AVOIDING EXTRA CONTRACTUAL CLAIMS:

THE LESSONS OF *LUSTIG*

Tort and Insurance Practice Section
Fidelity and Surety Law Committee
Mid-Winter Meeting
Friday, January 28, 2000

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YEAR 2000 MIDWINTER PROGRAM:

THE LEGACY OF *LUSTIG*[1]

I. INTRODUCTION.

From a claim-handling perspective, the First National Bank of Louisville (the "Bank") claim and litigation (hereinafter "*Lustig*"), is a classic case of "all's well that ends well."[2] However, it was indeed a bumpy road on which the insurers traveled, expending an enormous effort to defend allegations of bad faith, ineptness, and even outright corruption. The insurers ultimately prevailed on all claims of bad faith, but the cost of success was dear. *Lustig* provides to the armchair quarterbacks among us a classic opportunity to learn both from the mistakes and the successes of the insurers in the claim-handling process and gambles that we won and lost in the litigation. We will, with the luxury of this hindsight, examine the events which became the focal point of the Bank's bad faith claims and then review the litigation defense which led to a costly but ultimately successful vindication of the insurers' claim handling.

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[1] The contents of this paper are the sole opinions of the authors and are intended to analyze important legal and practical lessons to be learned from the *Lustig* cases for the insurance industry and policyholders alike.

[2] The writers acknowledge and thank Matt Farley and his colleague, Suzanne Fontan, of the Preaus, Roddy & Krebs firm, for their assistance with the voluminous *Lustig* public record and public history.

II. A PRIMER TO GOOD FAITH HANDLING OF FIDELITY CLAIMS

The two insurers (the "Insurers") in the claim-handling stage of the Bank's claim conducted a reasonable investigation and attempted to reach a good faith resolution of a complex fidelity matter. Obviously, all insurers should conduct a prompt, thorough, and balanced factual investigation. The Bank contended that the Insurers did not do so. It is preferable, as a precautionary measure, during the claim investigation to segregate factual materials from materials containing legal analyses. There is no indication in the *Lustig* record as reported that the Insurers did this. Separation of factual and legal materials helps preserve the attorney-client privilege, especially in situations where outside counsel is handling the investigation. Even where privileges are protected, the investigation should be thoroughly documented and in a form of material which will be discoverable. Otherwise, the insured will argue that it has been denied access to the facts upon which the insurer relied in denying the claim. The Insurers, for reasons examined later in this paper, were not particularly keen about preserving privileges.

The insurer should respond promptly to all inquiries from the insured and should keep the insured apprised of factual information developed as a part of the claim assessment process. While it is, of course, important to carefully review the insured's "files," it is of equal or greater importance to interview the witnesses with percipient knowledge. Current employees of the insured should, of course, be interviewed in the insured's presence. Former employees of the insured, with certain exceptions, should also be interviewed, generally in the presence of the insured. On the other hand, it is preferable to interview the allegedly dishonest employees outside the presence of the insured. While there is little law directly on point with regard to interviews, some insureds might argue that an insurer commits "bad faith" by conducting

separate witness interviews. Such a contention is groundless since the insurers have the right, and arguably the obligation, to obtain independent information from witnesses outside what can on occasion be the intimidating presence of the insured.

Of somewhat greater concern with respect to witness interviews is the risk that counsel assisting in the investigation will become "fact witnesses" should the reasonableness of the investigation become an issue or should the witness later change his story or disappear. Counsel for the insurer should be careful in dealings with the allegedly dishonest employee or his counsel so as to prevent third parties from drawing an improper inference from such interaction to the effect that the insurer and the employee are conspiring against the insured.[3] Much was made by the Bank of the allegedly cozy relationship between the Insurers' counsel and counsel for DeWitt and Lustig. Indeed, the court of appeals in *Lustig II* described that relationship in less than complimentary terms; but, ultimately, that issue was not a factor in the outcome of the case.

Key legal and factual issues frequently manifest themselves early in the claim handling. While the insurer will keep an open mind as to the potential for coverage of the claim, it should at the appropriate early opportunity explain to the insured the factual and legal issues it sees in the claim as it unfolds. To do otherwise exposes the insurer to a "sandbagging" or waiver argument as to defenses not raised until the late going. It is not clear from the available record

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[3] There are circumstances in which a former employee will not have the financial wherewithal to employ counsel to protect his interest during an interview and/or to employ counsel or other professionals to protect his interest in civil or criminal proceedings. There is some temptation, under certain circumstances, for the insurer to financially assist the former employee so as to afford him the practical opportunity to present his side of the story. Insurers should resist this temptation because it will, without regard to its true motivation, be characterized as an overt attempt to "defeat" the claim, which, under certain circumstances, is classic "bad faith."

whether the Insurers provided to the Bank contemporaneous notice of the coverage issues as they became evident, or whether those issues were presented at the conclusion of the claim investigation.

