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Our Reference Guide covers many areas of Arizona law, highlighting the most common issues associated with civil litigation. This resource is intended to provide a general overview of the subject matter, and is a supplement to the personal service we provide to our clients. It should not be relied upon as the sole source of information, and should not be substituted for competent professional legal advice for a particular situation. Should you have any questions, we encourage you to contact the authors listed at the end of each chapter or any JSH attorney.

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CHAPTER 8: INSURANCE BAD FAITH DISCOVERY

An insurance company commits bad faith when it (1) intentionally (2) denies, fails to process, or fails to pay a claim (3) without a reasonable basis for such action. ***Ness v. Western Sec. Life Ins. Co.***, 174 Ariz. 497, 500, 851 P.2d 122, 125 (Ct. App. 1992) (quoting ***Brown v. Superior Court***, 137 Ariz. 327, 336, 670 P.2d 725, 734 (1983)). "The bad faith cause of action arises only when all three of these elements are present." *Ness*, 174 Ariz. at 500, 851 P.2d at 125. An insured must prove that the insurer acted intentionally, not inadvertently or mistakenly, and that the insurer dealt unfairly or dishonestly with the insured's claim or failed to give fair and equal consideration to the insured's interests. *See* ***Rawlings v. Apodaca***, 151 Ariz. 149, 726 P.2d 565 (1986); ***Hawkins v. Allstate Ins. Co.***, 152 Ariz. 490, 733 P.2d 1073 (1987). Despite the high standard of proving bad faith, Arizona recognizes bad faith claims can exist even in the absence of a breach of contract. ***Deese v. State Farm Mut. Auto. Ins. Co.***, 172 Ariz. 504, 838 P.2d 1265 (1992).

The standard for punitive damages in bad faith cases is higher. In order to claim punitive damages, plaintiffs must establish that the true motive of an insurer's claim denial was unreasonable and that the insurer acted with an evil mind; that the insurer intended to injure the insured or consciously pursued a course of conduct knowing that it created a substantial risk of significant harm to the insured. Evil mind is usually established by circumstantial evidence, which generally is gleaned from the claim files. *See*, *e.g.*, ***Hawkins v. Allstate Ins. Co.***, 152 Ariz. 490, 733 P.2d 1073, 1081 (1987) (holding that evidence of insurer's routine practice of unjustifiably reducing amount offered for claims was sufficient evidence of "evil mind" to support claim for punitive damages).

Previously, requests for discovery had to be relevant or reasonably calculated to lead to the discovery of relevant or admissible evidence. ***State Farm Mut. Auto. Ins. Co. v. Superior Court***, 167 Ariz. 135, 138, 804 P.2d 1323, 1326 (Ct. App. 1991). Under the recent revisions to Arizona Rule of Civil Procedure 26(b), however, the standard for discovery is whether the request is "proportional to the needs of the case," which requires parties to consider the importance of the issues, the amount in controversy, and the parties' access to information. Parties must also take into account the parties' resources and whether the burden and expense outweighs the likely benefit.

The unique characteristics of a bad faith claim raise numerous discovery issues, including production of proprietary and confidential information, which must be individually assessed in each case. The following illustrates the various types of information that may be discoverable in an insurance bad faith claim.

DISCOVERY OF CLAIMS FILES

In an insurance bad faith case, the insurance claims file "constitutes the only source of information relevant to whether the insurer has a good faith basis for its decision." ***McClure v.***

Country Life Ins. Co., 2017 WL 3719880 (D. Ariz. Aug. 29, 2017). ***Brown v. Superior Court***, 137 Ariz. 327, 670 P.2d 725 (1983), set forth guidelines the court should use in determining whether documents in an insurer's claim files are protected or must be disclosed. In *Brown*, the insureds filed claims with their insurer for property damage and loss of earnings. The insurer paid the property damage portion of the claim, but not the loss of earnings claim. Thereafter, the Browns filed a bad faith action alleging breach of the implied covenant of good faith and fair dealing in the investigation and denial of the loss of earnings claim. During discovery, the insurer objected to producing its entire claims file in handling both the property damage and loss of earnings claim. The insurer asserted that the files were created in anticipation of litigation and also contained impressions, conclusions, opinions and other legal theories of attorneys which were entitled to absolute protection. The court looked at the following factors in determining whether the documents would be protected:

- the nature of the event that prompted preparation of the document and whether it is likely to lead to litigation;
- whether the document was prepared by a party or a representative;
- whether the document was routinely prepared in the course of the insurer's business; and
- whether the document was prepared in relation to the existence of claims or negotiations.

The court held that all documents prepared after the date the insurer wrote to the plaintiffs denying coverage were "prepared in anticipation of litigation" and therefore qualifiedly protected. Consequently, those documents would need to be produced only upon a showing of "substantial need." There, the "substantial need" requirement was satisfied because a claims file is a "unique, contemporaneously prepared history of the company's handling of the claim; in an action such as [bad faith] the need for the information in the file was not only substantial, but overwhelming ... [and] the substantial equivalent of this material cannot be obtained through other means of discovery."

