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MONOGRAPH

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Feature Article

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Waste Management: How Insurers Can Prevent Insureds from Trashing Their Right to Full Disclosure

Waste Management is an important holding for insurers because it protects rights provided under the cooperation clause of insurance policies. In *Waste Management Inc. v. Int'l Surplus Lines Ins. Co.*, 144 Ill. 2d 178, 579 N.E.2d 322 (1991), the Illinois Supreme Court decided the issue of whether a putative insured could avoid disclosure of documents to an insurer on the basis of attorney-client privilege or under the work product doctrine. In a landmark ruling, the Illinois Supreme Court held that the cooperation clause of insurance policies and the common interest doctrine preclude application of attorney-client privilege and work product doctrine as between insurer and putative insured. In practice, attempts by insurers to enforce this holding can result in some complicated

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situations. This is partly attributed to Illinois law requiring the underlying plaintiff to be joined as a necessary party in coverage actions. *M.F.A. Mutual Insurance Co. v. Cheek*, 66 Ill. 2d 492, 495, 363 N.E.2d 809, 811 (1977). Courts presiding over coverage actions encounter difficulties when documents and information are privileged as to some parties in the action, but not as to others. Often, the putative insureds will seize this difficulty as an opportunity to avoid disclosure of material which could be damaging to their arguments in the coverage action and to avoid the effect of *Waste Management*. Because of this dynamic, it is critical for insurers to be prepared to address those issues and have a strategy to deal with those issues when they arise. This article describes some of the challenges that arise from *Waste Management* and how putative insureds have attempted to avoid their disclosure obligations. The article also analyzes these issues in light of the existing case law and provides a framework to overcome these obstacles.

Waste Management Levels the Playing Field for Insurers

In *Waste Management Inc. v. Int'l Surplus Lines Ins. Co.*, Waste Management Inc. and Chemical Waste Management, Inc., (the Insureds), brought a declaratory judgment action against International Surplus Lines Insurance Company and American Risk Insurance Company, (the Insurers), seeking indemnification of defense costs and settlement payments incurred in defense and settlement of an underlying action. At issue in the coverage litigation was whether the Insureds satisfied the cooperation conditions of the applicable insurance policies by providing all of the documentation and information sought by the Insurers. The Insurers sought the litigation files from one of the underlying claims and the Insureds refused to produce them on the basis of attorney-client privilege and the work product doctrine.

The Illinois Supreme Court held the privileges to be inapplicable stating: “[t]he basic purpose of a cooperation clause is to protect the insurer’s interests and to prevent collusion between the insured and the injured party.” *Waste Management Inc.*, 144 Ill.2d at 191. The Illinois Supreme Court reasoned that the attorney client privilege is the exception to the general rule of disclosure and should be narrowly interpreted to when the client has a reasonable belief that the privilege exists. Because of the cooperation clause in the insurance policy, the insured cannot reasonably believe that the attorney client privilege would apply to the insurer. *Waste Management Inc.*, 144 Ill. 2d at 192, 579 N.E.2d at 330. The Illinois Supreme Court also found the common interest doctrine to be a sufficient basis to preclude application of these privileges.

Because the defense attorneys in the underlying action represent the interests of both the insured and insurer, there is no proper claim of privilege. This mutual interest makes the application of *Hickman v. Taylor* 329 U.S. 495 (1947) and Illinois Supreme Court Rule 201 (b)(2) (providing for the work product doctrine) inapplicable when an insurer is seeking documents prepared by the insured in preparation for the underlying action. *Waste Management Inc.*, 144 Ill.2d at 198.

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The practical effect of this holding levels the playing field in an otherwise inequitable situation. The relationship between a coverage action and an underlying lawsuit arising from a liability claim might be compared to a poker game. In the underlying action, the cards are dealt. In the coverage action, you are sometimes forced to play with the cards that are dealt to you. Rulings made in the underlying action can be determinative of the scope of issues presented in a coverage action and might be dispositive on some of those issues. The difficulty for insurers in this situation is that the putative insured and claimant are parties to the underlying action, while the insurer is not. As the putative insured and claimant have a mutual interest in coverage, this scenario may present an incentive for collusion. The insured and claimant may attempt to posture their evidence and issues so as to fall within the coverage provisions of the policy.

While the putative insured and underlying claimant may attempt to develop evidence in the underlying action which could affect the coverage action, *Waste Management* entitles the insurer to discovery of their insured’s attorney client privilege documents and trial preparation materials. If there is documentation or communications discussing any issue in the underlying action, it is discoverable by the insurer under the cooperation clause of the insurance policy. Therefore evidence of collusion between the insured and claimant, and trial strategy of the insured intended to gain an advantage for coverage purposes, should be discoverable by the insurer.

