Updates
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South Carolina Attorney-Client Privilege Ruling Is a Gift to Insurers

As *Law360* recently reported, the South Carolina Supreme Court delivered a gift to insurers facing bad faith claims in that state. The court determined that, where a policyholder brings a bad faith claim against its insurer and the insurer answers the claim by denying liability, the policyholder's right to obtain discovery of the insurer's attorney-client privileged communications concerning the insurer's handling of the claim must be determined on a case-by-case basis.

Despite the court's best efforts to balance competing concerns and reach a relatively innocuous holding, this decision will only invite more insurance-related discovery disputes in the future, while encouraging insurers to utilize outside lawyers for claims investigation and handling who are not acting in the policyholders' best interests.

The *Mount Hawley* Decision

The case, *In re: Mt. Hawley Insurance Company*, involved ContraVest Construction Company seeking coverage from its excess insurer, Mount Hawley Insurance Company, for a lawsuit alleging that ContraVest negligently constructed a property development. ContraVest's coverage action asserted, among other things, that Mount Hawley acted in bad faith by failing to defend or indemnify the company. ContraVest alleged that Mount Hawley previously applied a policyholder-favorable interpretation of its excess policy for prior claims but changed its view after consulting with an outside lawyer and denied their claim. Mount Hawley answered the bad faith allegations by denying them and asserting various affirmative defenses.

As is common in insurance bad faith actions, ContraVest served Mount Hawley with discovery requests seeking all of Mount Hawley's files on its insurance claims. Mount Hawley produced certain files but claimed communications with the outside lawyer were privileged.

The court refused to apply the simple "at issue" exception to attorney-client privilege, instead adopting a "case-by-case basis" standard. In doing so, the court adopted an Arizona Supreme Court decision which held that an insurer's privileged communications are discoverable in a bad faith action only where the insurer "relies on and advances as a claim or defense a subjective and allegedly reasonable evaluation of the law—but an evaluation that necessarily incorporates what the litigant learned from its lawyer."

The South Carolina court then went a step further and held that a mere denial of liability by the insurer is not enough; instead, "the party seeking waiver of the attorney-client privilege [must] make a prima facie showing of bad faith."

A Failure to Understand the Insurance Industry Special Relationship

Though the court focused on competing discovery-related policy concerns, the court ignored the unique nature of the insurance industry. Initially, the court noted that South Carolina has "long...recognized that insurance is a business affected with a public interest" and acknowledged the "special relationship" between insurer and insureds. The court, however, failed to acknowledge that an insurer is legally obligated to act in the best interests of, and determine coverage on behalf of, an insured, not the insurer. This creates an obligation for all insurance claims personnel, including attorneys hired to perform claims-handling work, to work for the policyholder.

At the same time, attorneys have an ethical duty to represent the best interests of their clients. As such, where an insurer hires an attorney to investigate coverage, the attorney is faced with the prospect of a competing loyalties. This necessarily raises concerns for policyholders where the insurer has initially acknowledged coverage, only to later deny a claim after attorney review. Thus the "special relationship" in and of itself strongly militates in favor of the policyholder being able to discover the attorney's client communications and work product in a bad faith action. The court's analysis failed to consider this important point.

Moreover, the court disregarded the fact that the purchase of an insurance policy is not a standard business transaction where both parties sit on relatively equal footing. Rather, the insurer is selling a complex legal product to a party that, as one South Carolina Supreme Court decision noted, "ordinarily possesses no bargaining power and no means of protecting himself from" being mistreated by the insurer. *Nichols v. State Farm Mut. Auto. Ins. Co.*, 279 S.C. 336, 340 (S.C. 1983). In fact, South Carolina's insurance bad faith regime arises out of the Supreme Court's historic understanding that "[a]bsent the threat of a tort action, the insurance company can, with complete impunity, deny any claim they wish, whether valid or not."[1]

Because insurance policies are complex legal products, it follows that insurance investigators, adjustors and claims handlers who spend their days analyzing whether a claim is covered under a policy are making inherently legal decisions. Indeed, courts regularly acknowledge that claim investigation and evaluation "is part of the regular, ordinary, and principal business of insurance companies."[2] Where insurers hire an outside attorney or refer a matter to in-house counsel to assist with the investigation, adjustment and/or handling of a claim, courts have routinely held that such materials are not protected by the attorney-client privilege because that attorney is "acting in his capacity as a claims investigator or claims adjustor, not as an attorney."[3] In other words, the attorney-client privilege does not apply because the attorney is doing the ordinary work of an insurance company.[4]

Accordingly, as the Washington Supreme Court aptly explained, "[w]e start from the presumption that there is no attorney-client privilege relevant between the insured and insurer in the claims adjusting process, and the attorney-client privilege and work product privilege are generally not relevant."[5] As a result, the *Cedell* court found it was the insurer's obligation to overcome the presumption of non-privilege by showing that the attorney's advice was not related to claims handling.[6] Here, the South Carolina Supreme Court never considered that the communications with outside counsel in "investigating the law" are not privileged in the first instance.

The Court's "Prima Facie Case" Requirement Is Unfair to Policyholders

The South Carolina Supreme Court ultimately imposed a narrow two-part burden of proof on the policyholder to overcome privilege. The policyholder must demonstrate, without using the "privileged" insurer communications with outside counsel, that the insurer relied on the advice of counsel to deny coverage, and that there is a prima facie case of bad faith.

A policyholder can apparently prove the first element of reliance on advice of outside counsel by inference or circumstantial evidence. The court cited with approval a case where the insurer was arguing a good faith interpretation of the law after it had consulted with counsel, which led to the inference that the legal position was supplied by counsel. Similarly, the policyholder here has evidence that Mount Hawley interpreted the policy differently for prior claims, but then asserted a different legal interpretation for this claim after consulting with outside counsel.

However, in most instances, the evidence of bad faith is contained in the very communications that are being withheld as privileged. As the Washington Supreme Court reasoned, "[t]he insured needs access to the insurer's

file maintained for the insured in order to discover facts to support a claim of bad faith.[7]

As to a prima facie case, the fact that the insurer answered the bad faith allegations in the complaint and denied liability, rather than moving to dismiss the allegations, is an admission by the insurer that the insured has stated a prima facie case of bad faith. If the insurer believed otherwise, it would have moved to dismiss for failure to state a claim.

The court's holding forces the insured to effectively seek a summary judgment-type ruling from the trial court that it has stated a prima facie case of bad faith, which effectively requires the policyholder to produce admissible evidence beyond that contained in the "privileged" claims handling documents. This gives insurers yet another tool to delay the case and throw up procedural roadblocks to an insured's recovery. And again, much of the evidence underlying a bad faith claim is based on the insurer's conduct and thus is typically found in the very documents at issue in a privilege dispute.

Takeaways

Though the South Carolina Supreme Court attempts to couch its privilege ruling in a lawyer-friendly "case-by-case analysis" framework, the court's adoption of the Arizona Supreme Court's holding together with a new "prima facie case" requirement is likely to lead to more confusion and coverage litigation.

Endnotes

[1] Id.

[2] Douga v. D & A Boat Rentals, Inc., No. Civ.A. 04-1642, 2007 WL 1428678 at *4 (W.D. La. May 10, 2007).

[3] St. Paul Reinsurance Co. v. Commercial Fin. Corp., 197 F.R.D. 620, 641 (N.D. Iowa 2000).

[4] Id.

[5] Cedell v. Farmers Ins. Co. of Washington, 176 Wash.2d 686, 698-699 (Wash. 2013).

[6] Id.

[7] Cedell, 176 Wash.2d at 696-697.

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