

**TWELFTH ANNUAL
NORTHEAST SURETY AND FIDELITY CLAIMS
CONFERENCE
SEPTEMBER 20 - 21, 2001**

**THE ADVICE OF COUNSEL DEFENSE IN SURETY &
FIDELITY LITIGATION:
THE GOOD, THE BAD & THE UGLY**

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1. Introduction¹

Handling a surety or fidelity claim is often a complicated matter. Sureties are expected not only to conduct a reasonable investigation, but also to understand and apply laws and statutes from the operative jurisdiction. Most sureties write bonds covering many states. A lack of understanding of applicable law in a particular jurisdiction may lead to increased losses, adverse judgments and – in the extreme cases – punitive damage awards and administrative penalties.

From this environment flows the simple reality that, before litigation, sureties and fidelity insurers often retain outside counsel to assist them in responding to claims. The level of involvement for counsel will depend on a range of factors, including the expertise of the claims handler, the complexity of the claim, the amount of the claim, and the procedural status of the claim. Prior to litigation outside counsel's role may include (1) answering a specific, narrow question about the law in the applicable jurisdiction; (2) assisting in the factual investigation; (3) rendering an opinion about the legal validity of a particular claim or claims; (4) drafting completion contracts, takeover agreements and related agreements; and (5) assuming the role of comprehensive claims manager, with the responsibility of coordinating all aspects of the surety's response to the claim.

When and if litigation finally commences, outside counsel's role will of course include representing the surety or the fidelity insurer in the litigation. Since the claimant in the litigation asserts that the surety acted illegally or improperly by, for example, unreasonably delaying action on the claim, not properly investigating the claim, basing its denial of claim on an erroneous interpretation of the law and the facts, or improperly discrediting the claimant's version of events. Apart from seeking to hold the surety liable on its bond, the claimant may also assert extracontractual theories of liability based on the implied covenant of good faith and fair dealing, or an unfair trade practices statute.

All surety litigators recognize that the assertion of a bad faith claim immediately raises the stakes in the litigation. The claimant may use its bad faith allegations as a procedural weapon to gain an advantage in the litigation. The existence of bad faith claims may preclude the surety from tendering the defense of the action to the principal's counsel. The surety may be exposed to greater liability in the action if the claimant succeeds. The surety's overall claims-handling practices may be subject to discovery and judicial scrutiny.

It is against this backdrop that the advice of counsel defense arises as an important consideration for any surety and fidelity insurer seeking to defend a claim of bad faith. In some cases the conduct which is the basis for the bad faith claim will directly implicate the actions and advice of outside counsel prior to the litigation. For example, the surety's denial of a claim may have been based on legal advice provided by outside counsel. The surety's investigation may have been conducted or controlled by counsel. Or outside counsel may have

¹ The author wishes to thank Gintare Tijunelis Grenier for her assistance in the preparation of this paper.

recommended a course of action which caused the surety to deny the claim, thereby precipitating the lawsuit. The surety may seek to defend the claim by introducing evidence that the conduct in question was approved or recommended by counsel. In each such case the surety and fidelity insurer must consider whether the defense can be raised, and – more to the point – whether the defense *should* be raised.

As will be discussed further in this paper, the advice of counsel defense is far from a risk free proposition. Indeed, asserting the defense is a significant tactical decision which may reap great rewards – or may create irreversible prejudice. The primary advantage of the defense is the potentially powerful message that it sends to the trier of fact: *we the surety did not act with malice toward the claimant; we did what our lawyer told us we could do*. But with this benefit comes the equally compelling risk that the invocation of the defense will force the surety and its counsel to disclose sensitive privileged communications or, worse, the surety's attempted reliance on counsel's advice will be viewed negatively by the judge or jury.