Finally, the court addressed whether the materials in the claims file containing the impressions, conclusions, opinions or other legal theories of the insured's attorneys were entitled to absolute protection. The court held that when mental impressions and the like are directly at issue in a case (such as a bad faith lawsuit), no absolute protection under the discovery rules is warranted. *Id*. at 337, 670 P.2d at 735; *see also* ***Raygarr LLC v. Employers Mut. Cas. Co.***, 2020 WL 919443 (D. Ariz. Feb. 26, 2020) (discussing use of claim log notes in ruling on contested motion for summary judgment.); ***ACS Int'l Prod. LP v. State Auto. Mut. Ins. Co.***, 2022 WL 1406688 (D. Ariz. May 4, 2022) (same.)

DISCOVERY OF FINANCIAL INFORMATION

Prima Facie Case of Punitive Damages Required

Plaintiffs often seek to discover financial information regarding the insurance company to support a punitive damages award. Documents related an insurer's financials are not relevant in determining if the insurer breached the duty of good faith and fair dealing during the adjustment of the claim, but may be relevant to a punitive damage claim. In ***Arpaio v. Figueroa***, 276 P. 3d 513, 229. Ariz. 444 (Ct. App. 2012), the court held that financial information regarding a defendant is not discoverable until a *prima facie* case of punitive damages has been established. The trial court "should determine, as soon as is reasonably possible, whether at a discovery hearing or pretrial conference, if a party has made a *prima facie* showing in support of punitive damages, 'through discovery, by evidentiary means or through an offer of proof.'" Even if a *prima facie* case of punitive damages has been established, courts will limit the scope of financial discovery to only the financial information that may be relevant to an award of punitive damages.

Interview Summaries

Undue Hardship Required

In ***Longs Drug Store v. Howe***, 134 Ariz. 424, 657 P.2d 412 (1983), Farmers Insurance Company undertook an investigation concerning the termination of a company's employee. As part of the investigation, Farmer's took recorded statements of the employees. Copies of these statements were provided to the in-house attorney and reviewed by him. Those statements formed the basis for legal advice he gave to the company. The discharged employee sought the statements and interview summaries from the investigation.

The court held that the recorded statements were within the qualified protection of Arizona's "work product" doctrine. However, like the materials in *Brown*, the court held that the plaintiff had a substantial need for the materials and was unable without undue hardship to obtain the substantial equivalent materials by other means. But the court did not require disclosure of the investigator's interview summaries, since they contained the investigator's subjective mental impressions and opinions. The court held that such material would be protected from discovery in all cases except those in which the insurer's state of mind was directly at issue (such as a bad faith action). *Id.*

Ex parte Communications

In ***Duquette v. Superior Court***, 161 Ariz. 269, 778 P.2d 634 (Ct. App. 1989), the court held that defense counsel in a medical malpractice case may not engage in *ex parte* communications with the plaintiff's treating physicians without the plaintiff's consent. The court reasoned that the advantages of the informal *ex parte* procedure are clearly outweighed by the dangers such conduct presents to the physician-patient relationship, and the pressures such communication places on both the physician and attorney participants. The court remanded the case to the trial

court to determine whether defense counsel had obtained information through the *ex parte* interviews that could not have been obtained by formal discovery and to fashion an appropriate remedy if this had occurred.

The *Duquette* rule does not apply to treating physicians who are employees of a corporate defendant that is itself a defendant in a medical malpractice action. ***Phoenix Children's Hosp., Inc. v. Grant***, 228 Ariz. 235, 238, 265 P.3d 417, 421 (Ct. App. 2011). A hospital has a right to discuss a plaintiff/patient with its own employees because of the employment relationship; and that right is not dependent upon the implied waiver arising from the filing of a malpractice lawsuit. *Id.* at 239, 421. Therefore, *Duquette* and the physician-patient privilege do not bar informal communications between a defendant hospital and/or its counsel and treating physicians employed by the hospital.

DISCOVERY OF COMMUNICATIONS WITH AN EXPERT WITNESS

A lawyer who communicates with an expert witness concerning the subject matter of the expert's testimony foregoes work-product protection even if the expert also plays a consulting role. Communications during consultation are not privileged if the expert later becomes a testifying witness. ***Emergency Care Dynamics, Ltd. v. Superior Court***, 188 Ariz. 32, 932 P.2d 277 (Ct. App. 1997). Here, the defendants in an antitrust/breach of contract action subpoenaed the file of the plaintiff's antitrust expert. Plaintiff objected and moved to quash the subpoena, arguing the file contained hypotheses, mental impressions, and litigation strategies that counsel had explored with the expert in his consulting role, prior to determining that the expert would testify. The trial court denied plaintiff's motion, ordered production of the expert's file, and declined to review the file in camera to determine if the entire file was discoverable. The court of appeals affirmed. Arizona courts support free-ranging, skeptical cross-examination of expert witnesses and open discovery to probe the groundwork for their opinions. This includes examining the source of the expert's knowledge and information, any alleged bias, and the expert's relationship with the hiring party and counsel. A party has an interest in exploring whether an expert's theories originated with the hiring lawyer, and such information can be obtained only through open discovery.