Discovery Issues

The inapplicability of the attorney-client and work product privileges for materials from the underlying action can become complex when the underlying plaintiff is joined as a party in the coverage action. Below are a few of the issues that may arise:

- (1) *Is the underlying plaintiff entitled to disclosure as a party to the coverage action?*
- (2) *Is the attorney-client privilege waived by the insured's disclosure to the insurer?*
- (3) *Does the insurer have bad faith exposure from seeking disclosure from its insured?*
- (4) *When can the insurer use privileged information obtained from its insured pursuant to Waste Management?*

Analysis Under Illinois Law

While the courts have provided guidance on the aforementioned issues, in some instances there is no definitive answer for insurers struggling with these issues. This section analyzes the applicable precedent and provides insight as to how these issues will be treated in Illinois courts:

(1) Is the claimant entitled to disclosure as a party to the coverage action?

This issue may arise when the underlying claimant seeks disclosure of discovery materials provided under *Waste Management*. Of course the insurer and insured have a mutual interest in protecting privileged materials from the underlying plaintiff, as both parties have an interest in reducing any exposure in the underlying lawsuit.

The Illinois Supreme Court Rules do not directly or specifically address this issue. In practice it is customary to include all counsel of record on discovery which is issued and responses to discovery. Rule 214 provides that the request for production shall be served on "all other parties entitled to notice," but does not specify what "entitles" a party to notice. Rule 213 does not state which parties are entitled to receive copies of the interrogatories or interrogatory responses.

One possible strategy is for the insurer and insured to agree to a voluntary review of the documentation sought by the insurer. A voluntary review is not subject to Illinois Supreme Court discovery rules, but is based upon the cooperation clause of the insurance policy. The drawback to this approach is that

it might be more difficult to create a formal record of what is disclosed and what is withheld. Another disadvantage is that the insurer will not have the benefit of discovery sanctions to ensure compliance. Because of these limitations it may be best to use this strategy as a starting off point.

One possible strategy is for the insurer and insured to agree to a voluntary review of the documentation sought by the insurer. A voluntary review is not subject to Illinois Supreme Court discovery rules, but is based upon the cooperation clause of the insurance policy.

A second possible strategy is to request entry of a protective order by the trial court. This approach will put the matter formally at issue and ensure that all parties have notice of the privileges asserted and ensure that the privileges are preserved. The order should be tailored to suit the concerns of the specific matter, but at a minimum should provide that any disclosures made by the insurer to the insured should remain privileged. Further, the order should place the burden of designating the privileged material on the insured. Finally, the order should provide a framework for resolving privilege disputes that arise between the insured and insurer.

(2) Is the privilege waived by disclosure to the insurer?

This argument may be raised by the underlying plaintiff in the coverage action that seeks disclosure of otherwise privileged materials. Illinois recognizes that the attorney client privilege can be waived by the party claiming the privilege. *See Illinois Emcasco Insurance Co. v. Nationwide Mutual Ins. Co.*, 913 N.E.2d 1102 (2009). In some instances the scope of the waiver has been argued to extend to all communications relating to the same subject matter. *See People v. O'Banner*, 215 Ill. App. 3d 778, 793, 575 N.E.2d 1261 (1991).

While Illinois courts have not directly addressed this issue, the resolution is fairly certain based upon the nature

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of these privileges. Clearly, it would be nonsensical to argue that the privilege between an attorney and client is waived because the attorney and client have engaged in discussions. This is because the attorney and client are in the protected group that is entitled to engage in protected communications. This same reasoning applies to resolve the issue of whether the privilege is waived when an insurer obtains information from an insured under the cooperation clause of an insurance policy. The communications between insurer and insured are privileged. See *Urban Outfitters, Inc. v. DPIC Companies, Inc.*, 203 F.R.D. 376 (N.D.Ill. 2001). Disclosure within the control group does not waive the privilege. This principle is in conformance and contemplated by the holding in *Waste Management*.

(3) Does the insurer have bad faith exposure by seeking disclosure?

The issue of bad faith might be raised by an aggressive insured that is attempting to gain leverage and avoid disclosure to the insurer. The insured might claim that information sought by the insurer could harm the insured in the underlying action. The insured might also state that the insurer is putting its own interest ahead of the insured.

In Illinois, the scope of what actions constitute "bad faith" by an insurer have been defined within statute. See 215 ILCS 5/155. With the exception of a failure to settle, the all purpose tort of common law bad faith against an insurer has been eliminated in Illinois. See *Cramer v. Insurance Exchange Agency*, 174 Ill. 2d 513, 675 N.E.2d 897 (1996). In Illinois, the statutory remedy provides relief for practices that are "vexatious and unreasonable." There is not an exhaustive list of what meets this standard, but courts will not find that behavior when: (1) there is a *bona fide* dispute concerning the scope and application of insurance coverage; (2) the insurer asserts a legitimate policy defense; (3) the claim presents a genuine legal or factual issue regarding coverage; or (4) the insurer takes a reasonable legal position on an unsettled issue of law. *Country Life Ins. Co. v. St. Paul Surplus Lines Ins. Co.*, 422 F.Supp.2d 977 (C.D. Ill. 2006).

