Whose Privilege Is It, Anyway? Asserting the Attorney-Client Privilege in Insurance Coverage Disputes

by Peter Hawkes, Lane Powell PC[1]

Consider the following common scenario: A general contractor is hit with a construction defect claim. The contractor submits a claim for coverage and tenders the defense to its liability insurer. The insurer accepts the defense under a reservation of rights and hires defense counsel on the insured's behalf. The insurer also begins to investigate coverage, and both the insurer and the insured hire separate counsel to advise them on coverage issues. Eventually, the insurer denies the insured's claim, and litigation over coverage commences. In that litigation, can the insurer assert that its communications with its coverage counsel prior to its denial of the claim are protected by the attorney-client privilege?

Instinctively, most attorneys would answer, "Of course!" After all, both the insurer and insured were separately represented by counsel. The advice that each received would seem to lie at the heart of the attorney-client privilege.

But a complicating factor is the duty of good faith that an insurer owes to its insured, both in discharging its duty to defend and in adjusting the claim for coverage. Do those duties make the insurer a fiduciary on behalf of the insured? And if so, can the insurer shield from the insured legal advice that the insurer obtained while it was supposed to be acting on the insured's behalf? In other words, whose privilege is it anyway—the insurer's or the insured's?

An insurer's duties to its insured

In *Georgetown Realty Inc. v. Home Ins. Co.*, 313 Or. 97, 110-11 & n. 7, 831 P.2d 7 (1992), the Oregon Supreme Court held that an insurer who undertakes the duty to defend its insured takes on a fiduciary duty toward the insured in handling the defense, including negotiating settlement. As the Court explained, "When a liability insurer undertakes to 'defend,' it agrees to provide legal representation and to stand in the shoes of the party that has been sued. The insured relinquishes control over the defense of the claim asserted. Its potential monetary liability is in the hands of the insurer." *Id.* at 110-11.

However, in *Farris v. U.S. Fidelity and Guaranty Co.*, 284 Or. 453, 458-60, 587 P.2d 1015 (1978), the Supreme Court held that an insurer's bad faith denial of coverage gives rise to a claim only in contract, not in tort. The Court found that, because the insurer had denied coverage and never undertook the duty to defend, "[i]t never undertook any fiduciary duty

1 Peter Hawkes is a shareholder at Lane Powell PC, where his practice focuses on commercial and appellate litigation.

by purporting to act in the interests of the insured." *Id.* at 460. Thus, under Oregon law at least, an insurer's duty of good faith to its insured in making a coverage determination is contractual, rather than fiduciary, in nature.

Other courts, however, have reached a different conclusion. The Washington Supreme Court, for example, has stated broadly that "[t]he good faith duty between an insurer and an insured arises from a source akin to a fiduciary duty." *St. Paul Fire and Marine Ins. Co. v. Onvia, Inc.*, 165 Wash.2d 122, 196 P.3d 664, 667 (2008). The court found that "[t]he duty of good faith is not specific to either of the main benefits of an insurance contract [*i.e.*, liability coverage and defense] but permeates the insurance arrangement." *Id.*

The "fiduciary exception" to the attorney-client privilege

A number of courts around the country have recognized a "fiduciary exception" to the attorney-client privilege. Under that exception, the beneficiary of a fiduciary relationship can gain access to communications between its fiduciary and the fiduciary's counsel, at least if there is good cause to do so. *See generally Construction and Application of Fiduciary Duty Exception to Attorney-Client Privilege*, 47 A.L.R.6th 255 (originally published in 2009).

One of the leading cases recognizing the exception, *Garner v. Wolfinbarger*, 430 F.2d 1093 (5th Cir. 1970), explained the exception's rationale in the context of corporate management's fiduciary duty toward shareholders. The *Garner* court noted that "it must be borne in mind that management does not manage for itself and that the beneficiaries of its action are the stockholders…. There may be many situations in which the corporate entity or its management, or both, have interests adverse to those of some or all stockholders. But when all is said and done management is not managing for itself." *Id.* at 1101. The court found that both management and shareholders "have a mutuality of interest" in management's ability to "freely" seek legal advice, "[b]ut management judgment must stand on its merits, not behind an ironclad veil of secrecy which under all circumstances preserves it from being questioned by those for whom it is, at least in part, exercised." *Id.*

Other courts, however, have rejected the fiduciary exception and its underlying rationale. For example, in *Huie v. DeShazo*, 922 S.W.2d 920 (Tex. 1996), the Texas Supreme Court held that a trustee could claim the attorney-client privilege in litigation with the trust beneficiary, notwithstanding the fiduciary relationship between them. The *Huie* court explained, "A trustee must be able to consult freely with his or her attorney to obtain the best possible legal guidance. Without the privilege, trustees might be inclined to forsake legal advice, thus adversely affecting the trust, as disappointed beneficiaries could later pore over the attorney-client communications in second-guessing the trustee's actions. Alternatively, trustees might feel compelled to blindly follow counsel's advice, ignoring their own judgment and experience." *Id.* at 924.