The court distinguished between consulting and testifying experts, prohibiting discovery from the former except under exceptional circumstances. But the same protection does not apply to an expert who acts as both a consultant and an expert witness. The court reasoned that disputes over which information was discoverable and which was not would immensely burden the courts. Thus, counsel who want to maintain the work product privilege for consulting experts must hire a separate expert to testify. *See also* ***Arizona Indep. Redistricting Comm'n v. Fields***, 206 Ariz. 130, 75 P.3d 1088 (Ct. App. 2003) (by designating consulting experts as testifying experts, the IRC waived any legislative privilege attaching to communications with those experts or any materials reviewed by them and relating to the subject of the experts' testimony).

In ***Arizona Minority Coal. for Fair Redistricting v. Arizona. Indep. Redistricting Comm'n***, 211 Ariz. 337, 358, 121 P.3d 843 (Ct. App. 2005), the court of appeals clarified that *Fields* "stands for the

proposition that the legislative privilege is waived when a consultant has been designated as the party's expert and 'will' testify as an expert." Thus, a party who has named a consultant as an expert can reinstate the privilege by removing that designation before expert opinion evidence is offered by producing a report, responses to discovery, or expert testimony.

DISCOVERY OF CLAIMS HANDLING MANUALS

Relevance of Manuals

In ***Miel v. State Farm Mut. Auto. Ins. Co.***, 185 Ariz. 104, 912 P.2d 1333 (Ct. App. 1995), the claimant sued the tortfeasor's automobile liability insurer and claims adjuster for breach of contract, negligence, and bad faith in connection with delay, following a time-limited settlement demand letter which was misplaced. The trial court admitted into evidence two articles from an in-house State Farm newsletter discussing the handling of excess liability claims, and a portion of State Farm's general claims manual relating to the handling of such claims. The manual noted that the failure to keep an insured informed of settlement offers can constitute bad faith. State Farm argued the evidence was irrelevant and, even if relevant, the prejudicial effect far out-weighed any relevance. The court of appeals disagreed, and held that both the articles and the claims handling manual were relevant. They addressed the company's policies and procedures for handling these claims, which the claims adjuster did not follow. Other courts in Arizona have followed a similar approach. ***White Mountain Cmtys. Hosp. Inc. v. Hartford Cas. Ins. Co.***, 2014 WL 6885828 (D. Ariz. Dec. 8, 2014) ("Given the broad scope of discovery established by the Federal Rules of Civil Procedure, the argument that the [internal best practices standards] are irrelevant fails."); ***Finkelstein v. Prudential Fin. Inc.,*** 2022 WL 604884 (D. Ariz. Mar. 1, 2022) (allowing production of training manuals for relevant period of time.)

DISCOVERABILITY OF PERSONNEL FILES AND PROFITABILITY GOALS

In ***Zilisch v. State Farm Mut. Auto. Ins. Co.***, 196 Ariz. 234, 995 P.2d 276 (2000), a claimant seeking underinsured motorist coverage sued State Farm for first party bad faith**.** The claimant had been injured as a passenger in an automobile accident. Her attorney prepared a settlement demand package and forwarded it to the adjuster demanding policy limits. The adjuster reviewed the claim and confirmed the nature and permanency of the claimant's injuries, requested additional medical information from the claimant, contacted the treating physicians, and received a report from claimant's treating physician setting forth the permanent nature of her injury.

The adjuster denied the claim on the ground that the amount claimant received from her liability coverage fully compensated her for her injuries. The claim was then reassigned to another claims representative who determined that the value of the claim was more significant than State Farm had initially evaluated. The adjuster made another offer to settle the claim, which was rejected. The matter ultimately went to arbitration, which resulted in a judgment in excess of the policy limits. Claimant sued State Farm alleging it breached its duty of good faith and fair dealing by deliberately refusing to pay policy limits, when it knew the claim exceeded that amount. As part of the discovery process, State Farm had to disclose personnel files, which revealed that State

Farm had payment goals for its claims personnel, and that promotions and salary increases were based upon reaching those goals. Plaintiff used this evidence at trial to establish both bad faith and punitive damages.

The court of appeals acknowledged that the use of this type of evidence could establish improper claims practices; and the supreme court emphasized that if an insurer acts unreasonably in the manner in which it processes a claim, it can be held liable for bad faith even if it did not breach the policy provisions.

Similarly, in ***Nardelli v. Metro. Grp. Prop. & Cas. Ins. Co.***, 230 Ariz. 592, 277 P.3d 789 (Ct. App. 2012), the plaintiffs presented evidence that at the time they made their claim, MetLife had "instituted an aggressive company-wide profit goal," and it had impressed upon its claims employees, including the employees who processed the plaintiffs' claim, "that they were to decide every aspect of every claim" based on meeting that profit goal. Furthermore, claims employee compensation was tied to the average amount paid on claims. Therefore, the court allowed discovery of certain parts of personnel files and profitability goals to support plaintiff's theory of the case.

