, the UIM carrier can pursue all the defenses against the UIM claimant that could have been asserted by the tort-feasor.

Moreover, the court pointed out that the "adversarial" nature of UIM coverage and the traditional fiduciary relationship between the insurance company and the insured "is difficult to resolve." *Barry*, 989 P.2d at 1176. The court opined that "[t]he difficulty is complicated by those cases where an attorney represents an insured in an action against the tortfeasor and then must represent the carrier when the insured makes a UIM claim." *Id.* However, in the case at bar, the insurance company attorney was involved only in the UIM claim, and the court therefore reasoned that the communications between the insurance company and its attorney concerning the UIM claim were privileged for purposes of the insured's bad faith suit against the carrier.

3. *Boone v. Vanliner Insurance Co.*: insured's claims files "unworthy" of protection?

In *Boone v. Vanliner Insurance Co.*, 744 N.E.2d 154, *reconsideration denied*, 747 N.E.2d 254 (Ohio), *cert. denied*, 534 U.S. 1014, 122 S. Ct. 506, 151 L. Ed. 2d 415 (2001), the Ohio Supreme Court held, in a "maverick"

decision, that an insured could discover privileged claims files where the insured's complaint alleged merely bad faith. In *Boone*, the insured brought an action against his automobile insurer to recover for bad faith denial of UIM benefits. The complaint alleged that the insurance company lacked "reasonable justification" for denying UIM coverage. To support his bad faith claim, the insured sought discovery of the company's claims file. The insurance company sought a protective order, contending that certain documents were protected from discovery by the attorney-client privilege and/or the work-product doctrine.

The court described the issue before it as whether, in an action alleging bad faith denial of insurance coverage, the insured is entitled to discover privileged documents that "may cast light on whether the denial was made in bad faith." *Boone*, 744 N.E.2d at 156. The court answered in the affirmative, concluding that "claims file materials that show an insurer's lack of good faith in denying coverage are *unworthy* of protection ." *Id.* at 158 [emphasis added].

In *Moskovitz v. Mt. Sinai Medical Center*, 635 N.E.2d 331 (Ohio), *cert. denied*, 513 U.S. 1059, 115 S. Ct. 668, 130 L. Ed. 2d 602 (1994), the Ohio Supreme Court had held that privileged documents showing the lack of a good faith effort to settle a claim were discoverable, except for matters in the file that pertained directly to the theory of defense in the underlying case. The *Boone* court distinguished *Moskovitz*, finding the *Moskovitz* holding inapplicable to the case at bar. The *Boone* court opined that, "while the lack of a good faith effort to settle involves conduct that may continue throughout the entire claims process, a lack of good faith in determining coverage involves conduct that occurs when assessment of coverage is being considered." *Boone*, 744 N.E.2d at 158. Therefore, the court limited the insured's discovery to privileged documents created prior to the denial of coverage. *Id.* (noting that, "[a]t that stage of the claims handling, the claims file materials will not contain work product… because at that point it has not yet been determined whether coverage exists"); see *Dennis v. State Farm Ins. Co.*, 757 N.E.2d 849, 855 (Ohio Ct. App.), *stay denied*, 751 N.E.2d 485, *cause dismissed*, 752 N.E.2d 983 (Ohio 2001) (in a case not alleging bad faith, applying the reasoning in *Boone* to allow the insureds to depose the claims adjuster about materials in the claims file existing prior to the filing of the complaint. "If the claims file itself is not protected prior to the time the claim is denied, then there is no reason to prohibit the insured from deposing the claims adjuster even if the purpose of the deposition is to obtain that unprotected information.").

The *Boone* court directed the trial court to issue a stay of the bad faith claim and related discovery pending the outcome of the underlying claim, but only if the trial court were to find that the release of the requested information would inhibit the insurance company's ability to defend the underlying claim. *Boone*, 744 N.E.2d at 158.

4. In-house counsel

Communications from *all* corporate employees to in-house counsel, not only communications from the so-called "control group" of employees (those "officers who play a 'substantial role' in deciding and directing a corporation's legal response"), may be covered by the attorney-client privilege. The determination of whether the privilege applies to a particular communication from a particular employee is determined on a case-by-case basis. See *Upjohn Co. v. United States*, 449 U.S. 383, 393, 396-97, 101 S. Ct. 677, 66 L. Ed. 2d 584 (1981) (rejecting the "control group test").

