

# The Bad Faith Sentinel

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*Standing guard on developments in the law of insurance bad faith around the country*

## Washington court upholds attorney-client privilege in first-person bad faith actions

*Cedell v. Farmers Insurance Co. of Washington*, No. 38921-5-11, 2010 WL 3003535 (Wash. Ct. App. Aug. 3, 2010)

Bruce Cedell made a claim for accidental fire damage under his policy with Farmers and when, after a year, Farmers failed to pay the claim, he filed suit. Cedell's suit alleged that Farmers: (1) failed to acknowledge pertinent communications; (2) failed to conduct a prompt investigation of his claim; (3) failed to act promptly, fairly, and equitably; (4) engaged in unfair and/or deceptive acts or practices; (5) effectively denied his claim by delaying action; and (6) acted unreasonably in denying his claim for coverage and/or payment of benefits. During the discovery phase of the case, Cedell sent Farmers interrogatories and a request for production of documents, including Farmers' case file. Farmers responded by providing a heavily redacted copy of the case file and included a privilege log, which cited attorney-client privilege and work product as the basis for over 200 redactions and withholdings. Farmers also declined to answer multiple interrogatories because of attorney-client privilege and work product. Cedell filed a motion to compel arguing that the attorney-client privilege and work product doctrine did not apply in bad faith litigations. In response, Farmers sought a protective order preventing discovery of all privileged communications.

The trial court held that, in the context of a claim arising from a residential fire, an insurer owes the insured a heightened duty that "is not, and should not be adversarial." The court thus determined that the insured is entitled to discover the entire claims file kept by the insurer without exceptions for any claims of attorney-client privilege, and ordered Farmers to provide Cedell with all documents that it withheld and/or redacted. The trial court also imposed sanctions and awarded Cedell attorney fees. Farmers filed a motion for discretionary review and an emergency stay, both of which were granted by the Washington Court of Appeals.

Cedell argued that there is no right to the attorney-client privilege in a first-party insured bad faith claim because information about the insurance company's reasoning and claims handling is central to the claim. The Court of Appeals rejected Cedell's argument, explaining that an insurance company does not lose attorney-client privilege protection simply because its litigation opponent raises an issue where advice of counsel may be relevant. The court also made clear that an insurance company cannot hire an attorney as a claims adjuster just to fall within the

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privilege; only information, investigation and advice a dual role attorney gave to the insurer in his capacity as an attorney is protected.

The court acknowledged that a fraud exception to the privilege exists that provides a litigant with sufficient means to discover relevant attorney-client communications. The exception, the court explained, is generally invoked only when the insured presents a prima facie showing of bad faith tantamount to bad faith. The party seeking discovery must show that (1) the insurer was engaged in or planning a fraud at the time the privileged communication was

made, and (2) the communication was made in furtherance of that activity. Although the trial court found that Farmers (1) made a one-time offer with an acceptance period that fell when Cedell was out of town, (2) threatened to deny coverage without explanation, and (3) offered far less than the value of damage to the house, these facts were not adequate to support a finding of fraud. While the trial court found a factual showing of bad faith, it did not find a factual showing of fraud and abused its discretion by ordering an *in camera* review on the evidence presented. Because the trial court did not find a foundation in fact for a claim of civil fraud, the appellate court vacated the order compelling discovery.

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## Pennsylvania Supreme Court holds that insurer is not entitled to reimbursement of defense costs absent an explicit policy provision so providing

*American and Foreign Ins. Co. v. Jerry's Sport Center, Inc.*, No. 88 MAP 2008, 2010 WL 3222303 (Pa. Aug. 17, 2010)

In June 2000, the National Association for the Advancement of Colored People (NAACP) and the National Spinal Cord Injury Association (NSCIA) filed a civil action against eighteen firearms wholesalers and distributors, including Jerry's Sport Center, in the Eastern District of New York. NAACP and NSCIA sought to hold the firearms industry liable for injury, death, and other damages to association members through the negligent creation of a public nuisance by virtue of the industry's failure to distribute firearms reasonably and safely. The complaint explicitly alleged that the defendants had caused bodily injury to their members.

