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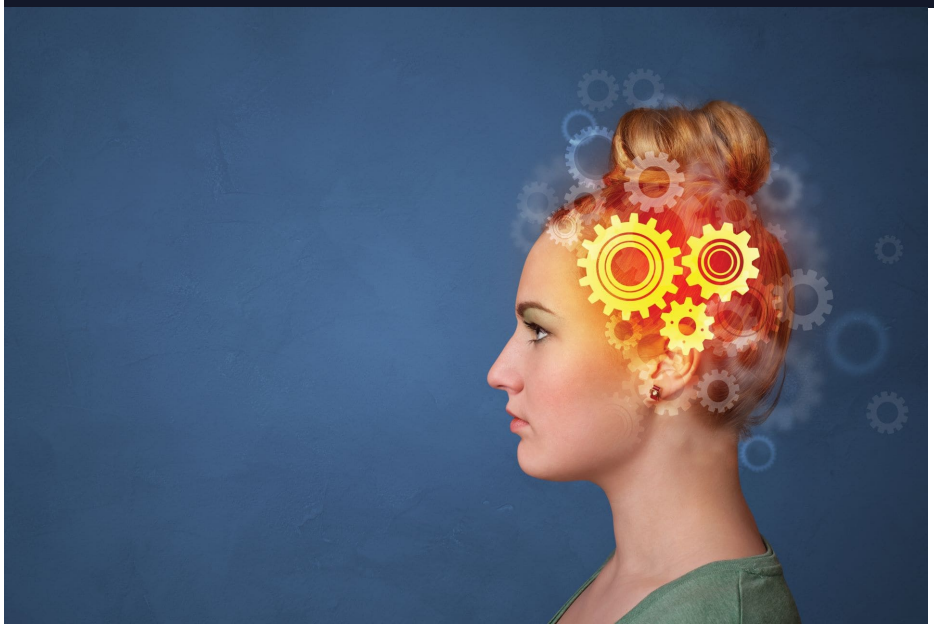

Building An Insurance Bad Faith Case

Obtaining Discovery of the Insurer's Subjective State of Mind Through Loss Reserves, Reinsurance Communications and Similar Claims

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Bad faith claims pose a unique set of risks to insurance companies and expose them to significant extra-contractual damages, including attorneys' fees, consequential damages, double or triple damages and other punitive damages depending on the jurisdiction in which the policyholder files its bad faith action.

Insurers facing bad faith claims feel vulnerable because their internal operations and decision-making processes become subject to intense scrutiny. Their claims handlers' state of mind in adjusting the claim and making coverage decisions becomes a key issue, with policyholders alleging that they acted unreasonably, dishonestly or improperly in processing, investigating, paying or settling a claim.

As a result, insurers strongly resist discovery into how they adjust claims and make coverage decisions. This creates a pricey, sometimes uphill, battle for policyholders. Yet discovery remains one of the best methods for gaining candid insight into an insurer's state of mind at the time it adjusted and made decisions about the claim. Discovery into the insurer's loss reserves, reports to its reinsurers and its actions and decision-making in similar "other claims" often shows the insurer's real-time thoughts and decision-making processes.

There is no uniform standard for proving bad faith, but many jurisdictions consider the insurer's subjective state of mind.

Some jurisdictions have a heightened standard for proving bad faith, which

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requires policyholders to show conscious wrongdoing and a state of mind reflecting dishonest purpose, moral obliquity or ill will. Other jurisdictions require the policyholder to show that the insurer either knew or recklessly disregarded the fact that its denial or failure to pay was unreasonable, which includes a subjective analysis as to whether the insurer committed consciously unreasonable acts. Even jurisdictions limiting the bad faith analysis to objective reasonability consider the insurer's subjective intent. And regardless of the bad faith standard, many jurisdictions require proof of malice before awarding punitive damages for bad faith-making evidence of subjective intent extremely valuable.