In short, the defense should be asserted only after a very careful and deliberate consideration of its costs and benefits. This paper addresses these issues both generally and specifically with respect to the unique issues of surety and fidelity litigation. The reader will note that most of the cases cited herein arise in the context of litigation against liability insurers. While the advice of counsel defense has been litigated extensively by liability insurers, such is not the case in surety and fidelity litigation. This may be because surety bad faith law is still emerging. Perhaps the better explanation is that unique aspects of the surety and fidelity claims environment simply render the advice of counsel defense unworkable. Whatever the reason, counsel should recognize that there is little direct authority addressing this issue in the context of fidelity and surety litigation.

2. Bad Faith and the Advice of Counsel Defense Generally²

The advice of counsel defense arose primarily as a defense to civil actions alleging malicious prosecution. With the emergence of the tort of bad faith against insurers, the defense now most often arises where extracontractual claims (*i.e.*, breach of the implied covenant of good faith and fair dealing, claims of unfair trade or insurance practices, etc.) have been asserted against insurers. Often, as one element of an action in bad faith, a plaintiff must show that the insurer *knew* that its actions were without a reasonable basis in law or fact. The advice of counsel defense is asserted as a defense to this element of the claim.

To determine whether the defense is available in a given case, counsel should first understand the elements of a bad faith claim which must be proven by the plaintiff. This, generally, will be a matter of state law. The key issue is whether the insurer's state of mind is an element in the plaintiff's cause of action. Some jurisdictions impose an objective-type standard. In these states the advice of counsel defense should - in theory – not apply, since the actual state of mind of the insurer is not at issue. Dodge v. Fidelity and Deposit Co. of

² For good discussions of the advice of counsel defense, both in the context of surety and fidelity litigation, and general insurance litigation, see David DiBiase & Carleton Burch, *Avoiding Extracontractual Claims: The Lessons of Lustig*, TIPS Midwinter, 2000; *Insurance Bad Faith Litigation*, Shernoff Gage & Levine, § 30.04; and *Bad Faith Actions*, Ashley, § 7:13

Maryland, 778 P.2d 1240, 1244 (Ariz. 1989) (standard is whether a reasonable insurer would have acted under the circumstances).

Other jurisdictions apply a more subjective standard. See, e.g. Centennial Insurance Co. v. Liberty Mutual Insurance Company, 404 N.E.2d 759, 762 (Ohio 1980) (bad faith “imports a dishonest purpose, moral obliquity, conscious wrongdoing, breach of a known duty through some ulterior motive or ill will partaking of the nature or fraud.”); Nicolau v. State Farm Lloyds, 869 S.W.2d 543, 551 (Tex. Ct. App. 1993) (“when reviewing a bad faith claim, the relevant inquiry is what facts the insurance carrier had before it at the time it denied the claim.”).

Courts which have found the existence of a tort for bad faith against sureties and fidelity insurers have largely adopted the bad faith standards developed in actions against liability insurers. See First National Bank of Louisville v. Lustig, 96 F.3d 1554, 1564 (5th Cir. 1996). In Lustig, the Fifth Circuit identified the elements of a bad faith cause of action against a fidelity insurer as: (1) the insurer is obligated to provide coverage under the terms of the policy; (2) the insurer had no reasonable basis for denying coverage for the claim; (3) the insurer knew there was no reasonable basis to deny the claim or the insurer acted with reckless disregard for whether a basis to deny the claim existed. Lustig, 96 F.3d at 1546.

Other courts have adopted insurance law principles in discussing the elements of a bad faith claim against a surety or fidelity insurer. Compare Dodge v. Fidelity and Deposit Co. of Maryland, 778 P.2d 1240, 1244 (Ariz. 1989) (tort of bad faith against performance bond surety “can be alleged only if the facts pleaded would, on the basis of an objective standard, show the absence of a reasonable basis for denying the claim, i.e., would a reasonable insurer under the circumstances have denied or delayed payment of the claim under the facts and circumstances.”) with Transamerica Premier Ins. Co. v. Brighton School Dist. 27J, 940 P.2d 348, 351 (Colo. 1997) (a commercial surety acts in bad faith when the surety's conduct is unreasonable and the surety knows that the conduct is unreasonable or recklessly disregards the fact that its conduct is unreasonable.)