Coverage counsel should eventually provide to the insured an impartial summary of the facts and at least some discussion of the law as they apply to the particular claim. If the insurer concludes that a covered loss was not sustained, it should provide an evenhanded explanation of the legal and factual bases for its coverage position. If a large volume of factual information has been developed, it should be shared, at least in substance, with the insured. The insurer's position in a subsequent "bad faith" suit will be strengthened if it leaves behind a record that it has maintained and shared with the insured an impartial view as to the law and the facts that apply to the claim. Again, the available record does not indicate whether and when the Insurers took formal positions on the Bank's claim and, if so, whether those views were communicated in writing.

As noted above, once the claim investigation has been completed, its key **factual** components should be maintained in a form which is discoverable.[4] Legal analysis can be maintained in separate writings clearly designated as "privileged communications." The substance of the factual investigation, if it supports a denial or compromise of the claim, might under some circumstances be made available to the insured. To do so is consistent with the general proposition that the insurer should share with the insured the bases in law, in fact, and in

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[4] The factual aspect of any claim investigation will often times be discoverable in subsequent litigation. Legal analysis by counsel is privileged. It is, therefore, good practice for the insurer to have a written, non-privileged package of investigative information which, if necessary, can be made available to the insured in subsequent litigation without any compromise to the attorney-client privilege.

relation to the policy, upon which the insurer refuses to pay in full, or chooses to compromise, a submitted claim.

Whether by in-person meeting, or in writing, the insurer's position on the claim should be clearly communicated to the insured. It is on some claims prudent to submit a "preliminary" statement of position on a claim, while affording the insured an opportunity to address any factual or legal conclusions of the insurer to which it takes exception. An insured should be invited to address those issues prior to the insurer taking a final position. Once the insured's input has been received and fairly evaluated, and unless further investigation is called for, the insurer should finalize its position and communicate it to the insured.

Insureds should be encouraged to meet face-to-face with the insurer, even where the purpose of the meeting is to receive "bad news." Such meetings, as the claim proceeds, or when the insurer finalizes its position, should involve three stipulations, if possible. First, the meetings should be agreed upon as mutually requested so as to preclude either party from later suggesting that the other was "forced" to make the time and effort to meet. Second, it is best if the meeting is "off the record" for all purposes, so as to encourage candid discussions and forthright communication. Finally, such meetings should be "without prejudice" to either party taking contrary positions at a later time. Neither the insurer nor insured should be subject to a "waiver" argument because a point was not raised or because a point was tentatively abandoned during such meetings.

If the purpose of a meeting is to reach a compromise of the claim, there is even further reason to conduct the meeting on an "off-the-record" basis. Aggressive insureds will argue that an insurer must offer its "bottom-line" dollar at the outset of a negotiation. Such would, of

course, belie the entire concept of the negotiation. A stipulation that the discussion is off the record for all purposes will obviate that problem. Evidence of settlement negotiations was received during the bad faith phase of the *Lustig* trial and may well have prejudiced the jury against the position of the Insurers.

As an aside for persons involved in claims in California, and other states with specific regulations issued in connection with fair claims practices statutes, it may, as the claim investigation proceeds, be necessary to give "notice" of certain Department of Insurance regulations and even point out policy and statutory limitations periods to the insured.[5]

If, in spite of the efforts to resolve the claim, litigation ensues, the insurer should seek early court resolution of all claims sounding in "bad faith." These claims are increasingly resolved as a matter of law, either on the pleadings by way of a motion to dismiss or demurrer, or at summary judgment. To posture the case for the early testing of the "bad faith" claims by summary judgment, defense counsel should serve early contention discovery seeking discovery of the evidence that the insured claims support its bad faith claim. This tactic is particularly useful as the insured, not the insurer, bears the burden of establishing that no reasonable basis existed for the insurer's position. The Insurers in the *Lustig* case pursued aggressive pre-trial motions with respect to claim handling and bad faith issues. Although not initially successful, those efforts in due course paid dividend by way of the *Lustig II* Fifth Circuit Court of Appeals decision to the effect that summary judgment could and/or should have been granted with respect to the Bank's bad faith claims.

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[5] *See* Spray, Gould & Bowers v. Associated Int'l Ins. Co., 71 Cal. App. 4th 1260 (1999) (a poorly reasoned decision at best).