Courts generally agree that confidential communications between in-house counsel and its corporate client (both from the attorney to the client and from the client to the attorney) are privileged to the same extent as communications between outside counsel and its client. *Rossi v. Blue Cross & Blue Shield of Greater N.Y.*, 540 N.E.2d 703, 704 (N.Y. 1989); see also *National Utility Serv., Inc. v. Sunshine Biscuits, Inc.*, 694 A.2d 319, 322 (N.J. Super. Ct., App. Div., 1997) (holding that memorandum at issue was written "as part of the duties of in-house

counsel who was retained to provide professional legal advice to the corporation, and the memorandum was prepared in furtherance thereof, [so] it is subject to the attorney-client privilege unless an exception applies").

However, unlike the situation where counsel works for an individual client, in-house counsel in the corporate context may have multiple roles. For example, staff attorneys may also serve as corporate officers, with responsibilities encompassing both business and legal matters. To demonstrate that the communication at issue is privileged, the company has the burden of "'clearly showing'" that in-house counsel provided the particular advice in a legal capacity, rather than as a business advisor. *Ames v. Black Entertainment Tel.*, 1998 WL 812051, at *8 (S.D. N.Y. Nov. 18, 1998) [citation omitted].

Because no specific test exists for distinguishing between protected legal communications and unprotected business or personal communications, a determination as to whether the privilege applies is a fact-specific one. For example, in *Rossi*, *supra*, New York's highest court, although noting that "not every communication from staff counsel to the corporate client is privileged," found that a memorandum from a corporate staff attorney to a corporate officer containing advice about an imminent defamation action against the company fell within the scope of the attorney-client privilege. *Rossi*, 540 N.E.2d at 705.

5. Exceptions to the attorney-client privilege

a. The civil fraud exception

A privileged communication may be discoverable if it falls within the very limited exception for "civil fraud." *Barry v. USAA*, 989 P.2d 1172, 1176 (Wash. Ct. App., Div. 3, 1999). Under the exception, a *prima facie* showing of a civil fraud perpetrated by the insurance company with the assistance of counsel "vitiates" the attorney-client privilege. *Freedom Trust v. Chubb Group of Ins. Cos.*, 38 F. Supp. 2d 1170, 1171 (C.D. Cal. 1999); see also *United Services Auto. Ass'n v. Werley*, 526 P.2d 28, 32-33 (Alaska 1974) ("Once a litigant has presented prima facie evidence of the perpetration of a fraud or crime in the attorney-client relationship, the other party may not then claim the privilege as a bar to the discovery of relevant communications and documents.").

Generally, the exception applies only where the insured presents a prima facie showing of bad faith "tantamount to civil fraud." *Barry*, 989 P.2d at 1176; *Cf. Freedom Trust*, 38 F. Supp. 2d at 1173 (in case of first impression, concluding that "bad faith denial of insurance coverage is not inherently similar to fraud" and holding that California Supreme Court would not agree with those courts that hold bad faith falls within scope of fraud exception to attorney-client privilege); *State v. Second Judicial Dist. Court*, 783 P.2d 911, 916 (Mont. 1989) (declining to extend civil fraud exception to allegations of bad faith).

b. Advice-of-counsel defense or "the devil made me do it"

As a defense to a bad faith claim, an insurance company may assert that it relied upon the advice of counsel. The insurance company's reliance on counsel's advice must be "reasonable." *Barnes v. Oklahoma Farm Bur. Mut. Ins. Co.*, 11 P.3d 162, 174 (Okla. 2000) (UIM insurance). If an insurance company elects to assert an "advice of counsel" defense to a bad faith claim, the insurance company waives the attorney-client privilege with respect to communications and documents related to the advice.

Courts do not agree on the scope of the defense. Some courts consider it a complete defense, others as one factor upon which the jury may rely in determining whether the insurance company has committed bad faith. *See generally* Stephen S. Ashley, *Bad Faith Actions, Liability and Damages* §7:13 (Clark Boardman Callaghan 1996).