Discovery into the insurer's state of mind during the relevant time period also may defeat an insurer's motion for summary judgment on the bad faith claim. Insurers often attempt to hide behind the "reasonable dispute" or "genuine dispute" doctrine, which holds that an insurer mistakenly denying coverage or delaying payment of policy benefits avoids bad faith liability if the basis of its actions was based on a genuine dispute with the insured about the existence of coverage or amount of liability. Insurers often attempt to show reasonableness in a vacuum, without reference to the history of the claim or the mental state of the adjuster at the time he or she denied coverage. Insurers rely on retained experts and litigation counsel to offer after-the-fact justifications of the way their adjusters acted in denying coverage. The relevant inquiry, however, is whether that decision was reasonable at the time it was made, a question that can only be answered through discovery of the adjuster's claim file and other documents, such as loss reserves and reports to reinsurers, detailing the adjuster's actions and decision-making processes in real time.

Loss Reserves: How the Adjuster Internally Evaluated Potential for Liability

Insurance companies are required by state statute or regulation to set loss reserves for each claim. Loss reserves are "the amount anticipated [by the insurer] to be sufficient to pay all obligations for which the insurer *may* be responsible under the policy with respect to a particular claim." See, e.g., *Spahr v. Amco Ins. Co.*, 2010 WL 11459909, at *1 (C.D. Cal. Sept. 29, 2010) (emphasis added). Loss reserves can reveal an unvarnished assessment of coverage that may differ substantially from what the insurer and its experts assert in litigation.

Insurers uniformly refuse to disclose reserves, and lodge a litany of relevancy and privilege objections in support of this refusal. They argue, for example, that reserves are not admissions and that they should not be penalized for setting aside capital to meet a claim in what they characterize as the unlikely event of coverage. The case law, however, is on the side of the policyholder. "The overwhelming majority of courts [] find reserves discoverable, especially in cases involving bad faith claims." *Central Ga. Anesthesia Servs., P.C. v. Equitable Life Assurance Soc'y of U.S.*, 2007 WL 2128184, at *2 (M.D. Ga. July 25, 2007); *OOIDA Risk Retention Grp., Inc. v. Bordeaux*, 2016 WL 427066, at *10 (D. Nev. Feb. 3, 2016) ("[The] bulk of cases to consider the issue have concluded that reserve information is relevant to whether an insurer acted in bad faith"); *Culbertson v. Shelter Mut. Ins. Co.*, 1998 WL 743592, at *1 (E.D. La. Oct. 21, 1998) (endorsing the line of cases "which hold that reserve information is discoverable where a claim of bad faith is asserted"); *Lexington Ins. Co. v. Swanson*, 240 F.R.D. 662, 667-68 (W.D. Wash. 2007) (citing treatise observing that "to this writer's knowledge, no case has held that reserves evidence is irrelevant in a bad faith case").

Many courts have found reserves relevant and discoverable precisely because they can shed light on the insurer's subjective state of mind and subjective assessment of liability. Courts often find that, where the insurer has denied coverage and refused a defense, the very fact that a reserve had been set, and certainly if a high reserve had been set, shows that the insurer knew that the potential for coverage existed – evidencing that it knowingly and in bad faith violated its duty to defend. Even where the insurer has acknowledged coverage, courts have found that reserves may show a seismic divergence between the insurer's genuine valuation of the claim and its position communicated to the policyholder, reflecting a lack of good faith in settling or paying the claim. Other courts have held that reserves may show that the insurer performed a negligent or uninformed evaluation of the claim, also evidencing bad faith.

Insurers argue that, even if reserves are relevant, they are only relevant in the context of third-party claims. Again, this is not so. Courts have found reserves relevant in both first- and third-party claims. Some have even held that the relevance of reserve information is even more pronounced in first-party claims.

Insurers next argue that, even if relevant, reserves are shielded from production by the work product doctrine. To qualify as work product, the insurer's document must have been created "in anticipation of litigation" rather than in the ordinary course of business. Courts have found that, generally, an insurer cannot anticipate litigation until it denies coverage and, until that point, an insurer's investigation of the claim – including its setting of loss reserves – is part of its ordinary course of business and, therefore, not protected by the work product doctrine. Reserves are set as part of routine adjusting pursuant to state statutes and regulations, not prepared "in anticipation of litigation." Courts have recognized this and refused to shield reserves from disclosure based on the work product doctrine.

Reinsurance Communications: What the Insurer Told Its Own Insurer About Potential Liability for the Claim

Communications between an insurer (the "cedent") and its reinsurer may also provide a treasure trove of insight into the insurer's state of mind. Reinsurers expect their cedent insurers to timely report claims and communicate regarding the potential for liability and coverage defenses. Reports to reinsurers often contain analysis of risk exposure and information regarding valuation of the claim and settlement opportunities, including reports from counsel regarding a coverage analysis. These reports show the insurer's real-time analysis of the claim, which may drastically differ from its characterization in subsequent litigation of its adjuster's investigation of and decisions concerning a denied claim based on a sanitized record.