In ***Ingram v. Great American Ins. Co.***, 112 F.Supp.3d 934 (D. Ariz. 2015), the plaintiff sought production of employee materials in a worker's compensation bad faith suit. The court, relying in *Zilisch*, found the potential probative value of the information contained in the employee records outweighed any privacy concerns. Furthermore, evidence regarding whether the insurer "set arbitrary goals for the reduction of claims paid" and whether "the salaries and bonuses paid to claims representatives were influenced by how much the representatives paid out on claims" was relevant to whether the insurer acted reasonably and knew it. The court also found unreasonable any "expectation that assessments of work performance and any financial incentives to minimize payments on claims would be kept private." The court did allow the insurer to redact personal and sensitive information of the employees. ***Finkelstein v. Prudential Fin. Inc.***, 2022 WL 604884 (D. Ariz. Mar. 1, 2022) (compelling production of personnel files for individuals who had more than a "de minimis" involved in the decision making level of the claim.)

DISCOVERY OF SIMILAR CLAIMS OR CLAIMS FILES

Nationwide Search Burdensome

In ***State Farm Mut. Auto. Ins. Co. v. Superior Court***, 167 Ariz. 135, 804 P.2d 1323 (Ct. App. 1991), the court criticized plaintiffs for serving overly broad and burdensome discovery requests demanding information regarding other lawsuits against State Farm around the country. Although discovery rules should be construed liberally, there is a limit on relevance which requires plaintiff to narrowly tailor their inquiry to meet the facts of the case. Requiring State Farm to undertake a nationwide search was unduly burdensome because it would require State Farm to review 175,000 claims per year from Arizona and millions of similar claims nationally.

Random Sample of Files

In ***Schwartz v. Farmers Ins. Co. of Arizona***, 166 Ariz. 33, 800 P.2d 20 (Ct. App. 1990), plaintiff sued Farmers for first party bad faith concerning an automobile property damage claim concerning the cash value of a car involved in an accident. The claimant had purchased a Porsche for $13,895, and it was totally destroyed in a collision 3-½ months after the purchase. Farmers utilized a computerized service known as AutoTrak to assess the value of automobiles. Various rating factors were placed into the system along with the vehicle's mileage, and the system would then value the vehicle. The AutoTrak system valued the Porsche at $9,042. Relying upon this value,

Farmers offered the claimant $11,000 as the actual cash value to settle the claim. The settlement was rejected and a breach of contract and bad faith suit ensued. The claimant sought to introduce all of Farmers' total loss files to demonstrate an alleged misuse of the AutoTrak valuation. In response, Farmers provided 78 randomly selected total loss files, and acknowledged that it was a random sample of AutoTrak's reports for total loss claims processed through the Farmers Phoenix Regional Office. The randomly selected reports were admitted into evidence as business records, and helped Farmers establish that it did not act in bad faith in the adjustment of the claim.

DISCOVERY OF OTHER BAD FAITH CLAIMS

In ***Miel v. State Farm Mut. Auto. Ins. Co.***, 185 Ariz. 104, 912 P.2d 1333 (Ct. App. 1995), a third party bad faith case, the plaintiff at trial posed a question to the State Farm representative about other bad faith cases. The court of appeals held the question was proper and material to the plaintiff's proposition that State Farm's failure to pay the demanded policy limit was not an isolated incident but rather one of several incidents. The court allowed the evidence of prior similar claims as relevant to the bad faith claim, citing ***Hawkins v. Allstate Ins. Co.***, 152 Ariz. 490, 733 P.2d 1073 (1987).

DISCOVERY OF MEDICAL EXPERT'S PREVIOUS REPORTS IN BAD FAITH CASE

In ***Cheatwood v. Christian Brothers Services***, 2018 WL 287389 (D. Ariz. Jan. 4, 2018), a bad faith case arising from a health benefits claim, the defendant insurer sought to quash a subpoena issued on a non-party physician requesting previous medical examinations and exhaustive financial information about the physician. The court partially quashed the subpoena, holding that the other medical reviews were "not likely to lead to evidence of bias, largely because they involve facts and circumstances different from the facts and circumstances involved in this case." The court also denied a request for a number of medical reviews performed for plaintiffs as opposed to defendants in the last five years.

DISCOVERY OF PRIVILEGE LOG AND WAIVER OF ATTORNEY-CLIENT PRIVILEGE

Beliefs Based Upon Attorney-Client Communications

In ***State Farm Mut. Auto. Ins. Co. v. Lee***, 199 Ariz. 52, 13 P.3d 1169 (2000), a class of 1,000 policyholders sued State Farm for bad faith, alleging improper denial of "stacked" underinsured and uninsured motorists claims. Before denying the claim, State Farm claims managers had, among other things, obtained counsels' view of the meaning of the relevant policies, statutes and case law. Plaintiffs therefore sought to discover the communication between State Farm's claim managers and counsel regarding the denial of the underinsured and uninsured claims. State Farm objected to disclosing the communications based upon the attorney-client privilege. The trial court ordered State Farm to produce the information because its claim managers had, in whole or in part, relied upon the advice of counsel in deciding to deny coverage.

The supreme court, in a three-to-two decision, held that when an insurance company in a bad faith case relies on and advances as a claim or defense a subjective and allegedly reasonable evaluation of the law that incorporates its lawyer's communications to it, the communication is discoverable and admissible. Because State Farm asserted that its actions were reasonable based on what it learned about the applicable law from counsel, State Farm waived the attorney-client privilege. All of the communication between counsel and State Farm was therefore discoverable and admissible. *Compare* ***Twin City Fire Ins. Co. v. Burke***, 204 Ariz. 251, 63 P.3d 282 (2003) (insurer did not impliedly waive the attorney-client privilege because the carrier did nothing to make its counsel's advice relevant to its case).