Whether to invoke the attorney-client privilege or assert the advice of counsel defense is not only a legal issue, but also a strategic one. Where the defense is *not* going to be used, care should be taken not to inad-

vertently waive the privilege. *Cf. State Farm Mut. Auto. Ins. Co. v. Lee*, 13 P.3d 1169, 1184 (Ariz. 2000), *reconsideration denied* (Mar. 20, 2001) (a "maverick" decision rejecting well-established law and majority rule, finding insurance company implicitly asserted advice of counsel when it made its claim of good faith conduct turn on "its legal research and the resulting subjective legal knowledge of its claims managers at issue in the case and when that knowledge necessarily included the advice of counsel as part of the decision-making process").

B. The Work Product Doctrine

1. Scope

Like the attorney-client privilege, the work-product doctrine may apply to protect an insurance company's claims files. *Maryland Am. Gen. Ins. Co. v. Blackmon*, 639 S.W.2d 455, 458 (Tex. 1982).

Under Federal Rule of Civil Procedure 26(b)(3),

> a party may obtain discovery of documents… prepared in anticipation of litigation… only upon a showing that the party… has substantial need of the materials in the preparation of the party's case and that the party is unable without undue hardship to obtain the substantial equivalent… by other means… . [T]he court shall protect against disclosure of the mental impressions, conclusions, opinions or legal theories… of a party concerning the litigation.

The purpose of this Rule (and comparable state rules) is to protect the confidentiality of materials prepared by or on behalf of attorneys and/or insurance companies in anticipation of litigation, that is, the attorney's work product. See *In re Grand Jury Matter*, 147 F.R.D. 82, 84 (E.D. Pa. 1992). Work-product protection of documents prepared in anticipation of litigation "is not negated simply because the documents were received and/or reviewed by the defendant's insurer." *State ex rel. Medical Assur. of W. Va., Inc. v. Recht*, 583 S.E.2d 80, 91 (W. Va. 2003).

Voluntary disclosure of materials otherwise protected by the work-product doctrine to the opposing party and/or to third parties waives work-product protection. *American Cas. Co. of Reading, Pa. v. Healthcare Indem., Inc.*, 2001 WL 1718275, at *6 (D. Kan. May 21, 2001).

To establish that the work-product doctrine applies, the party seeking its protection must establish that "(1) the materials sought to be protected are documents or tangible things; (2) they were prepared in anticipation of litigation or for trial; and (2) they were prepared by or for a party or a representative of that party." *Johnson v. Gmeinder*, 191 F.R.D. 638, 643 (D. Kan. 2000).

Protected work-product includes "mental impressions, conclusions, opinions or legal theories… of a party concerning the litigation." Fed. R. Civ. Proc. 26(b)(3). This so-called "opinion work product" encompasses interviews, statements, memoranda, correspondence, and briefs. *Hickman v. Taylor*, 329 U.S. 495, 511, 67 S. Ct. 385, 394, 91 L. Ed. 451 (1947).

The "opinion work product" rule is "distinct from and broader than the attorney-client privilege." *United States v. Nobles*, 422 U.S. 225, 238 n.11, 95 S. Ct. 2160, 2170 n.11, 45 L. Ed. 2d 141 (1975). In contrast to the attorney-client privilege, which protects only confidential communications, the opinion work-product rule may encompass "any writing" of the attorney prepared in anticipation of litigation. *Hodges v. Southern Farm Bur. Cas. Ins. Co.*, 433 So. 2d 125, 131 (La. 1983) (citing cases).

2. Insurance company claims files as work product

Courts differ about whether an insurance company's claims files constitute privileged work product. Frequently at issue is whether the files are prepared in the ordinary course of business and therefore freely discoverable or are prepared in anticipation of litigation and therefore protected by the work-product doctrine. See*, e.g.*, *Dennis v. State Farm Ins. Co.*, 757 N.E.2d 849, 855 (Ohio Ct. App.), *stay denied*, 751 N.E.2d 485, *cause dismissed*, 752 N.E.2d 983 (Ohio 2001) (in a case not alleging bad faith, holding that work-product protection did not apply to the "ordinary" work product of a UIM carrier during its initial investigation of a claim by one of its insureds and "would not prevent the taking of a deposition of the insurance adjuster responsible for the claims file, at least in relation to aspects of the file created prior to litigation with the insured").

a. The claims file "as a whole"