Insurers seeking to invoke the advice of counsel defense must generally prove the following:

- (1) The insurer disclosed to its attorney all information necessary to make the coverage determination;
- (2) The attorney was acting as the insurer's attorney in providing the advice;
- (3) The insurer relied on the attorney's advice in good faith; and
- (4) The insurer did, in fact, act on the advice.

See Insurance Bad Faith Litigation, Shernoff Gage & Levine, § 30.04[2], citing Hamilton County Bank v. Hinkle Creek Friends Church, 478 N.E.2d 689, 691 (Ind.Ct.App. 1985); Aetna Casualty & Surety v. Superior Court, 153 Cal.App.3d 467 (1984); Szumigala v. Nationwide Mutual Ins. Co., 853 F.2d 274 (5th Cir. 1988).

Where the advice of counsel defense is available, most courts have recognized that it is merely one factor which may be considered by the trier of fact in determining whether the insurer acted in bad faith. See, e.g. Chavers v. National Sec. Fire & Cas. Co., 405 So.2d 1,

8 (Ala. 1981); Szumigala v. Nationwide Mutual Ins. Co., 853 F.2d 274 (5th Cir. 1988); Crabb v. National Indemnity Company, 205 N.W.2d 633, 636 (1973). Thus, an insurer cannot generally obtain summary judgment or a directed verdict merely on the grounds that it relied upon the advice of counsel in taking a particular course of action. Id. But see Brandon v. Sterling Colorado Beef Co., 827 P.2d 559 (Colo. App. 1991) (defendant, which was a self-insured employer, was entitled to judgment as a matter of law on claims of bad faith where evidence established it to have pursued course of action based on the advice of counsel).

The mere fact that the insurer relied upon the advice of counsel may be insufficient to permit the carrier to invoke the defense. Instead, the insurer may be required to prove that the advice had some rational basis in law or in fact. The defense may therefore not be available where counsel's advice is patently incorrect. See Szumigala v. Nationwide Mutual Ins. Co., 823 F.2d 274, 282 (5th Cir. 1988). In Szumigala the trial court granted summary judgment for the insurer on the insured's claim that the insurer acted in bad faith by not paying for medical benefits pursuant to an uninsured motorists policy. The trial court ruled that the insurer's reliance upon the advice of outside counsel compelled summary judgment for the claimant. The 5th Circuit disagreed, holding that the attorney's advice was manifestly erroneous:

We agree that good-faith reliance upon advice of counsel may prevent imposition of punitive damages But it is simply not enough for the carrier to say that it relied on advice of counsel, however unfounded, and then expect that valid claims for coverage can be denied with impunity pursuant to such advice. The advice of counsel is but one factor to be considered in deciding whether the carrier's reason for denying a claim was arguably reasonable. We believe that where, through verbal sleight of hand, the advising attorney concocts an imagined loophole in a policy whose plain language extends coverage, such advice is heeded at the carrier's risk.

Szumigala, 823 F.2d at 282.

In the usual case, where the advice of counsel defense is available and has been properly asserted, it is evidence which the trier of fact may consider in determining whether the insurer has acted in good faith. See Peckham v. Continental Cas. Ins. Co., 997 F.Supp. 73, 80 (D. Mass. 1998) ("when an insurer reasonably relies on a diligent, good faith evaluation by its counsel, such reliance is evidence of the insured's good faith"; court considers the fact that insurer relied on the evaluation of outside counsel in making its settlement decision as some evidence of good faith).