The state of the law in the Ninth Circuit is unclear. In *Weil v. Investment/Indicators, Research and Management, Inc.*, 647 F.2d 18, 23 (9th Cir. 1981), the court acknowledged *Garner*'s holding, but, "[w]ithout passing on [its] merits[,]" found it "inapposite" to a non-derivative securities class action. While the Ninth Circuit has held that "the fiduciary exception applies generally in the ERISA context," *see, e.g.*, *Stephan v. Unum Life Ins. Co. of America*, 697 F.3d 917, 931 (9th Cir. 2012), neither the Ninth Circuit nor the District of Oregon has applied it in the context of other types of fiduciary relationships.

Application of the "fiduciary exception" to the insurer-insured relationship

Returning to the insurer-insured relationship, in *Cedell v. Farmers Ins. Co. of Washington*, 176 Wash.2d 686, 295 P.3d 239, 246 (2013), the Washington Supreme Court held that, because "an insurance company has a quasi-fiduciary duty to its insured[,]" a court must "start from the presumption that there is no attorney-client privilege relevant between the insured and the insurer in the claims adjusting process, and that the attorney-client and work product privilege are generally not relevant." The court held, however, that "the insurer may overcome the presumption of discoverability by showing its attorney was not engaged in the quasi-fiduciary tasks of investigating and evaluating or processing the claim, but instead in providing the insurer with counsel as to its own potential liability; for example, whether or not coverage exists under the law." *Id.* In that event, an insurer can obtain an *in camera* review of the claims file and redact those portions that "reflect[ ] the mental impressions of the attorney to the insurance company, unless those mental impressions are directly at issue in its quasi-fiduciary responsibilities to its insured." *Id.*

The *Cedell* opinion has been subject to criticism by other courts. In *Ingenco Holdings, LLC v. Ace Am. Ins. Co.*, No. C13–543RAJ, 2014 WL 6908512, at *4 (W.D. Wash. Dec. 8, 2014), the court observed that it was "aware of no state other than Washington that has declared the attorney-client privilege presumptively inapplicable in a bad faith claim from a first-party insured." In *Philadelphia Indem. Ins. Co. v. Olympia Early Learning Ctr.*, No. C12–5759 RBL, 2013 WL 3338503, at *3 (W.D. Wash. July 2, 2013), the court stated that *Cedell* "creates rather than alleviates confusion about what must be produced, and under what circumstances[,]" and in *MKB Constructors v. Am. Zurich Ins. Co.*, No. C13–0611JLR, 2014 WL 2526901, at *4 (W.D. Wash. May 27, 2014), the court similarly described *Cedell* as "inconsistent" and "unclear[.]"

Indeed, the *Cedell* opinion appears to conflate two separate issues: whether coverage counsel is essentially performing a non-legal function in investigating or adjusting the claim, and whether coverage counsel's communications with the insurer should nevertheless be accessible to the insured due to their "quasi-fiduciary" relationship. Some authorities have held that documents or communications reflecting an attorney's "*factual investigation* into whether the claim should be paid" are not privileged. Allen D. Windt, *Insurance Claims and Disputes* § 9:21, at 9-81 (6th ed.) (emphasis added; citation omitted); *cf. id.* at 9-79 n. 1 ("of course, [the attorney-client privilege exists] with respect to any counsel that the company might have hired on its own behalf to monitor the case"). In other words, "[c]laim file information is not protected by the attorney-client or attorney work product privilege simply because the in-house claims adjuster also happens to be a licensed

attorney." *Id.* However, it is generally recognized that "communications that reflect the requesting of, or rendering of, *legal advice* are protected by the attorney-client privilege." *Id.* (emphasis added).