At least one court has rejected an insurance company's suggestion that, regardless of whether work-product protection applies to particular documents in a claims file, the "selection and grouping" of those documents within the claims file "in and of itself accords them protection because the claims file was assembled in anticipation of litigation." *American Cas. Co. of Reading, Pa. v. Healthcare Indem., Inc.*, 2001 WL 1718275, at *3 (D. Kan. May 21, 2001). In *Audiotext Communications Network, Inc. v. U.S. Telecom, Inc.*, 164 F.R.D. 250, 252 (D. Kan. 1996), the Kansas federal court opined that "'[t]he selecting and grouping of information does not transform discoverable documents into work product.'" But see *Aguinaga v. John Morrell & Co.*, 112 F.R.D. 671, 683 (D. Kan. 1986) (holding that selection and compilation of documents used to refresh witness's memory protected by work-product doctrine pursuant to Fed. R. Evid. 612 ["Writing Used to Refresh Memory"]). *Cf. Vasquez v. Elco Admin. Servs.*, 2001 WL 1631535, at *2 (Mass. Super. Ct. Dec. 17, 2001) (not reported in N.E.2d) ("'An [i]nsurance company resisting discovery, must, therefore, establish a factual basis upon which it can demonstrate that it did not prepare certain documents in the ordinary course of business. Such a demonstration might be accomplished by segregating documents, contained in its claims files, into trial preparation materials and nontrial preparation materials.'") [citation omitted].

b. Individual documents in a claims file

Work-product protection applies to individual documents in a claims file if those documents were prepared by or for a party or a representative of that party *and* the documents were prepared in anticipation of litigation.

Some courts find that, unless the materials in a claims file are prepared under the supervision or direction of an attorney, those materials are presumed to be prepared in the ordinary course of business and are therefore unprotected by the work-product doctrine. *S.D. Warren Co. v. Eastern Elect. Corp.*, 201 F.R.D. 280, 282-83 (D. Me. 2001) (noting that one line of federal cases holds that all investigative materials obtained by an insurance company during the routine course of adjusting claims are presumed not to be protected work product "unless they are created or obtained at the behest of an attorney in anticipation of litigation") (citing *Thomas Organ Co. v. Jadranska Slobodna Plovida*, 54 F.R.D. 367 (N.D. Ill. 1972)); see*, e.g.*, *Atlanta Coca-Cola Bottling Co. v. Transamerica Ins. Co.*, 61 F.R.D. 115, 118 (N.D. Ga 1972) ("[T]he evaluation of claims of its policyholders is the regular, ordinary and principal business of defendant insurance company."); *Langdon v. Champion*, 752 P.2d 999, 1007 (Alaska 1988) (holding that "that materials contained in an insurance company's files shall be conclusively presumed to have been compiled in the ordinary course of business, absent a showing that they were prepared at the request or under the supervision of the claimant's attorney. Prior to such attorney involvement, materials held by insurers are subject to discovery without regard to any work product restrictions.").

However, courts have generally rejected the above approach because it restricts the literal language of Rule 26(b)(3), which gives work-product protections to communications and documents even though an attor-

ney is not involved in their creation. Rather, courts have preferred to interpret Rule 26(b)(3) "literally," giving work-product protection to all materials "actually" compiled in anticipation of litigation, not just to those materials created by or for attorneys. See *S.D. Warren Co. v. Eastern Elect. Corp.*, 201 F.R.D. 280, 283 (D. Me. 2001) (citing 6 James Wm. Moore, *Moore's Federal Practice* §26.70[3][c], at 26-216 (3d ed. 2000)); *Cf. Florida Farm Bur.Gen. Ins. Co. v. Copertino*, 810 So. 2d 1076, 1080 (Fla. Ct. App. 2002) (holding that memoranda created *during* litigation over bad faith issue were protected by work-product doctrine).

Of the federal courts that have addressed the issue, a minority have held that all materials in claims adjuster's files must be deemed to have been collected or created in anticipation of litigation "because it is in the nature of the insurance business to always be preparing for litigation." See *S.D. Warren Co.*, *supra*, 201 F.R.D. at 283 [footnote omitted] (citing cases). However, the "overwhelming majority" of federal courts have held that whether work-product protection applies depends upon a "fact specific inquiry" as to whether a particular document was prepared in anticipation of litigation. See *id.* (citing 6 James Wm. Moore, *Moore's Federal Practice* §26.70[3][c], at 26-216 to 26-217 (3d ed. 2000)).