The weight to be given to the defense will depend upon all of the facts and circumstances of a particular case. Often the insurer's reliance on the advice of counsel defense is deemed to be outweighed by other facts and evidence which demonstrates that the insurer's reliance upon counsel's advice was not reasonable. See, e.g. Crabb v. National Indemnity Company, 205 N.W.2d 633 (1973). In Crabb, the insured was involved in an automobile accident in which the other driver was killed. The other driver's estate sued and demanded the policy limits (\$10,000). The insurer refused to pay the limits, citing the advice of the attorney it had retained to defend the insured. The Supreme Court of South Dakota held that such reliance would not insulate the insurer from a punitive damages award, in part because the insurer's reliance on counsel's advice must be judged against other factors in the

case which amply demonstrated that the insured would likely face exposure beyond the policy limits.

As noted at the outset of this paper, there is little or no caselaw on the advice of counsel defense as it pertains specifically to fidelity and surety litigation. Thus, counsel must be prepared to borrow heavily from analogous caselaw in the insurance context. These cases suggest generally that the advice of counsel defense, in the appropriate case, can be a somewhat helpful tool in defending a claim of bad faith. However, the cases also suggest that courts will not allow an insurer to escape extracontractual liability simply on the basis that counsel's advice had been sought and relied upon. Moreover, for the reasons set forth below, in many instances the risks involved in invoking the defense may outweigh any potential benefit

3. Invoking the Defense

One preliminary procedural issue which counsel must confront at the start of the case is how the advice of counsel defense should be asserted in the case. Must the insurer raise it as an affirmative defense, or can the insurer simply deny the allegations of bad faith and introduce the advice of counsel evidence at trial? Not surprisingly, the answer will depend on the particular procedural and substantive law in the relevant jurisdiction. See State Farm v. Superior Court, 279 Cal.Rptr. 116 (Cal.App. 1991) (California Code of Civil Procedure permits assertion of the defense by general denial of bad faith allegations).

Some courts hold that the advice of counsel defense must be affirmatively pleaded by the insurer as a "special defense" or an "affirmative defense." See Orco Bank v. Proteinias del Pacifico, 577 N.Y.S.2d 841, 842 (1992). Other cases suggest that the insurer need not plead the defense affirmatively and can assert the defense by making a general denial of the plaintiff's allegations of bad faith. See e.g. Clemco Industries v. Commercial Union Insurance Company, 665 F.Supp. 816 (N.D.Cal. 1987). Clemco was a diversity action based on a claim of bad faith arising under California law. The insured moved at trial to preclude the insurer from offering any evidence that the insurer relied upon the advice of counsel in making its coverage determination. The insured argued that the insurer should be precluded from invoking the defense because it had failed to plead it as an affirmative defense in its answer to the Complaint. In dicta the Court observed that the advice of counsel defense is not identified as an affirmative defense in Federal Rule of Civil Procedure 8(c), and even if it was treated as an affirmative defense under state law, a federal court in diversity "is not bound to treat a matter that is considered an affirmative defense under state law as an affirmative defense for purposes of pleading under Rule 8(c)." Clemco, 665 F.Supp. at 829. The Court proceeded to hold that the issue of whether the defense had to be pleaded affirmatively was moot since the insured knew or should have known that the defense had been placed at issue in the case, because the insurer's pretrial list of witness narratives clearly disclosed that the insurer intended to introduce evidence concerning the advice of counsel. Id. at 830. The Court further held that the insured waived the issue by waiting until the close of the evidence to make an objection based on its "surprise". Id.

Whether the insurer has invoked the advice of counsel defense may become a contested issue in the case. This is often so because – as will be discussed below – invoking