As with reserves, courts have consistently held that reinsurance communications are relevant and discoverable. Courts have held that these communications indicate whether the cedent insurer believed its policies covered the claim and acted inconsistently with that knowledge Courts have also held that these communications explain the insurer's reasons for granting or denying coverage and may be probative of the relative adequacy of the insurer's investigation of the claim.

Insurers often assert blanket work product or attorney-client protections over their communications with reinsurers. Courts regularly refuse these protections, finding that the communications are either not protected or that

any protection was waived. Courts have recognized that cedent insurers' reports to reinsurers are created in the ordinary course of business pursuant to contractual obligations between the cedent and the reinsurer and are therefore not protected by the work product doctrine. Even documents qualifying for work product protection are otherwise discoverable as long as the policyholder shows a "substantial need" for the documents, which often exists in bad faith claims, because the insurer's communications with reinsurers may be the only reliable indication of the carrier's mental state and whether it acted in bad faith.

Insurers also argue that reports to their reinsurers are protected by the attorney-client privilege because they contain advice of coverage counsel concerning coverage and available coverage defenses. Again, courts have rejected this argument, finding either that the privilege never attached or that it was waived upon sharing the document with a reinsurer. Also, to the extent that outside coverage counsel acted as a claims adjuster in providing this advice or the insurer used a coverage attorney to conduct its usual claims handling process, the privilege will not attach. Even if privilege applies, however, the insurer generally is held to have waived it once the document is shared with the reinsurer.

Insurers attempt to avoid waiver by relying on the "common interest" doctrine to argue that privilege is not waived. The common interest doctrine, however, requires a joint legal interest. Courts regularly hold that insurers and their reinsurers may share a joint financial or commercial interest, but this is not the same as a joint legal interest, meaning any privilege is waived once counsel's report is shared with the reinsurer. Even if there is a joint legal interest, there also must be evidence of an agreement between an insurer and its reinsurer that establishes a cooperative and common enterprise toward an identical legal strategy as a matter of legal necessity, beyond a mere contractual authorization for the reinsurer to participate in litigation.

Other Claims: How the Insurer Evaluated and Valued Similar Claims by Other Policyholders

Discovery about the decisions an insurer has made in similar claims submitted by similarly situated policyholders also helps build a bad faith case. "Other claims" discovery may show that an insurer acted arbitrarily or unreasonably by denying the claim at issue but covering a substantially similar claim submitted by another policyholder under the same or similar facts and policy. Courts across the nation have found that "other claims" are relevant and discoverable in bad faith cases, as they may show inconsistent interpretations of substantially similar language and inconsistent application of exclusions and conditions. These documents are relevant and discoverable.

Insurers fight hard to avoid "other claims" discovery. Beyond relevancy objections, insurers contend that such requests are unduly burdensome because they do not keep records of claims by policy type, by substantive positions taken or by facts on which the claim is based. Experience teaches that all of these assertions are inaccurate in some manner. Insurers are regulated by the laws and regulations of the states in which they do business, and many state insurance regulations require insurers to maintain records of claims by lines of business so that state examiners can perform audits.

In each business line, there is usually a small handful of fact patterns and liability assertions that underwriters sell the specific insurance product to

cover. If an insurer truly had no way of identifying why it paid claims falling into these subcategories, it would have no statistical means of assessing whether the line of business was profitable or whether it needed to add or remove coverage limitations. Insurance companies are some of the most prolific generators of statistics in the world. An insurer's assertion that it cannot identify similar claims under similar policies without expansive efforts often lacks credibility. Moreover, the fact that an insurer maintains its claim files in a manner that makes access difficult is not a defense to discovery. An insurer cannot avoid discovery by failing to store or organize its files.

Loss reserves, reinsurance communications and "other claims" shed light on the insurer's subjective state of mind during the relevant time period of its decision-making and, as a result, are often critical to building a bad faith claim that can overcome a motion for summary judgment and prevail at trial. Insureds should fight insurers' resistance to producing these documents, as their bad faith claims may depend on it.

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