Thus, whether all or parts of a claims file will enjoy work-product protection depends largely on a particular jurisdiction's interpretation of the doctrine. Generally, materials prepared under the supervision or direction of defense counsel are immune from discovery. However, in bad faith cases, some courts find that the claimant's substantial need for the claims file justifies the waiver of any work-product protection. See *Siddall v. Allstate Ins. Co.*, 2001 WL 868376, at *1 (9th Cir. Aug. 2001) (California law) (not selected for publication in the Federal Reporter) (holding that, in a bad faith case, "'[a] plaintiff may be able to establish a compelling need for evidence in the insurer's claim file regarding the insurer's opinion of the viability and value of the claim. We review the question on a case-by-case basis.'") [citation omitted]; *National Security Fire & Cas. Co. v. Dunn*, 705 So. 2d 605, 607 (1997), *reh'g denied* (1998), *appeal after remand*, 751 So. 2d 777 (Fla. Ct. App. 2000) (opining that, "[g]enerally the contents of insurance claim files are protected by the work product privilege," which "may be overcome by a showing of need and undue hardship in obtaining substantially equivalent information by other means").

C. Self-Critical Analysis Privilege

The relatively new privilege of self-critical analysis, or the self-evaluative privilege as it is sometimes called, is a privilege recognized in a handful of states that provides protection for documents relating to a company's internal evaluation of its operations and procedures. *See generally* Note, *The Privilege of Self-Critical Analysis*, 96 Harv. L. Rev. 1083 (1983); *see also* Marla Clark, *The Privilege for Self-Critical Analysis*, 42-JAN Res Gestae 7 (1999). "In its broadest terms, the privilege has been stated to apply to any critique by a person or entity of its own operations, policies, or processes." *Cloud v. Superior Court*, 50 Cal. App. 4th 1552, 1556, 58 Cal. Rptr. 2d 365, 367 (1996) [citation omitted]. First recognized in the 1970s, the privilege originated in judicial protections given the records of hospital peer review bodies. See *Bredice v. Doctors' Hosp.*, 50 F.R.D. 249 (D. D. C. 1970), *aff'd*, 479 F.2d 920 (D.C. Cir. 1973).

Recognition of the self-critical analysis privilege by federal courts is a matter of federal common law. *See* Fed. R. Evid. 501; *Cloud v. Superior Court*, 50 Cal. App. 4th 1552, 1558, 58 Cal. Rptr. 2d 365, 369 (1996) (finding that Rule 501 "allows federal courts to recognize privileges, or not, under the developing common law 'in light of reason and experience,' in cases where Congress has not acted and in which state law does not apply") [citation omitted].

As of October 2003, none of the federal circuit courts of appeal addressing the issue has explicitly recognized the existence of the self-critical analysis privilege. *Freiermuth v. PPG Indus., Inc.*, 218 F.R.D. 694, 697 (N.D. Ala. 2003) (citing cases). The federal district courts, however, are split on whether to recognize the privi-

lege. *Id.* (citing cases); *compare Johnson v. United Parcel Serv., Inc.*, 206 F.R.D. 686, 693 (M.D. Fla. 2002) (declining to recognize privilege in employment discrimination context); *Cruz v. Coach Stores, Inc.*, 196 F.R.D 228, 232 (S.D. N.Y. 2000) (stating that "Court is doubtful it [the privilege] should be recognized at all") *with Reid v. Lockheed Martin Aeronautics Co.*, 199 F.R.D. 379, 385 (N.D. Ga. 2001) (applying privilege in Title VII action); *Reichhold Chems., Inc. v. Textron, Inc.*, 157 F.R.D. 522, 524-27 (N.D. Fla. 1994) (applying privilege in pollution case).