the defense can dramatically alter the rights and obligations of the parties with respect to pretrial discovery and the scope of admissible evidence at trial. See Marathon Ashland Pipe Line v. Maryland Cas. Co., 243 F.3d 1232 (10th Cir. 2001). Here the insured sued the insurer in bad faith on a theory that the insurer unreasonably delayed on deciding whether it owed a duty to defend the insured. The insurer defended on the grounds, *inter alia*, that it was delayed in making its coverage decision because it was awaiting a coverage opinion from outside counsel. The insurer did not, however, affirmatively plead advice of counsel as a defense. In the bad faith litigation the insured argued that the advice of counsel defense had in fact been invoked, and the insured thus sought production of attorney-client correspondence. The insurer argued that it was not invoking the defense and asserted the privilege. The district court agreed with the insurer that the defense was not asserted and ruled that the privilege had not been waived. On appeal the Tenth Circuit held that whether the insurer had invoked the defense was a “close question”. Marathon Ashland Pipe Line v. Maryland Cas. Co., 243 F.3d at 1253. The Court held that the lower court did not abuse its discretion in its finding that the defense had not been asserted; it also held that the insurer was precluded from offering any evidence at trial which it had previously claimed as privileged. Id. at 1253.

In other cases courts have held that an insurer does not invoke the advice of counsel defense merely where its defense implicates counsel’s advice. See Aetna Casualty & Surety v. Superior Court, 153 Cal.App.3d 467, 475 (Cal. App. 1984) (“Aetna claims it acted as it did not because it was advised to do so, but because the advice was, in its view, correct; and it is prepared to defend itself on the basis of that asserted correctness rather than the mere fact of the advice. Such a defense does not waive the attorney-client privilege.”) See also United States Fire Insurance Company v. Asbestospray, 182 F.3d 201, 212 (3rd Cir. 1999) (mere argument by insurer based on the record that it was justified in its delay on filing interpleader action held insufficient to invoke advice of counsel defense and trigger a waiver of the attorney-client privilege); and Palmer v. Farmers Insurance, 861 P.2d 895 (Mont. 1993) (evidence that the insurer in fact relied upon the advice of counsel is insufficient, in and of itself, to support a finding that the advice of counsel defense is being pursued; the attorney client privilege applies “unless the insurer directly relies on advice of counsel as a defense to the bad faith charge.”)

4. Waiver of Privileges

By far, the most significant risk associated with the advice of counsel defense is that it invariably leads to a partial or complete waiver of the protections of the attorney-client privilege, and possibly the work product privilege as well. The problems associated with production of otherwise privileged documents are obvious. Rarely does an attorney draft a letter to a client believing that the document will later become an exhibit at a deposition or trial. Such documents often contain opinions and legal conclusions of counsel which may undermine the defense which is being asserted at trial. While the insurer may seek to limit the scope of the waiver, there is without question an overriding risk that a court will permit a plaintiff to discover communications between the insurer and the attorney which extend beyond the limited advice which forms the basis of the defense. In short, where privileges are concerned, counsel and client must always proceed with extreme caution.

The standards governing the attorney-client privilege are well established. The privilege applies where the following elements are met: “(1) Where legal advice of any kind is sought (2) from a professional legal advisor in his capacity as such, (3) the communication relating to that purpose, (4) made in confidence (5) by the client, (6) are at this instance permanently protected (7) from disclosure by himself or by the legal adviser, (8) unless the protection be waived.” United States ex rel U.S.F. & G v. District Court, 783 P.2d 911, 914-915 (Mont. 1989) citing Admiral Insurance v. United States District Court, 881 F.2d 1486 (9th Cir. 1989). The privilege “enourage[s] full and frank communication between attorneys and their clients and thereby promote[s] broader public interests in the observance of law and the administration of justice.” Id. at 914.

In general, where the insurer asserts the advice of counsel defense, it will be deemed to have waived its attorney-client privilege as to its communications with the attorney(s) who gave the advice. Vicinanzo v. Brunswick & Fils, Inc., 739 F.Supp. 891 (S.D.N.Y. 1990). The rationale for finding a waiver is not complicated: by introducing the advice of counsel as a defense, the insurer voluntarily places the scope and content of its attorney’s advice at issue, making it a relevant subject for discovery and testimony at trial. See, e.g. Wender v. United States Auto Ass’n., 434 A.2d 1372, 1374 (D.C.App. 1981). Courts generally reason that it would be unfair to permit the insurer to defend on the basis of its counsel’s advice while at the same time withholding documents and information regarding that advice. When faced with this issue courts often invoke the venerable analogy of the “sword and the shield”. Vicinanzo v. Brunswick & Fils, Inc., 739 F.Supp. at 893.