Where there has been extensive interviewing of witnesses in the investigation process, depositions of these witnesses should be taken to reduce these results to a proper evidentiary form. Reliance upon the statements in taking a position can thereupon be utilized in pre-trial coverage and claim-handling motions.

One issue litigated in such cases is that of the insurer's alleged "oppression" of the insured because it is very difficult to establish that the insurer acted with actual malice.[6] Insureds typically try to prove that insurers exploit alleged economic advantage to coerce them into accepting nominal settlements. Where the insured is solvent and where the claimed loss will not make a material difference in the insured's bottom line, such arguments should fail.[7] Early discovery in the form of request for admissions can generally put this issue to rest. On the other hand, where an insured can legitimately claim that its loss threatened its financial existence, care must be given to leave a clear track record that no economic oppression by the insurer has occurred.

The insurer might need to retain a claims handling expert early in the litigation to examine and, if appropriate, to testify to the reasonableness of the claim handling by the insurer and/or the unreasonableness of the claim presentation of the insured. There were a number of experts offered up by the Bank and the Insurers in the *Lustig* case. Both the Bank and the Insurers had mixed success in the use of their experts. It is evident that both sides spent

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[6] *See, e.g.*, CAL. CIVIL CODE § 3294 (1992). As later discussed, damages recoverable for "bad faith" do not necessarily include punitive damages. Malice, fraud, and oppression are typically probative of punitive damage claims. Punitive damage claims arise only where the insured first establishes that the insurer committed bad faith.

[7] *See, e.g.*, Slottow v. American Cas. Co. of Reading, 10 F.3d 1355, 1361 (9th Cir. 1993).

substantial sums on experts. The Bank's experts opined that the Insurers misbehaved in handling the claim. The Insurers' experts opined that the Bank and its counsel perpetrated a "fraud on the court." In the final analysis, the experts did not have a material impact on the outcome of the case. Although experts should not be allowed to address legal issues, they are frequently asked to fact-find with respect to the components of the definition of dishonesty.

In defense of discovery sought by the insured, the insurer should firmly resist the attempts to obtain privileged communications with counsel and/or information relating to reserves or reinsurance communications. As well, the insurer should resist insured's attempts to obtain other claim files, especially claim files that do not derive from the same underlying incident.

Finally, when sued for bad faith, an insurer should in most cases resist the urge to invoke the so-called "advice of counsel" defense. To do so could compromise the attorney-client privilege as to communications with coverage counsel prior to the outbreak of litigation and lead to a number of other complications. As discussed later in this paper, the advantages of the "advice of counsel" defense are generally outweighed by the consequences of the assertion of that defense. This is particularly true where coverage counsel has been involved in the claim investigation and has shared with the insurer the "pros and cons" of the claim submitted. Once an insured has its hands on any writing suggesting that there is a plausible basis for coverage, even where outweighed by viable coverage defenses, such writing will find itself expanded to a 3-foot by 6-foot poster which will be paraded before the jury and relied upon as a basis to argue that the insurer knew there was coverage all along.

III. THE FIFTH CIRCUIT APPEAL IN *FIRST NATIONAL BANK OF LOUISVILLE V. LUSTIG*, 96 F.3d 1544 (5th Cir. 1996)

In a two-step proceeding following remand from the 1991 appeal,[8] the jury found against the Insurers on both coverage and "bad faith" claims. In a bifurcated trial, the jury awarded the Bank $17,806,313 in damages under the coverage portion of the case, concluding that the Bank's loan losses were, as contended, the direct result of fraudulent or dishonest acts on the part of DeWitt. The Insurers obliquely attacked the coverage decision of the jury but concentrated their efforts on the "bad faith" portion of the judgment.[9]

The court of appeals reversed the bad faith verdict, finding that the district court had erred in denying the Insurers' motion for judgment as a matter of law on such claims. This victory on appeal eliminated the $11,760,000 award of bad faith ("lost earnings") damages. On separate grounds, the court of appeals also reversed the $5,850,000 award of attorneys' fees incurred in connection with the claim and suit, although it affirmed the award of attorneys' fees under General Agreement F of the bond of attorneys' fees incurred by the Bank in defending certain third-party litigation. The victory on the bad faith and attorney fee awards was no doubt gratifying to the Insurers because the court of appeals reversed a jury determination of bad faith. In substance, the Fifth Circuit found that "no reasonable juror" could have found bad faith.

The claim history of the matter at first blush seems unremarkable. In April 1986, the Bank notified the Insurers of a potential loss. However, an investigation of the Bank's losses on

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[8] The 1991 appeal addressed only coverage issues.

