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Implied waiver of the attorney-client privilege in insurance bad-faith litigation

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Unlike nearly every other type of contractual dispute, a dispute over an insurer's obligations under an insurance policy can give rise to extracontractual, or "tort" liability, for "bad faith" claims handling.

Unlike contract law, which limits recovery to actual contract benefits plus interest, the tort of insurance bad faith exposes the insurer to the full panoply of tort remedies, including consequential damages for emotional distress and lost business opportunity.

To raise the stakes in a dispute over policy benefits, insureds typically allege that the insurer acted "unreasonably" and, in some jurisdictions, that the insurer subjectively understood its conduct was unreasonable.

The simplest way for an insurer to rebut the insured's allegations of unreasonableness is to assert that its conduct was based on the reasoned advice of counsel. But doing so is likely to constitute a waiver of the attorney-client privilege, opening the door to discovery of all attorney-client communications.

Consequently, the advice of counsel rarely is expressly asserted as an affirmative defense in insurance bad-faith litigation. Instead, insurers argue that their claims-handling conduct was reasonable in light of the totality of circumstances without directly invoking the advice-of-counsel defense.

Increasingly, however, courts are finding that insurers have waived the attorney-client privilege even in the absence of an express invocation of the advice-of-counsel defense. They find an *implied* waiver of the privilege based on the manner in which the insurer defends the reasonableness of its claims-handling conduct.

In *In re Mt. Hawley Insurance Co.*, 829 S.E.2d 707 (S.C. 2019), the South Carolina Supreme Court attempted to bring some clarity to the vexing question of how to determine when an insurer may be deemed to have injected privileged communications with its attorney into a dispute over claims handling, thus causing an implied waiver.

This article will examine the result, reasoning and implications of the court's decision.

In a nutshell, the court held that an insurer's denial of bad faith and/or the assertion of good faith in response to its insured's bad-faith lawsuit does not, standing alone, place privileged communications between the insurer and its attorney "at issue" and thus does not waive the insurer's attorney-client privilege.

The insurer may, however, waive the attorney-client privilege without expressly relying on the advice of counsel as a defense to bad-faith liability. The insurer's reliance on the advice of counsel may be implied where the facts show that the insurer developed its coverage position in consultation with counsel, the court held.

FACTUAL BACKGROUND

The insured, a construction company, settled a construction-defect lawsuit brought by the homeowners association for a residential development project after the insured's excess liability carrier, *Mt. Hawley Insurance Co.*, refused to defend the lawsuit.

Following the settlement, the insured contractor and the homeowners association sued *Mt. Hawley*, alleging bad-faith failure to defend or indemnify, breach of contract and unjust enrichment. *Mt. Hawley* removed the case from South Carolina state court to the U.S. District Court for the District of South Carolina.

Unlike contract law, the tort of insurance bad faith exposes the insurer to the full panoply of tort remedies, including consequential damages for emotional distress and lost business opportunity.

During discovery, the plaintiffs sought production of *Mt. Hawley*'s claims files both for the underlying construction-defect lawsuit and for all of the insured construction company's claims.

Contending that the files contained privileged attorney-client communications, *Mt. Hawley* produced the files in redacted form with accompanying privilege logs.

The plaintiffs moved to compel production of the entire files, arguing that *Mt. Hawley* had waived the attorney-client privilege by denying liability for bad-faith refusal to defend or indemnify and thereby putting the communications "at issue."

The District Court ordered an in-camera inspection of the documents. *Mt. Hawley* then sought a writ of mandamus from the 4th U.S. Circuit Court of Appeals prohibiting inspection of the attorney-client communications contained in the documents.

In response, the 4th Circuit certified the following question to the South Carolina Supreme Court:

> Does South Carolina law support application of the "at issue" exception to attorney-client privilege such that a party may waive the privilege by denying liability in its answer?

With even the insured conceding that a mere denial of liability in a pleading does not put attorney-client communications at issue, the South Carolina high court reformulated the question to limit its analysis to the context of an insurance bad-faith action against an insurer.

Courts are increasingly finding an *implied* waiver of the attorney-client privilege based on the manner in which the insurer defends the reasonableness of its claims-handling conduct.

Having so limited the question, the Supreme Court answered as follows: "No, denying liability and/or asserting good faith in the answer does not, standing alone, place the privileged communications 'at issue' in the case."

If the court had stopped there, its opinion would have provided courts little guidance about when and how an insurer may waive its attorney-client privilege in insurance bad-faith litigation.

In an attempt to find a workable rule, the court surveyed the approaches of courts around the country to balancing the tension between the public policies underlying the attorney-client privilege — encouraging "full and frank" communication between attorneys and their clients — and the tort of insurance bad faith — preventing insurers from unreasonably withholding benefits.

First, the court noted that a "substantial minority" of jurisdictions have broadened the crime-fraud exception to the attorney-client privilege and found the privilege does not extend to any communications in furtherance of any crime *or* tort, including bad-faith insurance claims. The court rejected this approach, finding it gives too much weight to the goal of holding insurers accountable.