A seminal case discussing waiver in the context of the advice of counsel defense is Handgards v. Johnson & Johnson, 413 F.Supp. 926 (N.D.Cal. 1976). In Handgards, the plaintiff alleged that the defendant had pursued patent infringement actions against it in bad faith. During discovery the plaintiff learned that the defendant intended to call its former counsel to testify at trial that the infringement actions had been commenced pursuant to the advice of counsel. The Court held that this constituted a waiver of the attorney-client privilege, and ordered the disclosure of documents which would otherwise have been protected from disclosure. The Court declared:

An important consideration in assessing the issue of waiver is fairness... Thus, a party may not insist on the protection of the attorney-client privilege for damaging communications while disclosing other selected communications because they are self-serving. Voluntary disclosure of part of a privileged communication is a waiver as to the remainder of the privileged communication about the same subject.

Handgards, 413 F.Supp. at 929.

The Court further held that the Plaintiff was entitled to the discovery and production of documents in the attorney’s files which constituted work product of counsel. The Court noted that a waiver of the attorney client privilege did not necessarily trigger a waiver of the attorney work product doctrine. Nonetheless, the Court found that the Defendant’s invocation of the advice of counsel defense placed the attorney’s work product at issue, and thereby allowed the Court to find that on fairness grounds the Plaintiff has established a “substantial need and

undue hardship” necessary to overcome the limited work product protection codified in Federal Rule of Civil Procedure 26(b)(3):

The principal issue in the case at bar is the good faith of the defendants in instituting and maintaining the prior patent litigation against plaintiff. Plaintiff’s success in the instant action depends upon a showing that defendants pursued the prior suits knowing they would be unsuccessful on the merits. Since the lawyers who managed and supervised the former litigation for the defendants are being called as witnesses to express their opinions as to the merits of the prior suits and the validity of the underlying patents, plaintiff has a particularized and compelling need for the production of the relevant work product of these attorneys. Without discovery of the work product, plaintiff will be unable to ascertain the basis and facts upon which the opinions of these witnesses are based. This will undoubtedly impair plaintiff’s ability for effective cross-examination on a crucial issue.

Handgards, 413 F.Supp. at 931.

Waiver issues are inherent in the advice of counsel defense. As such, it is imperative that counsel for the insurer make a determination about whether the defense will be invoked as soon as possible after the case is first filed. An insurer’s switch in strategy on this issue in mid-litigation may not be feasible or, in some cases, may not be permitted at all. A good example is Wender v. United States Auto Ass’n., 434 A.2d 1372, 1374 (D.C.App. 1981). In Wender the insurer was sued in bad faith in connection with a claim that it wrongfully refused to defend an action against its insured. The insured served an initial set of written discovery upon the defendant, in which it sought production of all correspondence between counsel and the insurer regarding the defense of the first action. The insurer objected to this discovery and asserted the attorney-client privilege as to some of the requests. The insured did not challenge the objections at that time, and the documents were not produced. Immediately prior to trial, the insurer announced its intentions to use at trial some of the materials which it had previously withheld as privileged. The insured objected on the grounds that it had not been provided with these documents in discovery. The Court permitted the insurer to introduce the evidence upon the condition that it turn over the documents to the insured. Following a verdict for the insurer, the District of Columbia Court of Appeals granted a new trial to the insured. It held that (1) the insurer’s use of the documents was a waiver of the attorney-client privilege; (2) the insurer improperly sought to use the privilege as both a shield (when it first invoked the privilege) and then a sword (when it sought to introduce the materials at trial); and (3) the insured was entitled to a new trial because it was prejudiced by the trial court’s handling of the issue. Wender, 434 A.2d at 1374-75.