[9] The court of appeals expressly states that the Insurers (referred to as the "Sureties" in the opinion) "do not appeal the jury's findings of coverage under the bond." The court's statement does not make sense in that several arguments raised by the Insurers appear to be directed to coverage-related issues (causation, allocation issues, and jury interrogatories on coverage issues) rather than claim-handling issues. Unfortunately for purposes of this paper, the briefs in the appeal in *Lustig* remain under seal and thus cannot be discussed directly in this paper.

the Lustig loans by the FBI prevented significant independent investigation of the matter by either the Bank or the Insurers for more than 15 months after the initial notification.[10]

At a point in time not disclosed in the opinion, the Bank began submitting claim information to the Insurers. Aetna, as lead underwriter, retained outside counsel to assist it in the investigation of the matter. As the court of appeals described the investigation of the Insurers:

> The Sureties conducted few interviews and, in fact, interviewed only one FNBL representative. [Lead counsel for the bonding companies] conducted interviews with DeWitt and Lustig and developed an amicable relationship with their attorneys. The relationship was apparently beneficial as FNBL documents were freely exchanged between Martin [insurers' counsel] and Lustig's attorney, Frank Haddad, without FNBL's permission or knowledge. The sureties never provided the information they received from Lustig to FNBL.[11]

The court's implication is that the Insurers were too cozy with the alleged wrongdoers. Indeed, the Bank and its counsel pursued that theme with vigor.

The court of appeals concluded that the Insurers saw that there was wrongdoing on the part of DeWitt. It noted that:

> [T]estimony and other evidence show that the Sureties knew that the "benefit to an employee" element of the bond coverage in at least four of the DeWitt loans was probably satisfied due to DeWitt's involvement and receipt of money from Lustig in connection with those loans. During settlement negotiations, the Sureties offered to settle the case for $5.5 million. Evidence including testimony showed that the Sureties knew that

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10 96 F.3d 1554, 1560. Insureds and government prosecutors frequently suggest that the insurer abate its investigation pending completion of what are frequently very lengthy criminal inquiries. The reality is that prosecutors are concerned with criminal prosecutions and typically have very little interest in the insurance claim. They are pleased to ask insurers for their help but are rarely inclined to reciprocate by sharing information with the insurers. It is frequently prudent, notwithstanding the pendency of a criminal investigation, to carry on with the claim investigation anyway.

11 *Id.* at 1560.

> this offer was well below FNBL's claimed actual loss. FNBL refused to accept this offer and stated that unless the Sureties presented an offer of at least $10 million, FNBL would not continue the negotiations.[12]

Both reported *Lustig* decisions from the Fifth Circuit address DeWitt's guilty pleas. The Insurers in *Lustig II* aggressively argued at trial and, on appeal, that the guilty plea was the product of manipulation on the part of the Bank and should on that basis, as well as others, be excluded from evidence. Initially, the Insurers argued that the guilty plea could not be relied upon, as the judge who had entertained it had substantial business connections with FNBL and should have recused himself. Indeed, he had rejected an earlier guilty plea by DeWitt, thus tainting its reliability in the eyes of the Insurers. More importantly, the Insurers argued, with strong factual support, that the Bank, through its counsel, manipulated the indictment on which DeWitt pleaded. The indictment, revised per FNBL's suggestions, is remarkable for its similarity to many of the provisions of the bond's insuring agreements.[13] Indeed, as the court of appeals noted: "Evidence also demonstrated that FNBL may have had final approval of the finished product."[14] Just as the court of appeals implied that coverage counsel and counsel for the wrongdoers were perhaps too familiar with one another, the court criticized any attempt by an insured to manipulate a criminal prosecution in order to enhance its bond claim.[15]

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[12] *Id.* at 1560. Obviously, evidence of settlement negotiation was discovered and received into evidence in the *Lustig* case. Such evidence will invariably be contorted by the insured. It is for this reason, as suggested throughout this paper, that the insurer should do its best to conduct settlement discussions on an agreed-upon "off-the-record" basis.

[13] *Id.* at 1562.

[14] *Id.* at 1562.

[15] *Id.* at 1573.

The court of appeals noted that while the trial court allowed the admission of the guilty plea, it also allowed the Insurers to attack the reliability of the plea at trial. The Fifth Circuit essentially found that this approach was "balanced" and fair to both parties. Thus, the Bank and its counsel escaped punishment despite the clear evidence of improper involvement of a criminal proceeding. That conduct, however, may have been a subtle factor leading to the Fifth Circuit's receptiveness to the Insurers' appeal from the bad faith verdict.