Mendoza v. McDonald's Corp., 222 Ariz. 139, 213 P.3d 288 (Ct. App. 2009), applied *Lee* to the worker's compensation arena. McDonald's claimed the attorney-client privilege and started redacting adjusters' notes regarding Mendoza, who then sought to compel McDonald's to produce the entire claim file, including the redacted material. Mendoza contended that McDonald's' ICA attorneys regularly influenced and directed McDonald's' claims decisions and, by representing that its actions were subjectively reasonable while also asserting its privilege, McDonald's was able to hide the real reasons for its decisions.

The court of appeals agreed. An insurer's implied waiver of the attorney-client privilege is not limited to cases in which the company claims its actions were reasonable based on its subjective evaluation of the law. In the bad faith context, when an insurer raises a defense based on factual assertions that, either explicitly or implicitly, incorporate the advice or judgment of its counsel, it cannot deny an opposing party the opportunity to discover the foundation for those assertions in order to contest them. And because McDonald's affirmatively asserted its actions in investigating, evaluating, and paying Mendoza's claim were *subjectively* reasonable and taken in good faith, McDonald's placed at issue their subjective beliefs and directly implicated the advice received from ICA counsel. The attorney-client privilege, if it applied, would shield from Mendoza the very evidence she would need to challenge the company's representations that its adjusters subjectively believed their actions were reasonable and taken in good faith.

In ***Everest Insurance Company v. Rea***, 236 Ariz. 503, 342 P.3d 417 (Ct. App. 2015), plaintiffs claimed that the insurance company acted in bad faith by entering into a settlement agreement that exhausted the liability coverage of an Owner Controlled Insurance Program. The insurer argued it reached the settlement decision in good faith based on its subjective beliefs regarding the relative merits of the various available courses of action, which it formed after consulting with counsel. The superior court ruled that this defense impliedly waived the attorney-client privilege and ordered the insurer to produce otherwise privileged documents.

The court of appeals reversed in a split decision, holding that waiver will be implied only when a party affirmatively asserts it was acting in good faith because it relied on such advice for its own evaluation and interpretation of the law. The majority interpreted ***State Farm Mut. Auto. Ins. Co. v. Lee***, 199 Ariz. 52, 13 P.3d 1169 (2000), to mean that for waiver to apply, a party must affirmatively claim its conduct was based on its understanding and advice of counsel, rather than merely stating that it consulted with and received advice from counsel. The majority rejected the argument that the insurer waived the privilege by defending itself on subjective reasonableness grounds following consultation with counsel.

In ***Sell v. Country Life Insurance Company***, 189 F. Supp. 3d 925 (D. Ariz. 2016), the court considered whether the insurer willfully violated the discovery rules by asserting that the attorney client privilege and work-product doctrine applied to, among other things, correspondence between an in-house attorney and claims adjuster. Specifically, the court addressed whether draft denial letters and notes written on the drafts were protected from disclosure in the bad faith lawsuit. Relying on Arizona substantive law, the court said that for the communication to be privileged, it must be made to or by the lawyer for the purpose of securing or giving legal advice, must be made in confidence, and must be treated as confidential, citing ***Samaritan Foundation v. Goodfarb***, 176 Ariz. 497, 501, 862 P.2d 870, 874 (1993). In addition, under A.R.S. § 12–2234(B), attorney-client communications are protected from disclosure if the communication is either (1) for the purpose of providing legal advice to the entity or employer or to the employee, agent or member, or (2) for the purpose of obtaining information in order to provide legal advice to the entity or employer or to the employee, agent or member.

The court rejected the insurer's assertion of privilege, stating that the insurer "simply withheld such communications solely because a company attorney was named on the email." The court also ruled that there were other willful discovery violations, including the failure to preserve and produce relevant materials in response to requests for production, and presenting false deposition and hearing testimony. As a result, the court struck the answer and entered default against the insurer.

In ***Robert W. Baird & Co. Inc. v. Whitten***, 224 Ariz. 121, 418 P.3d 894 (Ct. App. 2017), a client sued attorneys who prepared documents for a transaction. The attorneys argued that subsequent attorneys were comparatively at fault for the client's damages. The court held that the first attorneys did not waive the privilege for the client's subsequent attorneys. Applying the *Hearn* test, the appellate court held that the attorney defendants (who were not the privilege holders), rather than the client, put the privileged information at issue by arguing that the client

and others were at fault. The court confirmed the Arizona rule that a privilege holder must affirmatively inject attorney-client communications into a case to waive the attorney-client privilege.