In distinguishing between an attorney's performance of the "tasks of investigating and evaluating or processing the claim" and "providing the insurer with counsel as to…whether or not coverage exists under the law[,]" 295 P.3d at 246, the *Cedell* court appears to be drawing a distinction between legal and non-legal functions performed by an attorney. But of course, the line between "investigating and evaluating" a claim and providing legal advice on "whether or not coverage exists under the law" can be elusive, to say the least. Moreover, the *Cedell* court appears to suggest that, even if the attorney is providing advice concerning "whether or not coverage exists under the law[,]" the communication is nevertheless discoverable if the attorney's "mental impressions are directly at issue in [the insurer's] quasi-fiduciary responsibilities to its insured." *Id.* But when an attorney's coverage advice is "directly at issue" with respect to an insurer's "quasi-fiduciary responsibilities to its insured" in a coverage dispute is rather unclear.

Oregon's rejection of the "fiduciary exception"

Just last year, the Oregon Supreme Court declined to recognize a "fiduciary exception" to the attorney-client privilege under Oregon law. In *Crimson Trace Corp. v. Davis Wright Tremaine LLP*, 355 Or. 476, 493-94, 326 P.3d 1181 (2014), a client that had sued its attorneys for malpractice contended that, because those attorneys owed it a fiduciary duty as its counsel in the underlying lawsuit, the attorneys could not assert the attorney-client privilege with respect to communications with the firm's in-house counsel regarding the potential malpractice claim. The Court began its analysis by noting that the "fiduciary exception" to the attorney-client privilege is "a judicially created rule that originated in English trust cases in the mid- to late-nineteenth century" that had subsequently been adopted by some—but by no means all—American courts. *Id.* at 494-95. The Court observed, however, that most of the courts adopting the exception "are not governed by a legislatively adopted privilege[.]" *Id.* at 496. By contrast, OEC 503, the rule of evidence governing the attorney-client privilege in Oregon, "is a statute, enacted into law by the legislature. Accordingly, the scope of the privilege—as well as any exceptions to it—is a matter of legislative intent." *Id.* The Court concluded that, because OEC 503(4) specifically enumerates five exceptions to the attorney-client privilege, "the legislature fairly may be understood to have intended to imply that no others are to be recognized." *Id.* at 497. The Court found it immaterial that the communications at issue might actually violate the attorneys' ethical obligations to their clients, stating that, while "rules of professional conduct may require or prohibit certain conduct, and the breach of those rules may lead to disciplinary proceedings[,] …that has no bearing on the interpretation or application of a rule of evidence that clearly applies." *Id.* at 500-01. The Court therefore held that the "fiduciary exception" to the attorney-client privilege "does not exist in Oregon[.]" *Id.* at 501.

While *Crimson Trace* did not deal with the specific context of the insurer-insured relationship, its reasoning strongly suggests that Oregon courts would *not* require disclosure of an insurer's pre-denial communications with its coverage counsel in the scenario described at the outset of this article. Even if the insurer-insured relationship is in some respects "fiduciary" in nature, there is no "fiduciary exception" to the attorney-client privilege under Oregon law.

Moreover, under *Georgetown Realty* and *Ferris*, the fiduciary relationship between the insurer and the insured arises only with respect to the *defense* of the claim against the insured, not to the insurer's *coverage determination*. It would make little sense to require an insurer to disclose its communications with its coverage counsel on an issue where no fiduciary duty exists simply because the insurer owes a fiduciary duty to its insured in a separate aspect of their relationship.

Recently, the Oregon Supreme Court granted an alternative writ of mandamus in response to a petition challenging a trial court's order requiring an insurer to produce to its insured communications with its coverage counsel prior to its denial of coverage. *See Liberty Surplus Ins. Co. v. Seabold Constr. Co.*, No. S062915, Order Allowing Petition for Alternative Writ of Mandamus (Or. Sup. Ct. Apr. 9, 2015). (Full disclosure: my firm and I represented the insurer in that mandamus proceeding.) While the underlying case settled before the matter could be fully briefed and argued, the fact that the Court allowed the writ suggests that it at least harbored serious doubts about the viability of a "fiduciary exception" argument in the insurer-insured context.

Conclusion

Insurance coverage disputes can present difficult questions regarding the application of the attorney-client privilege. Whether an insurer owes a fiduciary duty to the insured in making its coverage determination, and the extent to which any such duty may vitiate the attorney-client privilege between the insurer and its coverage counsel, can vary significantly depending on what jurisdiction's law applies. While it is highly likely that the privilege can be maintained at least in Oregon courts, other jurisdictions, such as our neighbors to the north in Washington, may apply a different analysis that is less favorable to insurers.