On the key issue of bad faith, the court of appeals described the controlling test under Kentucky law as follows:

> To prevail on a bad faith claim under Kentucky law, an insured must establish (1) that the insurer was obligated to provide coverage under the terms of the policy; (2) that the insurer had no reasonable basis for denying coverage for the claim; and (3) that 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.[16]

The Kentucky test is relatively evenhanded. Other jurisdictions have significantly different standards. Reported authorities in a few jurisdictions disallow the tort of "bad faith" altogether.[17] Other courts have refused to find such a tort in the context of a first-party policy.[18]

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[16] *Id*. at 1564.

[17] *See generally*, Vincent v. Blue Cross-Blue Shield, Inc., 373 So. 2d 1054 (Ala. 1979); Kewin v. Massachusetts Mut. Life Ins. Co., 295 N.W.2d 50 (Mich. 1980); Debolt v. Mutual of Omaha, 371 N.E.2d 373 (Ill. 1978).

[18] *See* Spencer v. Aetna Life & Cas. Ins. Co., 611 P.2d 149 (Kan. 1980).

Most jurisdictions recognizing a common law tort of "bad faith" require the insured to establish that the insurer's coverage position is unreasonable, or lacking any reasonable basis.[19]

Some jurisdictions add additional elements to the tort liability itself. For example, Kentucky, as discussed in the *Lustig* case, requires a showing of scienter, or a knowledge of the insurer that its position on coverage was not reasonable.[20] [21] Still others require a showing that the actions of the insurer amounted to an unfair business practice which if not remedied will perpetrate a fraud upon the public, at least for purposes of awarding punitive damages.[22]

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[19] *See e.g.*, Gruenberg v. Aetna Ins. Co., 510 P.2d 1032 (Cal. 1973); Waller v. Truck Ins. Co., 11 Cal.4th 1, 35 (1995); Love v. Fire Ins. Exch., 221 Cal. App. 3d 1136, 1161 (1990). *See generally* Nobel v. Nat'l American Life Ins. Co., 624 P.2d 866 (Ariz. 1981); Grand Sheet Metal Products Co. v. Protection Mut. Ins. Co., 375 A.2d 428 (Conn. 1977); L.F. Pace & Sons, Inc. v. Travelers Indem. Co., 514 A.2d 766 (Conn. 1986); U.S.F.&G. v. Peterson, 540 P.2d 1070 (Nev. 1975); Rover Farms Resort, Inc. v. Investors Ins. Co. of America, 323 A.2d 495 (N.J. 1974); Jones v. Continental Ins. Co., 920 F.2d 847, 849, 850 (11th Cir. 1991); Whyte v. Connecticut Mut. Life Ins. Co., 818 F.2d 1005, 1013 (1st Cir. 1987) (applying Massachusetts law); *see generally* GUY KORNBLUM, FIRST PARTY INSURANCE BAD FAITH: A DEFENSE PERSPECTIVE, pp. 1-20 Volume 1988, Number 1, Defense Research Institute (1988).

[20] Authorities from other jurisdictions appear to be generally in accord with Kentucky. *See, e.g.*, Higgenbotham v. State Farm Auto Ins., 103 F.3d 456 (5th Cir. 1997) (applying Texas law); TPLC, Inc. v. United Nat'l Ins. Co., 44 F.3d 1484 (10th Cir. 1995) (applying Colorado law); *accord see generally* Prisco Serena Strum Architects Ltd. v. Liberty Mut. Ins. Co., 126 F.3d 886 (7th Cir. 1997) (applying Illinois law and requiring the insured to prove the carrier's position lacks any reasonable basis and is vexatious).

[21] *Lustig II*, 96 F.3d 1544, 1564.

[22] *See* Thomas v. Met. Life Ins. Co., 40 F.3d 505, 510 (1st Cir. 1994) (applying New York law).

A decided minority of opinions take the other extreme and have allowed "bad faith" even where there is no coverage.[23] Most courts considering the issue require as a condition to a bad faith claim that the claim was wrongly denied.[24]

The finding of "bad faith" alone typically will not result in an award of punitive damages. Although substantial "bad faith" damages were assessed by the jury, no punitive damages were evidently awarded at any stage of the *Lustig* litigation.[25] However, tort damages, most notably attorneys' fees in the context of a commercial fidelity bond or a financial institution bond, may in some states be awarded.[26] Indeed, an award of such fees was a key issue in the *Lustig* case. Some states, by statute, provide for an award of attorneys' fees where an insurer's refusal to pay is deemed unreasonable.[27]

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[23] *See generally*, Rawlings v. Apodaca, 726 P.2d 565 (Ariz. 1986).

[24] *See, e.g.*, Waller v. Truck Ins. Co., 11 Cal. 4th 1, 35 (1995); Love v. Fire Ins. Exch., 221 Cal. App. 3d 1136, 1161 (1990).