Notwithstanding some judicial recognition of the privilege in a variety of settings, courts have not agreed on a uniform set of criteria that would trigger the protection of the privilege. *Morgan v. Union Pac. R. Co.*, 182 F.R.D. 261, 264 (N.D. Ill. 1998), *reconsideration granted* (Oct. 8, 1998). Courts do agree, however, that the essential purpose of the privilege is to "protect from disclosure documents containing candid and potentially damaging self-criticism." Donald P. Vandegrift, Jr., *The Privilege of Self-Critical Analysis: A Survey of the Law*, 60 Albany L. Rev. 171, 175-76 (1996). According to one court, the purpose of the self-critical analysis privilege is "to protect certain information from discovery particularly in instances where public policy outweighs the needs of litigants and the judicial system for access to information relevant to the litigation." *Granger v. National R.R. Passenger Corp.*, 116 F.R.D. 507, 508 (E.D. Pa. 1987) [citations omitted]. Thus, the privilege serves public policy by encouraging self-improvement through candid self-analysis and self-criticism. *In re Crazy Eddie Secs. Litig.*, 792 F. Supp. 197, 205 (E.D.N.Y. 1992).

In applying the self-critical analysis privilege in tort cases, some courts have adopted the standards used in employment discrimination cases. *Morgan*, 182 F.R.D. at 265 (citing *Culinary Foods, Inc. v. Raychem Corp.*, 151 F.R.D. 297, 304, *order clarified*, 153 F.R.D. 614 (N.D. Ill. 1993); *Roberts v. Carrier Corp.*, 107 F.R.D. 678, 684 (N.D. Ind. 1985)). However, in *Morgan*, *supra,* a tort case involving on-the-job injuries, the court concluded that different standards should apply. The court pointed out that the purpose of the self-critical analysis privilege in employment discrimination cases is "to assure fairness to employers who are legally required to engage in self-evaluation." *Morgan*, 182 F.R.D. at 265. On the other hand, the purpose of the self-critical analysis privilege in tort cases is "to promote public safety through voluntary and honest self-analysis." *Id.* The court therefore opined that "whether a particular document was prepared pursuant to a governmental mandate is unrelated to the policy goals that the self-critical analysis privilege seeks to achieve in tort cases." *Morgan*, 182 F.R.D. at 266.

Because of this "fundamental difference" in the purposes of the self-critical analysis privilege between employment discrimination cases and tort cases, the *Morgan* court declined to apply the standards applicable to employment discrimination cases to tort cases. Instead, the court applied the test set out in *Dowling v. American Hawaii Cruises, Inc.*, 971 F.2d 423 (9th Cir. 1992) (a tort case), in which the Ninth Circuit had concluded that the self-critical analysis privilege would attach only if the party asserting the privilege could establish that (1) the information sought resulted from a critical self-analysis undertaken by the party seeking protection; (2) the public has a strong interest in preserving the free flow of the type of information sought; (3) the information is of the type whose flow would be curtailed if discovery were allowed; and (4) the document wasprepared with the expectation that it would be kept confidential, and has in fact been kept confidential.

Morgan, 182 F.R.D. at 266 (citing *Dowling*, 971 F.2d at 426). *Cf. Paladino v. Woodloch Pines, Inc.*, 188 F.R.D. 224, 225 (M.D. Pa. 1999) (in case involving injury of guest on defendant's premises and subsequent preparation of "Guest Claim Investigation and Prevention Report," holding self-critical analysis privilege did not apply and "will not extend to reports, analyses, surveys and the like which are not mandated by the government") [court's emphasis] [citation omitted].

In bad faith cases, as well as other types of cases, an insurance company may want to assert the self-critical analysis privilege where possible to protect from disclosure documents such as internal reviews of claims-handling techniques and employee performance. The insurance company can readily argue that the dis-

closure of such information could have a chilling effect on the company's ability to engage in constructive self-criticism, ultimately resulting in a disservice to its insureds as well as the general public. *See generally* Ronald J. Levine & Amy Bitterman, *Self-Critical Analysis Privilege Pointers*, 15, No. 3, Prod. Liab. & Strategy 4 (Sept. 1996).

D. Certain Material in Insurer Claims Files as "Trade Secrets"

Federal Rule of Civil Procedure 26(c) states, in relevant part:

> (c) Protective Orders. Upon motion by a party… the court… may make any order which justice requires to protect a party or person from annoyance, embarrassment, oppression, or undue burden or expense, including one or more of the following:
>
> …
>
> (7) that a trade secret or other confidential research, development, or commercial information not be revealed or be revealed only in a designated way.

