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KD Alert: Recent Decision Provides Opportunity to Strengthen Bad Faith Defenses

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A recent trial court discovery opinion further enlarges what is discoverable in Pennsylvania coverage actions, especially those containing bad faith allegations. This decision reminds insurance carriers of a growing trend that increases the scope of discovery in insurance coverage litigation as well as the need to establish a factual record early on in claims investigation in order to defeat breach of contract and bad faith allegations. To view the decision, click here.

Facts Giving Rise to Litigation

At issue in Henriquez-Disla v. Allstate Property and Casualty Insurance Company were two claims insureds made under a homeowners insurance policy within days of one another. The first claim was for theft, and the second claim was for fire loss. Allstate coverage counsel, retained during claims investigation, gathered information from the insureds and conducted EUOs. After their claims were denied, the insureds filed suit, alleging breach of contract and bad faith. Allstate filed a counterclaim for insurance fraud, claiming intentional and fraudulent misrepresentations. In denying the bad faith claim, Allstate denied "taking the depositions of Plaintiffs for the pretext of trying to find a reason to deny the Claims" and "applying improper standards to substantiate its denial of Plaintiffs' first-party benefit claims."

Plaintiffs sought broad discovery of Allstate's claim logs, the identity of individuals within Allstate who determined that counsel needed to investigate the claims, the identity of counsel who participated in the investigation, as well as counsel who determined EUOs were necessary. Plaintiffs also sought the production of Allstate's policy and procedural manuals used to determine: (1) whether to deny the claims; (2) whether to hire counsel to investigate claims; and (3) whether to obtain EUOs.

Allstate produced redacted claim logs, withholding information based on the attorney-client privilege. Allstate similarly refused to provide the identity of the persons requested and refused to produce its policies and manuals, asserting that the information sought was confidential, proprietary, irrelevant, subject to the attorney-client and work product privileges, and that the requests were overbroad. Plaintiffs moved to compel production of the withheld information, and the trial court granted the motion in part and denied it in part.

Identity of Counsel and Redacted Claim Log Entries Production

Allstate justified redactions to its claim logs by arguing they were generated by counsel retained to provide legal advice, an event that Allstate argued is "not an unusual occurrence when an insurer is considering denying a claim." Finding no Pennsylvania case law with respect to whether EUOs are part of the ordinary business of claims investigation, the court looked to New York law to confirm they are.

With this basis, the court ordered the production of claim "log entries and emails related to the scheduling and taking of the EUOs, including the collection of information for the EUOs" because such "are part of the ordinary business function of claims investigation and therefore fall outside the attorney-client privilege." The court, however, refused to order the production of "any communication seeking counsel's advice," finding that such communications are privileged. The court also found that "once the EUO was taken,

counsel's observations and opinions concerning the content of the statement are privileged, as it was legal advice regarding the propriety of the denial of the claim."

The court also found that claim log entries, regarding information about subrogation possibilities and obtaining a cause and origin report, are ordinary business functions in claims investigations and, similarly, are discoverable. The court refused to compel production of the counsels' identity, who participated in the investigation and who determined EUOs were necessary, ruling that the claim log entries Allstate was ordered to produce would suffice.

Policy and Procedural Manual Production

The court ordered Allstate to produce "the claims procedures which inform its employees' decisions to deny claims similar to Plaintiffs', obtain EUOs, and hire counsel to investigate claims (in the context of preparation for the EUOs)." In reaching this conclusion, the court focused on Allstate's bad faith denials contained in its pleadings, where Allstate denied it "appl[ied] improper standards." Critical to the court was the insureds' ability to "test the legitimacy of these defenses," which required the insureds to "need to know the policies which inform such decisions." Framing the issue as such, the court relied on a recent trial court decision – Platt v. Fireman's Fund Ins. Co., No. 11-4067, 2011 WL 5598359 (E.D. Pa. Nov. 16, 2011) – to determine certain manuals are discoverable.

After reviewing numerous decisions, all of which gradually increased the discoverability of policy and procedural manuals in bad faith litigation, the Platt court found "that the materials used by Defendant [insurer] in processing Plaintiff's insurance claims may be relevant to her cause of action for bad faith." As a result, the Platt court ordered the production of discovery, limited to "any material which pertains to instructions and procedures for adjusting claims and which was given to the adjusters who worked on [Plaintiff's] claim," and ordered that the material be kept confidential.