[25] See discussion of punitive damages beginning at page 44, *infra.*

[26] *See generally* Brandt v. Superior Court, 693 P.2d 796 (Cal. 1985).

[27] *See, e.g.*, GA. CODE ANN. §§ 33-4-6 (1998); IDAHO CODE §§ 41-1209, 41-1839 (1999); KAN. STAT. ANN. §§ 40-256, 40-468, 40-1517 (1998); LA. REV. STAT. ANN. § 22:658; MO. REV. STAT. § 373.296 (1999); NEB. REV. STAT. §§ 44-359 (1999); OR. REV. STAT. §§ 743.114, 746.350 (1997); TENN. CODE ANN. §§ 56-7-105 (1999); TEX. INS. CODE Art. 1.14-1 (1999). *See generally* WILLIAM SHERNOFF, SANFORD GAGE, HARVEY LEVINE, INSURANCE BAD FAITH LITIGATION, pages 7-37, Section 7.04(3)(c) (Matthew Bender 1999).

A few states have allowed a private right of action for violation of the State Insurance Practices Act.[28] Other authorities in other states have declined to do so.[29]

As a practical matter, even in jurisdictions that do not allow the use of the express pleading of a statutory cause for "bad faith," insureds will often argue that the Fair Claims Practices Act describes the standards to which the insurer is held accountable and that failure to comply with such standards is evidence of bad faith. Whether a particular statute is relevant to the assessment of an insurer's coverage position may or may not make sense in light of the particular facts of the case. The key is that of reasonableness. It is the burden of the insured to establish that the insurer's coverage position, viewed as a whole and in light of the facts available at the time, was not palatable. It is, of course, to the distinct advantage of the insurer to have that issue resolved, as a matter of law, by the court. Whether by judge or jury, however, the insurer has a right to be wrong on coverage provided that its coverage decision was "reasonably debatable." The Fifth Circuit ultimately concluded, as a matter of law, that the position of the Insurers was indeed reasonably debatable.

The Fifth Circuit was influenced in its bad faith determination by the unique coverage requirements contained in the bond. The court noted that the law in the State of Kentucky on

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[28] FLA. STAT. § 624.155(1) (1998); *see, e.g.*, Griswold v. Union Labor Ins. Co., 442 A.2d 920 (Conn. 1980); American Home Assurance Co., 616 F. Supp. 906 (D. Mass. 1985); Smith v. Globe Life Ins. Co., 597 N.W.2d 18 (Mich. 1999).

[29] *See* Moradi-Shalal v. Fireman's Fund, 250 Cal. Rptr. 116 (1988); Farmers Group, Inc. v. Trimble, 658 P.2d 1370 (Colo. Ct. App. 1982), *affirmed en banc*, 691 P.2d 1138 (Colo. 1984); Langendorf v. Travelers State Ins. Co., 625 F. Supp. 1103 (N.D.Ill. 1985); *but see* Bageanis v. American Bankers Life Ins. Co., 783 F. Supp. 1141 (N.D. Ill. 1992); Seaman v. Liberty Mut. Ins. Co., 322 N.W.2d 35 (Iowa 1982); Earth Scientists (Petroleum Services) Ltd. v. U.S.F.&G. Co., 619 F. Supp. 1465 (D. Kan. 1985); Morris v. American Family Mut. Ins. Co., 386 N.W.2d 233 (Minn. 1986).

"manifest intent" to cause a loss to the insured was unsettled. Accordingly, as legal authority from other jurisdictions, together with some evidence, supported the Insurers' position, a finding of "bad faith under Kentucky law" was precluded.[30]

Next, the court held that there was sufficient evidence presented to the jury in support of the Insurers' early termination defenses that would have allowed the jury to find for them on this point. In its extensive discussion of the facts of the claim, the court noted that the Insurers had offered evidence supporting their position that the bond's coverage had terminated as to the principal DeWitt, by the early knowledge of the Bank of acts of dishonesty on his part. They had presented evidence that more than one year prior to the notification of the potential claim to the Insurers, the Bank had learned that DeWitt had made misrepresentations to it in his training program and, more substantively, that he had made misrepresentations regarding the credit histories of the borrowers on at least two of the early loans that gave rise to the claim.[31] The court of appeals found that this factual dispute provided a further basis for finding that the Insurers had a reasonable basis for their coverage position. It all but precluded the Bank from proving the second prong (no reasonable basis for denial) of the "bad faith" test under Kentucky law.[32]

Finally, the court goes on to note that the Bank had presented no evidence to support its contention that the Insurers had acted with knowledge of the incorrectness of their coverage position. Under Kentucky law, such a "mental state" is necessary to transform an ordinary

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[30] *Lustig II*, 96 F.3d at 1567.