Applying these standards, there should be no potential for bad faith liability when an insurer seeks disclosure from its insured under the cooperation clause because: (1) the insurer is acting pursuant to a legitimate policy provision; and, (2) Illinois courts have now recognized the validity of the insurer's position and request for disclosure in *Waste Management*. In Illinois, when an insurer seeks to disclaim coverage under a policy it must generally either defend under a reservation

of rights or file a declaratory judgment action to preserve its rights. *Uhlich Children's Advantage Network v. National Union Fire Co. of Pittsburgh*, 398 Ill. App. 3d 710, 929 N.E.2d 531 (1st Dist. 2010). Illinois law also normally requires that the underlying claimant must also be joined in the litigation. *M.F.A. Mutual Insurance Co.*, 66 Ill. 2d at 495, 363 N.E.2d at 811; Finally, Illinois law also generally provides that declaratory judgment actions may proceed during the pendency of the underlying claim and should only be stayed if the issues to be litigated in the declaratory judgment action are determinative of the issues in the underlying litigation. See *Sharp v. Trans Union L.L.C.*, 364 Ill. App. 3d 64, 75, 845 N.E.2d 719, 729 (1st Dist. 2006); *Allianz v. Guidant Corp.*, 373 Ill. App. 3d 652, 869 N.E.2d 1042 (2d Dist. 2007). The decision as to whether the issues are inextricably linked is not one to be made unilaterally by the insurer, but is only one that can be made by the trial court. In order to avoid estoppel, Illinois law expressly provides that an insurer may file a declaratory action. See *Uhlich Children's Advantage Network*, 398 Ill. App. 3d 710, 929 N.E.2d 531.

Practically speaking, both the insured and insurer have a common interest to avoid assisting the underlying plaintiff. It is certainly conceivable that information disclosed by an insured during the course of a coverage action could be damaging to the defense's interests in the underlying litigation. The cases are related and information might be revealed during the coverage action which was not disclosed by the insured or was not sought by the underlying plaintiff. In this situation, the party that is in the best position to avoid inadvertent disclosure is the insured, because the insured is litigating the coverage action and the underlying action. If there is information that is potentially harmful to the defense in the underlying action which can be labeled as confidential in the coverage action, then the insured should seek a protective order. If the insured has a legitimate concern and proactively raises that concern with the insurer and the court, then the insured and insurer should be able to avoid any prejudice to the defense of the underlying action.

(4) When can the insurer use information obtained under Waste Management?

When an insured has produced documents pursuant to *Waste Management*, the question becomes: When can an insurer use these documents or information in a coverage action? This issue is a bit more difficult to resolve as it is clear that if information provided by the insured to the insurer is going to be used in a trial or dispositive motion within the coverage action, it may need to be disclosed to the underlying plaintiff.

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Because the underlying plaintiff is required to be joined as a necessary party, the underlying plaintiff will have an opportunity to contest the insurer's coverage positions. *See M.F.A. Mutual Insurance Co.*, 66 Ill. 2d at 495, 363 N.E.2d at 811.

If there is information that is potentially harmful to the defense in the underlying action which can be labeled as confidential in the coverage action, then the insured should seek a protective order.

As mentioned in the previous subsection, the insured is in the best situation to notify the insurer of which information is potentially damaging to the defense in the underlying action and which can be disclosed. In most circumstances the potentially damaging information can be submitted in redacted form to allow for its use while avoiding prejudice to the defense of the underlying action. However, if the insurer and insured cannot agree as to what information is potentially damaging to the defense of the underlying action, the issue should be submitted to the court. At that point, the court should determine whether disclosure of the information would prejudice the insured in the defense action. If the information is important to the determination of issues in the underlying action and is also required for the insurer in the coverage action, the court may stay the coverage action until resolution of the underlying action. *See Sharp v. Trans Union L.L.C.*, 364 Ill. App. 3d 64, 75, 845 N.E.2d 719, 729 (1st Dist. 2006).

Conclusion

Insurance companies should be prepared to address the potential issues related to the application of *Waste Management* to coverage disputes to ensure that this holding is not eroded by the argument of insureds attempting to avoid disclosure. Illinois law is clear that *Waste Management* does not destroy privileges between the defense and underlying plaintiff, nor does Illinois law support a bad faith finding against an insurer enforcing its rights under the cooperation clause of an insurance policy. While the presence of the underlying plaintiff in the coverage action may add a few wrinkles, there are workable solutions for those potential problems.