In ***United Specialty Ins. Co. v. Dorn Homes Inc.***,334 F.R.D. 542 (D. Ariz. 2020), the district court analyzed whether an advice of counsel defense waives attorney work-product protected documents the attorney did not communicate to the insurer client. The court held that the insurer must disclose the documents--even if they had not been communicated to the insurer--if the insurer waived the attorney client privilege by asserting an advice of counsel defense. The court reasoned that permitting the work-product documents to remain privileged would ignore "the potential for litigation abuses, and erects too much of an impediment to the truth seeking process. The court also ordered production of work-product documents created after the declaratory action was filed, rejecting the insurer's argument that once it filed its declaratory judgment complaint, the attorney's thought process changed from "advice of counsel" to litigation strategy. Important to that ruling, however, was the fact that the claims adjusting process was still ongoing when the litigation was filed.

In ***Jalowsky v. Provident Life Insurance***, 2020 WL 3492554 (D. Ariz. June 25, 2020), the district court rejected attempts to obtain unredacted audit trail logs which contained information protected by the attorney-client privilege. The court reasoned that the identity of the individual accessing the information was discoverable but not the "description" of the work, which would intrude in privileged communications.

Communications with Expert Might Waive Privilege

In ***Hunton v. Am. Zurich Ins. Co.,*** 2017 WL 3712445 (D. Ariz. Aug. 29, 2017), the insurer's expert testified in a deposition that he did not know why the insurer denied a claim after receiving a medical examination favorable to the plaintiff, but speculated the reason "was a discussion [the claims adjuster] had with counsel the day she accepted it." The court held that the insured, through "the testimony and opinion of its bad faith expert, has put the subjective beliefs of the claims adjuster directly at issue, and those beliefs implicate the advice she received" from the insurer's attorney. By electing to defend the case on the subjective reasonableness of the adjuster's actions, the insurer placed those actions at issue, and found an implied waiver of the attorney-client privilege.

Untimely Prepared Privilege Log

When objecting to production of materials on the basis of attorney-client privilege, it is essential to prepare a privilege log identifying what is being withheld. Failure to timely produce a privilege log can lead to a waiver of the attorney-client privilege. ***Burlington N. & Santa Fe Ry. Co. v. U.S. Dist. Ct. for the Dist. of Mont.***, 408 F.3d 1142 (9th Cir. 2005). *Burlington* makes clear that that there is no "per se waiver rule that deems a privilege waived if a privilege log is not produced within Rule 34's 30-day time limit." Instead, *Burlington* encourages courts to engage in a "holistic reasonableness analysis" and make a case-by-case determination based on various factors,

including the delay in producing the privilege log, the magnitude of the document production, and the degree to which the assertion of privilege enables the adverse party to evaluate whether the withheld documents are privileged. If the delay in producing the log was not a "tactical manipulation of the rules and discovery process," courts are hesitant to find a waiver of the privilege. ***Labertew v. Chartis Prop. Cas. Co.***, 2018 WL 1876901 (D. Ariz. Apr. 19, 2018).

Failure to Raise Attorney-Client Privilege

In ***Scottsdale Ins. Co. v. Superior Court***, 59 Cal. App. 4th 263, 69 Cal. Rptr. 2d 112 (Cal. App. 1997), the insurer filed a declaratory judgment action regarding coverage. The insured served discovery requests on the insurer. The insurer objected, but failed to raise the attorney-client privilege objection, though that objection was raised later. The California Court of Appeal held that the company's failure to expressly raise the attorney-client privilege objection in the initial response waived the privilege.

Attorney-Client Communications from Work Computer

In ***Scott v. Beth Israel Med. Ctr. Inc.***, 17 Misc.3d 934, 847 N.Y.S.2d 436 (2007), a New York court held that e-mail messages between a doctor and his attorney regarding the doctor's termination, sent from the doctor's work e-mail, were not protected by attorney-client privilege or the attorney work-product doctrine. The doctor had filed a breach of contract action against his employer and a related entity after he was terminated. When he discovered that defendants possessed e-mails pertaining to the litigation that he sent to his attorney from his work e-mail, he sought a protective order to have the e-mails returned to him.

Denying the motion, the court first reviewed defendants' e-mail policy, which stated that the employees had no privacy rights with regard to e-mails sent using their communications systems and defendants had the right to access such communications at any time and without prior notice. The court said that such a policy is the equivalent of "the employer looking over your shoulder each time you sent an e-mail" so that otherwise privileged communications – those between an attorney and client for the purpose of seeking legal advice – are not privileged because they were not made in confidence. Attorney-client privilege does not protect workplace e-mails if (1) the company has a policy banning personal use, (2) the company monitors employees' emails, (3) third parties are allowed access to these e-mails, and (4) the employee had notice of these polices. Here, the attorney-client privilege was waived because plaintiff and his attorney did not take reasonable precautions to prevent inadvertent disclosure. Further, the e-mails' *pro forma* provision stating that it may be confidential was insufficient to overcome defendants' e-mail policy.

DISCOVERY OF RESERVES

A.R.S. § 20-516 provides:

> An insurer shall maintain reserves that place a sound value on its liabilities under its policies, annuities, and subscriber contracts. The reserves shall not be

> less than the amount, estimated and consistent with the provision of this title, necessary to assure the payment of the insurer's unpaid policy holder and contract holder obligations, whether those obligations are reported or reported together with the expenses adjustment or settlement of the obligations.