Other Jurisdictions

Courts applying Kentucky, New York, Arizona, Texas, Oklahoma, California, New Jersey, Michigan, and South Carolina law have held that discovery of extra contractual material such as claims manuals, internal insurer newsletters, and policy drafting histories are discoverable in bad faith litigation under varying reasons. The following cases are representative of those decisions.
Grange Mut. Ins. Co. v. Trude, 151 S.W.3d 803 (Ky. 2004) (holding training and policy manuals were relevant and discoverable, framing the issue as whether the insurer's internal policies and manuals embodied or encouraged bad faith);

Champion Intern Corp. v. Liberty Mut. Ins Co., 129 F.R.D. 63 (S.D.N.Y. 1989) (holding insured entitled to discovery of insurer's instructions to sales personnel and claims manuals);

Miel v. State Farm Mut. Auto. Ins. Co., 912 P.2d 1333 (Ariz. Ct. App. 1995) (holding claims manuals and discussions of claims handling in insurer's in-house newsletter was relevant in bad faith action);

State Farm Mut. Auto. Ins. Co. v. Engelke, 824 S.W.2d. 747 (Tex. App.1992) (finding no abuse of discretion in requiring insurer to provide all documents, manuals and training materials used in training claims handlers);

Vining v. Enterprise Fin. Group. Inc., 148 F.3d 1206 (10th Cir. 1998) (applying Oklahoma law and ruling evidence of insurer's training manual was admissible);

Glenfed Development Corp. v. Superior Court, 62 Cal. Rptr. 2d 195 (Cal. Ct. App. 1997) (ruling claims manual was discoverable);
Nestle Foods Corp. v. Aetna Cas. & Sur. Co., 135 F.R.D. 101 (D.N.J. 1990) (ruling that policy drafting histories and documents reflective of handling other claims were discoverable, even if not ultimately admissible);

U.S. Fire Ins. Co. v. City of Warren, No. 2:10–CV–13128, 2012 WL 1454008 (E.D. Mich. Apr. 26, 2012) (ordering production and ruling "internal claims manuals or claims processing guidelines may contain information relevant to resolving any ambiguities in the [insurance policy]");

Beazer Homes Corp. v. Hartford Fire Ins. Co., 4:10-CV-2419, 2012 WL 6210323 (D.S.C. Dec. 13, 2012) (applying South Carolina law and ruling claims handling guidelines were relevant and discoverable).

Florida courts, however, follow a bifurcation – or abatement – model for extra contractual discovery. A number of decisions provide that discovery of extra contractual information only is discoverable after a finding that coverage is afforded under the subject policy. This is because under Florida law, "a party may not assert a first-party claim for bad faith against an insurer until the insured has proven liability in her underlying contractual claim." Dennis v. Northwestern Mut. Life. Ins. Co., No. 3:06-cv-43, 2006 WL 1000308, at *2 (M.D. Fla. Apr.14, 2006) (noting Florida Stat. § 624.155(1)(b) provides that a claim for bad faith does not accrue until after an insured as proven liability in her underlying contractual claim). The following cases are reflective of the "Florida Approach." Granada Ins. Co. v. Ricks, 12 So.3d 276 (Fla. Dist. Ct. App. 2009) (holding its "decision [preventing discovery] is based upon the universally applied rule that discovery which concerns only potential issues of bad faith or other purported improprieties in defending the claim are wholly impermissible unless and until it is determined that the policy indeed provides coverage."); Allstate Ins. Co. v. Langston, 655 So.2d 91 (Fla. 1995) (same); D'Aprile v. UNUM Life Ins. Co. of Am., 2:09-CV-270FTM36SPC, 2010 WL 3340197 (M.D. Fla. Aug. 25, 2010) (ruling claims manuals, guidelines, and practices are not discoverable in first party breach of contract claim until coverage is determined to be owed, opening the insured's right to assert a claim of bad faith).

Impact of the Decision

The court's ruling in Henriquez-Disla reminds carriers that they must be vigilant against the growing increase in court decisions that allow for discovery of information that was once thought to be protected by claims of privilege and questions of relevance. Carriers should be aware that when denying allegations of bad faith during litigation by asserting that proper standards were used to substantiate the denial of an insured's first-party benefit claim may well open carriers' extra contractual documents to discovery, including the discovery of claims procedure policies and manuals. Such vigilance will benefit carriers whose claims manuals are followed and who deny claims in lock step with tested, unambiguous, and established policies and procedures.

When and why coverage counsel is hired is now at issue in light of the growing trend for insureds to argue that retaining counsel is pretext to a bad faith claim denial. Essentially, the argument is that insurance companies retain counsel early in the investigation in order to shield its investigation under the attorney-client privilege in an effort to hide unwarranted claims denials. Carriers can continue to hire coverage counsel in the process of claims investigations as long as carriers are aware that factual information relayed to and from coverage counsel may be subject to discovery.

The takeaway from this case is that a regular review of claims manuals and adherence to them by claims handlers will go a long way in defeating insureds' claims of bad faith.

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