In some cases a plaintiff can effectively use the possibility of the waiver of privilege to force the insurer to declare whether it intends to assert the defense. Vicinanzo v. Brunswick & Fils, Inc., 739 F.Supp. 891 (S.D.N.Y. 1990). In Vicinanzo the plaintiff sought to compel production of otherwise privileged documents on the theory that the defendant had waived the privilege by invoking the advice of counsel defense. The plaintiff further argued that the defense had been invoked because the defendant, in discovery, had voluntarily produced certain documents which discussed the legal strategy pursued by the defendant. On that basis the Plaintiff argued that the attorney-client privilege had been waived, and sought production

of all otherwise privileged documents. The Court found that the mere production of these documents did not, by itself, constitute an invocation of the advice of counsel defense. However, the Court further ordered that the defendant either produce the documents in question or formally “abandon” the advice of counsel defense within 30 days. Vicinanzo, 739 F.Supp. at 894.

Where the defense is invoked, and a corresponding waiver of the privilege is found, the insurer may seek to limit the extent of the waiver. See Transamerica Title Ins. Co. v. Superior Court, 188 Cal.App.3d. 1047 (1987). Here a title insurer was sued by the insured on a theory that it acted in bad faith by not honoring its title insurance policy. The insurer filed an answer denying the bad faith and asserting a counterclaim for declaratory judgment. The answer did not assert advice of counsel as an affirmative defense. The insured then served an interrogatory asking whether the insurer intended to rely on the advice of counsel defense. The insurer answered that it did intend to rely on the defense, and attached a letter from counsel which contained the advice in question. Arguing that a waiver had occurred, the insured then sought all communication relating to the advice. The insurer argued, and the Court agreed, that the insurer only sought to introduce evidence of the advice of counsel to justify the filing of the counterclaim for declaratory judgment. As such, the Court held that the limited invocation of the defense would not trigger a complete waiver of all privileged communications relating to the claim. Transamerica Title Ins. Co. v. Superior Court, 188 Cal.App.3d. at 1054.

Notwithstanding the insurer’s success in Transamerica Title Ins. Co. v. Superior Court, a surety should never assume that a court will limit the scope of the waiver of privilege where the advice of counsel has been invoked. To the contrary, the surety and its counsel should instead assume the possibility of a “worst-case” scenario – i.e., a finding by the Court that the invocation of the defense has triggered a sweeping waiver of the privilege which will require production of all communications relating to counsel’s representation of the surety on the claim in question. The advice of counsel defense should be invoked only after a full consideration of the ramifications of such a waiver.

5. Strategy and Special Considerations for the Surety & Fidelity Insurer

The lack of any caselaw addressing the advice of counsel defense in the context of fidelity and surety litigation suggests a number of questions: Is there something unique about the fidelity and surety claims handling environment which renders the defense less appropriate than in the context of general insurance litigation? Should the surety or fidelity insurer ever invoke the defense? If so, under what circumstances? What steps should the surety and fidelity insurer take to maximize the benefits and minimize the risks if it decides to assert the defense? And, are there less risky alternatives to the advice of counsel defense which could allow the surety or fidelity insurer to accomplish its objective of defending the bad faith claims without the attendant waiver of privilege.

Given the caselaw addressing this issue in the insurance context, why does it appear that the defense is rarely invoked in surety litigation? Probably because a surety claim is generally more complicated and more complex than a claim on an insurance policy. In the insurance coverage case the issues are often simple and straightforward: did the insurer have

a legal duty on the policy to defend and indemnify the insured, or, was it obligated to pay benefits to the claimants. Insurers often ask outside counsel for a legal opinion regarding their obligations on the policy. Where the insurer is later sued for bad faith, the issue becomes whether the attorney's opinion was correct. The attorney's legal advice thus becomes a discrete issue which can be litigated via the advice of counsel defense.