FIRST PARTY CLAIMS

Relevance of Reserve Information

In insurance bad faith cases, policyholders often seek information pertaining to loss reserves to show "what [the insurer] actually knew and thought, and what motives animated its conduct, which are critical areas of inquiry in bad faith cases and fully fair game for discovery." ***W. Sur. Co. v. United States***, 2018 WL 6788665 (D. Ariz. Dec. 26, 2018). Arizona courts have come out both ways on the issue of whether reserve information is permitted discovery.

In ***Metropolitan Life Insurance Co. v. Ogandzhavona***, 2013 WL 1442581 (D. Ariz. 2013), a doctor sued her insurer, MetLife, for bad faith following a dispute about the disability benefits MetLife owed the doctor. The doctor "requested that MetLife provide her with reserve information relating to her claims," and MetLife objected, arguing reserve information was irrelevant to the doctor's bad faith claim. The court stated that "[c]entral to the relevance (or lack thereof) of reserve information in a given case is the method of calculation. If the insurers can show their calculations do not include analysis of the factual or legal merits of the insured's specific claim, but instead rely on automatic factors, then the relevance of reserve information diminishes significantly. On the other hand, courts have granted motions to compel production of reserve information when the insurers have failed to produce evidence that the reserve arithmetic does not include analysis of the claim's merit." MetLife had "shown that it does not analyze the factual and legal merit of a claim when it sets and adjusts the reserve amount," and therefore the court denied the doctor's request for reserve information. ***Finkelstein v. Prudential Fin. Inc.***, 2022 WL 604884 (D. Ariz. Mar. 1, 2022) (reserve information not discoverable when it was set on generally applied factors versus claim specific information.)

In ***United Specialty Ins. Co. v. Dorn Homes Inc.***,334 F.R.D. 542 D. Ariz 2020), the defendant policyholder sought production of the reserve information because it was "wholly relevant" to the bad faith claims. The court analyzed the testimony of the claims adjusters to determine how the reserves were set and whether they were set "automatically." Overruling the insurer's objections, the court found that the reserves were calculated based on the factual or legal merits of the insured's specific claim, and therefore were discoverable in the case.

Reserve Information as an Admission

A district court in California—a state with a statutory reserve requirement similar to Arizona's—stated, "[t]he legislature … established reserve policy. For this reason alone, a reserve cannot accurately or fairly be equated with an admission of liability or the value of any particular claim." ***In Re Couch***, 80 B.N.R. 512, 517 (S.D. Cal. 1987), citing ***Union Carbide v. Travelers Indemnity Company***, 61 F.R.D. 411, 413 (W.D. Pa. 1973.)

In ***J.C. Assocs. v. Fid. Guar. Ins. Co.***, 2003 WL 1889015 (D.D.C. 2003), the court held that discovery of reserve information was not relevant to the litigation, and could not be used as an admission in the circumstances presented in the case. Reserve information might be proof of bad faith if an insured claims the insurer failed to offer a settlement within policy limits or denied coverage, thereby subjecting the insured to a judgment in excess of the policy amount. *See, e.g.*, ***Athridge v. Aetna Cas. Ins. & Sur. Co.***, 184 F.R.D. 181 (D.D.C. 1998). When the question relates to coverage, however, the reserve information could be considered an admission only if it qualified as a confession by the insurer of potential liability despite its claim of no coverage. If other considerations drove the setting of the reserve, or its amount was dictated by state law or tax considerations, it becomes ambiguous and uncertain as to whether the setting of a reserve becomes an admission that can be used against the insurer. The court held that a reserve figure is not an admission unless it is in fact an assessment of liability, rather than the product of State Law or regulation, or driven by tax or other financial considerations. As a result, the court prohibited plaintiff from obtaining copies of the reserve information.

THIRD PARTY CLAIMS

In ***American Prot. Ins. Co. v. Helm Concentrates Inc.***, 140 F.R.D. 448 (E.D. Cal. 1991), plaintiff brought a declaratory judgment action claiming its policy did not cover the insured's claimed losses due to the failure of machinery within its manufacturing plant. The defendant plant owner filed a counterclaim and third party claims against American Motorist Insurance Company Inc. and Lumbermen's Mutual Casualty Company. All of the insurers provided coverage under separate policies issued as part of an "all-risk" package policy. The court considered a motion to compel disclosure of information in American Protection's files relating to the reserves established on the claims at issue. American Protection objected on the grounds such information was not relevant. In considering whether an insurer acted in bad faith in denying its duty to defend under a third party liability policy, the fact that it established a reserve particularly for litigation costs is probative on the issue of whether there is a potential for liability. Thus, when an insurer, by it actions, acknowledges the potential for liability and fails to attempt to settle a claim against its insured, and/or fails to defend, reserve information is relevant to the issue of good faith.