Jerry's Sport Center notified its insurer, Royal Insurance Company of America, of the NAACP action and requested defense and indemnification, claiming that the complaint fell under the "bodily injury" coverage provided by the liability insurance. Royal retained counsel to represent the insured in the NAACP action, believing the insured would fair better with its own counsel rather than as part of a group defense assembled by other defendants. By letter dated June 15, 2001, Royal informed Jerry's that it was examining

available coverage under the policy and reserved all of its rights, including the right to seek reimbursement for any and all defense costs ultimately determined not be covered. Jerry's expressed concern that if Royal ultimately determined there was no coverage available, it might be less costly to join a defense group. Royal responded that Jerry's had the right to retain its own counsel to represent its uninsured interests or to continue to permit Royal's chosen counsel to represent their mutual interests. Jerry's did not obtain independent counsel. In July 2001, Royal sent another letter, this time indicating that it may be under no duty to defend or indemnify Jerry's and that again it specifically reserved the right to disclaim defense and indemnity based upon the terms of the insurance contract and the right to seek reimbursement of defense costs. A similar letter followed several weeks later. In September 2001, Royal issued a final coverage determination letter, informing Jerry's that Royal was contemplating filing a declaratory judgment action to seek a declaration that it was under no duty to defend and, in fact, filed one just five days later.

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The trial court granted summary judgment in Royal's favor in February 2003. The decision was affirmed in April 2004. Thereafter, Royal sought reimbursement of defense fees expended on Jerry's behalf in the NAACP action from the date Royal filed the declaratory judgment action in 2001. In August 2004, the trial court found that Royal was entitled to restitution, based on the equitable doctrine of unjust enrichment, specifically finding that Royal conferred the benefits of a legal defense upon Jerry's; Jerry's retained those benefits; and to allow Jerry's to accept and retain those benefits without payment would constitute unjust enrichment. Jerry's appealed, arguing that the trial court erred in finding unjust enrichment where the parties' relationship was governed by a written insurance contract that was silent on the issue of reimbursement of defense fees. A panel of the Superior Court agreed with the insured and reversed the trial court.

The Pennsylvania Supreme Court granted allocatur to decide whether an insurer is entitled to reimbursement of defense costs when a court has determined that the insurer has no duty to defend the insured and the insurer has claimed a right to reimbursement only in a series of reservation of rights letters. In support of its position, Royal made three arguments. First, Royal argued that the NAACP action was not potentially covered, and therefore never triggered Royal's duty to defend, as demonstrated by the trial court's declaratory judgment holding. In connection with that argument, Royal asserted that whether an insurer initially provided a defense under the belief that a claim was potentially covered is not relevant, but rather that the existence of the duty to defend is a question that can only be answered by the courts. Secondly, Royal invoked the remedy of restitution based on the equitable theory of unjust enrichment to claim a right to be reimbursed. Lastly, Royal argued that permitting it to be reimbursed would properly induce insurers to provide a defense under a reservation of rights where there is a dispute between the insurer and the insured about whether a claim is covered.

Jerry's responded to each of Royal's arguments in turn. First, it argued that the claims in the NAACP action were potentially covered under the policy, thus triggering Royal's duty to defend, notwithstanding the court's subsequent declaratory judgment that the claims were not within the policy's protections. Jerry's asserted that if an insurer needed a court determination before it knew

whether to provide a defense for claims that may or may not be covered, then every questionable claim tendered to an insurer would require a declaratory judgment action prior to the provision of a defense. Thus, Jerry's argued, it is the insurer's duty to decide whether to defend, and if the insurer believes there is no duty, it should deny its insured a defense at the outset instead of defending and later attempting to recoup defense costs. Next, Jerry's argued that Royal had no contractual right to reimbursement arising from either the insurance contract or the reservation of rights letters. Rather, according to Jerry's, the parties' rights and obligations were defined by the insurance contract, and given the silence in the contract on the matter of reimbursement, allowing reimbursement pursuant to Royal's reservation of rights letters was an impermissible, unilateral modification of a written contract. Further, Jerry's asserted, even if the equitable theory of unjust enrichment were to apply, Royal defended Jerry's for its own benefit at least as much as for Jerry's.