Unlike the simple insurance coverage case, surety cases often are generally complex affairs. Certainly there are some instances when the surety will seek an opinion from outside counsel on a narrow issue of law. But it is more likely that the surety (particularly a performance bond surety involved in a large construction claim) will find itself relying on counsel for advice on much more than a single issue. Outside counsel's expanded involvement in the claims handling process makes the defense more risky and less manageable. The invocation of the defense will result in some waiver of the attorney-client privilege. Notwithstanding efforts by the surety to limit it, the waiver may extend to all aspects of outside counsel's representation of the surety. In a complex construction case, this means that counsel may be called to testify (either in deposition or at trial) on all aspects of the surety's handling of the project.

When should the surety consider invoking the defense? This will of course depend on the facts, circumstances and exigencies of each case. The surety should first determine whether evidence of counsel's advice would likely change the outcome of the case. If the evidence would be only marginally helpful, then it is probably not worth the risk. If, on the other hand, the entire case hinges on an action by the surety which was undertaken based on the advice of counsel, then the defense merits consideration. The defense is best asserted where the advice at issue was rendered on a narrow legal issue and was included in a written opinion letter or memorandum in the surety's claim files. By narrowly framing the issue the surety is better able to defend against the proverbial "fishing expedition" likely to follow.

Next the surety and its outside counsel should review their files and consider the potential that otherwise privileged documents will be ordered disclosed. This would include not only counsel's underlying opinion letter, but also all other correspondence between the attorney and the surety with respect to the bond or bonds at issue. Consider whether any of the documents include potentially inflammatory statements, questionable advice, off-color language, or opinions which might undermine the defense. If so, consider whether you want these documents in the hands of your adversary – or in front of the jury.

If counsel who rendered the advice is also counsel in the litigation, also keep in mind that the invocation of the defense may require that counsel be called as a witness at trial, thereby forcing disqualification of counsel – and perhaps counsel's entire firm. The retention of new counsel for the litigation may lead to significant transactional costs which the surety must be prepared to absorb if it intends to proceed with the defense.

The surety and its counsel should also consider alternatives to the formal invocation of the advice of counsel defense. One possibility is the retention of an attorney expert witness who could render an opinion as to the reasonableness of the actions taken by the surety. The expert would, of course, not be the same counsel who rendered the advice in question. Also, the surety should consider whether it can introduce evidence regarding the advice given

without actually having to formally assert the defense. For example, the surety's representative at trial could testify that the surety retained counsel who assisted in the investigation and the handling of the claim. The witness would not be asked directly whether the surety relied upon counsel's advice in taking the course of action in question. By eliciting such testimony the surety probably has not invoked the advice of counsel defense. However, the surety has conveyed to the trier of fact that – at least by implication – the advice of counsel was sought and obtained in connection with the issue at hand.

6. Conclusion

Given the high stakes in bad faith litigation, the advice of counsel defense should always be considered where the claim against the surety or fidelity insurer implicates pre-suit advice by an attorney. The defense should not be invoked without a careful consideration of the relative risks and rewards, including waiver of privilege and disqualification of counsel. Assert the defense only in cases where there is a compelling need to do so, and only when the less risky alternatives have been considered and are deemed inadequate.

Gary M. Case is a partner in the firm of Wolf, Horowitz, Etlinger & Case & LLC. He practices in the areas of fidelity and surety law, construction law, insurance coverage and defense, and subrogation. He received his undergraduate degree cum laude from Fairfield University and his law degree with High Honors from the University of Connecticut School of Law. He has been an Adjunct Instructor of Law at the University of Connecticut School of Law since 1994. He was a contributing author to "The Law of Payment Bonds," published in 1998 by the Tort and Insurance Practice Section of the American Bar Association. He was also a contributing author to the "Law and Practice of Insurance Coverage Litigation", published by the West Group in 2000.

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