DISCOVERY OF CONTRACT BETWEEN INSURER AND INDEPENDENT ADJUSTER

The duty of good faith and fair dealing is non-delegable, and an insurer cannot bring a claim of negligence against an independent insurance adjuster who owes the insured no duty of care. However, Arizona courts have found that where an "insurer and its agent are engaged in a joint venture...each is jointly and severally liable with the other for a bad faith refusal to pay," notwithstanding an absence of "proof of profit and loss sharing and...joint right to control." Most recently, a court compelled production of any contracts, promotional materials, and proposals exchanged between an insurer and independent contractor. ***Ingram v. Great Am. Ins. Co.***, 112 F. Supp. 3d 934, 940 (D. Ariz. 2015). The court held that the substance of these documents could be relevant to whether the independent adjuster advertised more aggressive claims handling to promote business with the insurer, or whether the insurer promised financial benefits to the independent adjuster in return for lowering costs by paying out fewer claims. *See also* ***Finkelstein v. Prudential Fin. Inc.***, 2022 WL 604884, (D. Ariz. Mar. 1, 2022) (finding a master services agreement between insurer and vendor relevant to the case.)

DISCOVERY SANCTIONS

Evidentiary Hearing Requirement

In ***Wayne Cook Enter., Inc. v. Fain Props. Ltd P'ship***, 196 Ariz. 146, 993 P.2d 1110 (Ct. App. 1999), the trial court dismissed plaintiff's action because plaintiff's counsel supplemented his disclosure five weeks before trial with a single document the defendant characterized as "relevant to the heart of the case." Defendant asserted that the document's late disclosure was an outrageous violation of the plaintiff's disclosure obligations and sought sanctions. Relying on Rule 37(d) (if a party or attorney knowingly fails to timely disclose damaging and/or unfavorable information, the imposition of serious sanctions, including dismissal of the claim or defense may result), the court dismissed the action. It reasoned that plaintiff's attorney had violated discovery rules, and his failure to explain why gave rise to a strong inference that the failure to disclose was deliberate. The court of appeals reversed. The sanction of dismissal is warranted only when the court makes an express finding that a party, as opposed to his counsel, has obstructed discovery and the court has considered and rejected lesser sanctions as a penalty. The imposition of such strong sanctions requires an evidentiary hearing and findings on these critical issues.

Prejudice Relative to Timing of Trial

In ***Zimmerman v. Shakman***, 204 Ariz. 231, 62 P.3d 976 (Ct. App. 2003), plaintiff's case was dismissed for failing to disclose. The case had been set for trial, and in the parties' joint pretrial statement, each party objected to the other's exhibits and witnesses as non-disclosed. The case was tentatively settled but an agreement was never entered with the court. The court set another cutoff date for disclosures. Plaintiff filed its supplemental list of witnesses and exhibits when they were due. Defendant filed a motion in limine and for sanctions, stating he had not received the requested disclosures and documents from plaintiff. Plaintiff did not respond to the motion, and the trial court granted the motion in limine. Defendant then immediately filed a motion to dismiss

the complaint, arguing that the granting of the motion in limine meant that plaintiff could not prove his claims at trial. The trial court granted the motion and dismissed the case.

The court of appeals reversed. The policy behind the disclosure rules is not to create a "weapon for dismissing cases on a technicality." And while any failure to follow the disclosure rules may lead to some form of sanctions, there is little reason to completely bar the use of evidence when no trial or case dispositive motion is pending. If trial is imminent, on the other hand, the possibility of prejudice will increase. In such case, the trial judge has considerable latitude in determining whether good cause has been shown for a late disclosure. If good cause is lacking, a reasonable sanction might be to bar the evidence not previously disclosed. Here, since the plaintiff had already disclosed witnesses and exhibits, the court said trial could proceed, limited to the evidence that had been disclosed.

Protective Orders

When disclosing confidential and proprietary information in a bad faith case, it is important to analyze whether you need to protective order. A protective order can prevent the disclosure of the documents and testimony in other matters, including other cases handling by the attorney. ***Jalowsky v. Provident Life and Accident Insurance Co.***, 2020 WL 8184343, (D. Ariz. June 18, 2020) provides an example. In this case, the attorney representing the policyholder sought to use documents obtained in another case against the insurer. The district court rejected the attempt, finding there was no exception in the original protective order in which the documents were obtained to allow them to be used in another matter, even though the documents were relevant to the case. Rather, the protective order stated the documents "may be used only in connection with the case at bar, and may not be disclosed for other purposes."

Business Audits/Computer Audits

In ***Finkelstein v. Prudential Fin. Inc.***, 2022 WL 604884 (D. Ariz. Mar. 1, 2022), the district court denied the insured's request for financial audits because the insured did not explain how the request was proportional to the needs of the case. The court also denied a request to perform an audit of the computer claims handling system. The court reasoned that the insured failed to "specific, concrete evidence of concealment or destruction of evidence" in order to access a computer system maintaining claim information.

Additional Bad Faith Discovery

In addition to the discovery discussed above, trends in bad faith law show that Plaintiffs often request additional items during the course of discovery, including but not limited to, audit trails, leakage memorandums, market conduct reports, combined loss ratios, organizational charts, advertisement materials, and underwriting guidelines. Although there are no reported decisions specifically addressing the discoverability of these items, we have litigated many cases in which these requests are made. If faced with a situation where counsel is requesting these materials, or have questions regarding retention or discoverability of these materials pre-suit, please feel free to contact us so that we may guide you through the process. Each bad faith case is unique, and limiting the potential discovery can not only reduce the scope of discovery, but also lead to better results at mediation or trial.

If you have questions regarding the information in this chapter, please contact the author.

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