The Supreme Court addressed the jurisdictional split to determine whether Pennsylvania would follow the "majority" or "minority" view of reimbursement of defense costs. The "majority" view, based on a California case, *Buss v. Superior Court*, holds that an insurer may recover defense costs from its insured where the insurer agrees to provide the insured pursuant to an express reservation of the right to recover defense costs, claimed in correspondence with the insured, the insured accepts the defense, and a court subsequently finds that the insurer did not owe the insured a defense. The other view, endorsed by a growing number of courts, including the Third Circuit in *Terra Nova Ins. Co. v. 900 Bar, Inc.*, holds that reimbursement is inconsistent with the broad duty to defend and insurers voluntarily undertake the defense of insureds for their own interests, even if payments are made "under some rudimentary form of protestation." Based on its review of the two lines of cases, the Supreme Court concluded that the reasoning of the *Terra Nova* line was more consistent with the broad duty to defend under Pennsylvania law when viewed in light of the policy language of the parties' insurance contract. The court concluded that although insurers may sometimes face a difficult decision as to whether a claim falls, or potentially falls, within the scope of a policy, the decision is one that insurers must make. Further, the court held, an insurer cannot employ a reservation of rights letter to create a right it does not have under the contract.

## California court holds that factual predicate for good faith coverage determination must go beyond testimony and evidence from underlying litigation

*Howard v. American Nat'l Fire Ins. Co.*, No. A123187, 2010 WL 3156851 (Ct. App. Ca. Aug. 11, 2010).

Howard, who as a young child was molested by a Catholic priest, sued the Bishop who retained the priest in the diocese for negligent retention. A jury found the Bishop liable and the court entered judgment in the amount of \$5.5 million. The Bishop settled with Howard while the case was on appeal, and agreed to join Howard in an action against the Bishop's insurers to recover on the judgment and for bad faith refusal to defend, settle, and indemnify the molestation case.

American insured the Bishop from November 1, 1978 through November 1, 1979, under a comprehensive general liability policy for all sums the Bishop became obligated to pay as damages for "bodily injury caused by an occurrence" during the policy period. American also agreed to defend civil lawsuits brought against the Bishop. When the Bishop was sued for negligent retention of a molesting priest, the Bishop sought defense and indemnity from several insurers, including American. A number of insurers defended the Bishop; American did not, maintaining that the molestation was not covered by the policy because it occurred after expiration of the policy. The trial court, finding that Howard was molested during American's policy period, held that American was liable for breach of contract and bad faith. American appealed the judgment.

American contested the trial court's holding that the molestation occurred during the policy period, arguing that the evidence presented in the underlying litigation failed to show that the abuse occurred between 1978 and 1979. American insisted that the only evidence admissible in the coverage action was the evidence that was presented to the jury in the underlying action and it was error

for the trial court in the coverage action to consider other evidence. The appellate court disagreed; holding that although a party may be collaterally estopped from relitigating issues, in general, insurance coverage and personal injury liability present distinct issues. Importantly, a personal injury plaintiff is not concerned with the theory of liability that produces victory, but rather only with procuring the largest possible judgment. In the case at hand, the exact dates of the molestation were not adjudicated in the underlying litigation and thus provided no grounds for invoking the doctrine of collateral estoppel. Even though the timing of the molestation was a subject of testimony in the underlying litigation, the *specific* dates, and whether those dates fell within the insurance policy term, were not adjudicated. The appellate court found that the trial court properly considered new evidence on the timing of the molestation and did not reject its finding that it fell within American's policy term.

American argued that its conduct was not unreasonable and thus not actionable as tortious bad faith. American asserted that its refusal to settle was prompted by a genuine dispute concerning coverage (whether the molestation occurred within the policy period). The court held that substantial evidence did in fact exist that American unreasonably refused to settle, finding that American's refusal to settle was founded on an "unfair and selective reading" of evidence from the underlying litigation and ignored "powerful indications" that a multimillion-dollar judgment was likely. The court held that American also acted in bad faith in refusing to indemnify the Bishop after judgment was entered, relying again on American's selective reading of evidence. The appellate court thus affirmed the trial court's holding.

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