[31] *Id*. at 1559.

[32] *Id*. at 1567.

contractual dispute into a tort claim. The court held that in light of the lack of evidence supporting this third prong, the district court should not have allowed the "bad faith" claims to go the jury.

As noted above, the Insurers made a great deal about the alleged acts on the part of the Bank and its counsel with respect to the guilty plea and other criminal proceedings. That purported activity supported the Insurers' "fraud on the court" defense. With respect to the "fraud on the court" arguments, the court of appeals makes its opinion of the acts of Judge Ballentine and the Bank's counsel plain. It stated:

> We must make clear that we do not in any way condone the actions taken by FNBL in this case. Civil litigants should not in any way read this case to mean that they may attempt to influence a United States attorney in a criminal case for their own benefit in a companion civil case. Further, we express our dismay at Judge Ballentine's failure to automatically recuse himself from DeWitt's criminal case in light of his substantial interest in FNBL. Nevertheless, we find no abuse of discretion with the District Court's findings on this matter. No evidence was presented to show that Judge Ballentine was bribed or pressured by FNBL or anyone involved in this case. No evidence shows that any language in the superseding information was fabricated.[33]

Although the Fifth Circuit's view of the activities of Bank counsel did not prompt them to undo the jury verdict on coverage,[34] it no doubt made the Fifth Circuit more receptive to the Insurers' arguments on bad faith issues.

Lustig suggests several important claims handling guidelines for insurers. First, insurers should carefully investigate and analyze claims documenting the factual and legal basis for their

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[33] *Id*. at 1573, 1574.

[34] As noted above, the Fifth Circuit suggested in *Lustig II* that the Insurers did not appeal coverage. If that was the case, the only evident purpose of the Insurers' "fraud on the court" arguments was to show that, in relative terms, the actions by the Insurers were entirely appropriate.

coverage positions. Where a reasonable basis exists for these positions, courts should not find the insurers liable in tort, even if they disagree with their ultimate conclusion. A key part of this protection is the requirement that the insured establish that the insurer lacked a reasonable basis for its coverage position and persisted in this position with actual knowledge or reckless disregard of the incorrectness of that position. It is here that a written invitation to an insured to address, in writing, the insurer's coverage position is helpful. Where the insured declines to refute the coverage position taken, it is clearly more difficult for an insured to establish that the insurer knew all along that its position was wrong.

On the other hand, the *Lustig* court's failure at the trial level and on appeal to find for the Insurers on the "fraud on the court" arguments relating to the negotiation of the guilty plea in the DeWitt criminal case illustrates a reluctance by the courts to sanction insureds for the over-zealous pursuit of claims. The insurer resisting such tactics may take comfort in the apparent willingness of the courts, as a practical matter, to consider such misconduct in addressing the claims of "bad faith" that counsel representing such insureds and employing such tactics invariably raise to leverage the value of their cases.

Of interest is the fact that the court of appeals declined to place any weight upon the alleged "beneficial" relationship between coverage counsel for the Insurers and counsel for DeWitt and Lustig. Though mentioned in the statement of facts, the independent meetings between the pre-litigation coverage counsel for the Insurers and defense counsel for DeWitt and Lustig does not receive extensive discussion in the legal analysis of the court of appeals' opinion. Although the *Lustig* court viewed this as a "non-issue," as it should have, insurers might not fare as well elsewhere.

The Bank sought punitive damages from the Insurers in the *Lustig* case. There is at best scant discussion of the punitive damage claim in the *Lustig II* decision, in no small part because punitive damages were not awarded by the jury. Punitive damage claims are, of course, best taken seriously by insurers, even where no evident ground for support of same exists. Although punitive damages were not central to the *Lustig* litigation, they are an important, perhaps the most important, factor in dealing with bad faith claims in many jurisdictions. For this reason, punitive damages will be briefly addressed later in this paper.

IV. WHAT WE LEARN FROM *LUSTIG*

There were few, if any, overt mistakes made by the Insurers in their handling of the Bank claim. To the extent that mistakes were made, they are perhaps only mistakes with the benefit of hindsight. However, the Insurers did leave themselves vulnerable to several ultimately unsuccessful attacks by the Bank and its counsel. The "lesson" to be learned is to minimize the activities during the claim stage which can be exaggerated, mischaracterized, or exploited to support such attacks. In essence, an ounce of prevention in the claim investigation can save hundreds of thousands of dollars in defense expenses incurred in defending unfounded charges of bad faith.