In *Hamilton v. State Farm Mutual Automobile Insurance Co.*, 204 F.R.D. 420 (S.D. Ind. 2001), State Farm Mutual Automobile Insurance Co. ("State Farm") sought and obtained a protective order on the ground that its claims files were "trade secrets." In that case, the insured was injured in an automobile collision and sought coverage for medical payments and lost pay under her liability insurance contract. Although the insured received treatment for her injuries, she brought suit against State Farm, alleging that it unreasonably delayed the review and payment of a portion of, or arbitrarily denied coverage for, her medical and health care bills. The insured asserted claims for breach of contract, bad faith, and intentional infliction of emotional distress. Pursuant to her suit, the insured sought discovery of State Farm's general claims-handling policies, practices, and procedures. In response, State Farm moved for a protective order, seeking to shield that information. The court rejected State Farm's proposed order as too broad and not in compliance with pertinent case law. However, the court did enter a modified protective order based upon the concept that the information sought by the insured fell within Rule 26(c)(7), quoted above.

VI. Good Faith Audit Check List

A. Claims Handler Level

- Did you undertake a thorough investigation?
- Did you avoid lulls or passive handling of the claim?
- Does the file reflect consideration and reconsideration of key facts as they develop and change during the investigation?
- If a liability claim, did you report timely developments to *both* the insurance company and the insured?
- If a liability claim, did you advise the insured of all settlement negotiations?
- Did you obtain a second opinion to help evaluate the case for liability and damages? Possible second opinions from:
  - — experienced lawyers;
  - — retired judges and mediators; or
  - — focus groups and/or a mock trial;
- Did you take the initiative in mediation and/or settlement?

- Did you consider the best time to try for settlement? Possible times include:
  - before filing;
  - right after filing and service and before answering or discovery;
  - after or during discovery;
  - after or before mediation;
  - during scheduling conference with the judge;
  - after any motion *in limine* or motion for summary judgment; or
  - during trial.
- Did you check as needed with local claims-handling guidelines?
- Did you make an effort to ensure that any coverage positions were consistent with other positions taken by the company on that issue?

B. Supervisor's Level

- Did you ensure that the claims handler had the appropriate amount of experience for the claim involved?
- Did you ensure that the claims handler was aware of internal company procedures and policies that might be applicable to that claim?
- Did you maintain a level of oversight that would permit you to describe, at least generally, the status of the claim at any particular time?
- Did you consider whether the claims handler's procedures and coverage positions were consistent with other positions taken by the company that you are aware of?

C. Company Level

- Does the company maintain appropriate "best practices" procedures for claims handling?
- Do the "best practices" procedures require the claims handler to be aware of, and conform to, all local claims handling statutes and regulations?
- Does the company maintain an archive of any changes to policy forms, "best practices" guidelines, and training?
- Does the company have a means of retaining important historical information ("institutional memory") beyond the retirement of key individuals?
- Has the company identified someone to oversee document production and provide uniform responses to document requests and electronic information requests?

VII. Conclusion

Precautionary procedures and sensitive claims handling can minimize an insurance company's exposure to bad faith claims. However, if litigation results, insurance companies and their defense counsel should be prepared to use internal investigatory methods and protocols that take full advantage of those privileges designed to protect confidential documents from discovery and further be prepared to articulate solid reasons for their actions and decisions.

Endnotes

[1] Bad faith terminology can be very confusing. Lawyers and judges have not been consistent in their use of the terms "third party bad faith" and "first party bad faith." Lawyers and judges tend to apply the term "third party bad faith" to bad faith cases involving liability insurance and the term "first party bad faith" to nonliability coverages, such as property insurance. Stephen S. Ashley, *Bad Faith Actions, Liability and Damages* §3:01, at 3–2, §5 (1997). However, Ashley, *supra*, suggests that the term "third party bad faith" be reserved for bad faith cases arising from a liability insurance company's failure to accept a third party claimant's offer to settle his claim against the insured. Ashley, *supra*, §3:01, at 3–2. When the term is used more broadly, problems arise. For example, liability coverage generally requires the insurance company to defend its insured against suits by third parties. Some jurisdictions recognize an action for a bad faith refusal to defend, which involves the denial of a benefit that the policy expressly promises to the insured. According to Ashley: "To describe a bad faith refusal to defend as 'third-party bad faith' could mislead one to apply third-party bad faith standards in what is essentially a first-party bad faith case arising out of a liability insurance policy." Ashley, *supra*, §3:01, at 3–3.

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