Second, at the other extreme, the court found jurisdictions that have upheld the attorney-client privilege absent direct, express reliance on a privileged communication by the insurer in defending the bad-faith allegation.

In effect, these jurisdictions hold that an insurer must assert that its denial of coverage was reasonable because it relied on the advice of counsel. Mt. Hawley urged the court to adopt this approach, but the court refused to do so on the ground that it gave too little weight to the policy considerations underlying the tort of insurance bad faith.

The court instead relied on a "middle-ground approach" embodied in the Restatement (Third) of the Law Governing Lawyers § 80(1)(a), which provides that an insurer may *impliedly* waive the attorney-client privilege.

To illustrate, the court relied on the Arizona Supreme Court's decision in *State Farm Mutual Automobile Insurance Co. v. Lee*, 13 P.3d 1169 (Ariz. 2000) (en banc). The issue in *Lee* was whether the insurer's interpretation of the policy to prohibit stacking was reasonable.

During discovery, State Farm refused to produce attorney-client communications, arguing that its disavowal of express reliance on the subject communications precluded a finding of waiver.

The Arizona high court disagreed. It explained that express invocation of the advice-of-counsel defense is not determinative of whether the insurer put attorney-client communications at issue.

Instead, the court said, an insurer may impliedly waive the attorney-client privilege if the facts show that the insurer obtains information from a lawyer as part of its investigation and considers the lawyer's advice in forming its own subjective understanding of the policy, which is what happened in *Lee*.

The court in *In re Mt. Hawley Insurance Co.* relied on a "middle-ground approach" embodied in the Restatement (Third) of the Law Governing Lawyers § 80(1)(a), which provides that an insurer may *impliedly* waive the attorney-client privilege.

The court emphasized that the insurer did not defend based exclusively on an objective reading of disputed policy provisions without input from counsel.

It acknowledged that insurers will likely confer with counsel in virtually all bad-faith cases, and that "most if not all actions taken will be based on counsel's advice."

The court cautioned: "This does not waive privilege." Rather, it said waiver occurs when an insurer "claims its actions were the result of its reasonable and good-faith belief that its conduct was permitted by law and its subjective belief based on ... information and advice received from ... lawyers."

IMPLICATIONS

The case-by-case middle ground approach to at issue waiver in insurance bad-faith cases has the potential to undermine the attorney-client privilege — something that concerned both the South Carolina court in *Mt. Hawley* and the Arizona Supreme Court in *Lee*.

Typically, it is the privilege holder, not the other party to the litigation, that affirmatively injects an issue that implicates privileged communications.

In the context of bad-faith litigation, however, the plaintiff may put the insurer's attorney-client communications at issue, at least in jurisdictions that define bad faith to require both objective and subjective unreasonableness.

The case-by-case middle ground approach to "at issue" waiver in insurance bad-faith cases has the potential to undermine the attorney-client privilege — something that concerned both the South Carolina Supreme Court in *Mt. Hawley* and the Arizona Supreme Court in *Lee*.

Under the two-pronged test employed in many jurisdictions, the plaintiff must prove both that the insurer acted unreasonably and that it knew it was acting unreasonably or acted with such reckless disregard that such knowledge can be imputed to it.

In these jurisdictions, depending how the implied waiver rule is applied, the insurer may find itself impaled on the horns of a dilemma: Either waive the privileged nature of communications with its attorneys or forgo an attempt to defeat the subjective element of a bad-faith cause of action.

It is true that the *Mt. Hawley* court admonished against finding a waiver merely because the insurer received legal advice before it acted.

But so did *Lee*, and subsequent to *Lee* at least one Arizona court noted the absence of anything in *Lee* "to suggest an insurer will *only* be deemed to impliedly waive the privilege when it argues its actions were reasonable based on its subjective evaluation of the law." *Mendoza v. McDonald's Corp.*, 213 P.3d 288 (Ariz. App. 2009) (emphasis in original).[1]

A court could use the limiting language employed by *Lee* and quoted by *Mt. Hawley*, and still find that an insurer's refusal to settle based on its subjective assessment of a claimant's damages and its insured's liability "was permitted by law ... based on ... information and advice received from lawyers."

Nothing in the court's language limits implied waiver to circumstances where an insurer denies coverage based on advice received from attorneys about recently decided case law interpreting a key policy provision.

Until courts define with more precision the circumstances that give rise to an implied waiver of the attorney-client privilege, battles are likely to rage between policyholders and insurers over the permissible scope of discovery in insurance bad-faith cases.[2]

Notes

[1] But see *Everest Indem. Ins. Co. v. Rea*, 342 P.3d 417 (Ariz. App. 2015) ("the attorney-client privilege is impliedly waived only when the litigant asserts a claim or defense that is *dependent* upon the advice or consultation of counsel" because its defense was based on its "investigation and evaluation" of the law).

[2] Steven Plitt & Joshua D. Rogers, *The Battle to Define the Scope of Attorney-Client Privilege in the Context of Insurance Company Bad Faith: A Judicial War Zone*, 14 UNIV. NEW HAMPSHIRE L. REV. 105 (January 2016).

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