A. How to "Prove Up" the Advice of Counsel Defense

The Insurers asserted in the claim-handling phase of the *Lustig* trial the "advice of counsel" affirmative defense. It is evident from the record that the Insurers intended to use the fact that advice of counsel had been sought to demonstrate that it sought out and obtained an independent assessment of the Bank's claims. From the fact that the affirmative defense as pleaded specifically attempted to reserve privileges, the insureds evidently hoped to preserve

such privileges. Unfortunately, the court went against the Insurers on that gamble. In so doing, however, the Insurers inadvertently opened the door to all manner of arguments from counsel for the Bank. Counsel for the Bank attacked the legal opinion, attacked the attorneys who provided the legal opinion, aggressively delved into the personal and professional relationship between the claim professional and the attorneys involved in the opinion, and otherwise exploited the Insurers' assertion of that defense to try to create a bad faith case. Thus, assertion of the defense achieved the opposite of what was intended by the Insurers.

While it is true that the advice of counsel defense may, in certain circumstances, provide the insurer with some protection from a bad faith and/or a punitive damage claim, it is a defense which should be asserted only in certain cases. Along with other relevant evidence, that defense tends to show the insurer acted reasonably in its handling of the claim.[35]

The elements of this defense are similar to those required for such a defense in malicious prosecution cases. It may be available where (1) the insurer acted in good faith reliance upon the advice of counsel and in what it believed was a manner necessary to protect its interests; (2) the insurer was not so knowledgeable as to the legal standard involved that it knew the advice of counsel was erroneous; (3) it made full disclosure of all relevant facts to the counsel (or counsel acted on the basis of facts determined by his or her own investigation on behalf of the insurer), and (4) the insurer was willing to reconsider and act accordingly when it determined that the advice was incorrect.[36]

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[35] *See, e.g.*, State Farm Mutual Auto Ins. Co. v. Superior Court, 228 Cal. App. 3d 721, 725-726 (1991); Merritt v. Reserve Ins. Co., 34 Cal. App. 3d 858, 878 (1973).

[36] *See, e.g.*, Melarich Builders, Inc. v. Superior Court, 161 Cal. App. 3d 931, 936, 937 (1984); Bertrero v. Nat'l Gen. Corp., 13 Cal. 3d 43, 53-54 (1974); Dalrymple v. USAA, 40

But the advice of counsel defense is far from an absolute privilege. It only provides "some evidence" of proper behavior on the part of the insurer in reaching its coverage determination. Furthermore, it is a difficult burden to meet and one which can be overcome by the insured in a number of ways. For example, even where the insurer meets the multi-part test spelled out above, it must be able to resist the inevitable counter-argument from the insured that the advice given was "patently unsound."[37] Accordingly, invocation of the doctrine invites the plaintiff and the trier of fact to second guess the soundness of the legal advice given.

It is very important to note that in some jurisdictions, an insurer waives, or at a minimum compromises, the attorney-client privilege by asserting the advice of counsel defense. The cases that so hold argue that the insurer has placed the reasonableness of the conclusion in issue, thus placing the privileged communications themselves and the nature of the relationship in issue.[38] Rarely does it make sense for an insurer to waive the attorney-client privilege. The cost benefit analysis of the assertion of the advice of counsel defense must accordingly weigh the significant potential detriment that follows where the privilege is impaired.

One variant of the advice of counsel defense arises when the claims representative is deposed. The claims representative will, in the course of the deposition, invariably be asked what he or she did to reach the claim determination. Naturally, the claims person will, if outside counsel has been consulted, disclose that he or she has consulted with outside counsel. But does

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Cal. App. 4th 497, 514-515 (1995).

[37] Moore v. American United Life Ins. Co., 150 Cal. App. 3d 610 (1984); Allen v. Allstate Ins. Co., 656 F.2d 487, 489 (9th Cir. 1981).

[38] *See, e.g.*, Aetna Cas. & Sur. Co. v. Superior Court, 153 Cal. App. 3d 467, 476 (1984); Transamerica Title Ins. Co. v. Superior Court, 188 Cal. App. 3d 1047, 1053 (1987); Handgards, Inc. v. Johnson & Johnson, 413 F. Supp. 921, 929 (N.D. Cal. 1975).

that mean, per se, that "advice of counsel" has been asserted? Unless the insurer is prepared to risk disclosure of its attorney-client communications, it should make clear that the advice was but one factor upon which the coverage decision was made. It makes good sense for the jury to hear from the insurer's decision maker that he, not his outside counsel, made the coverage decision, and that it was a reasoned decision which took into account a variety of considerations including, but not limited to, the input of outside counsel. The claims representative should emphasize that while he or she consulted with outside counsel, the ultimate claim decision was his or hers. It is clear that a disclosure that such a consultation has occurred does not waive the privilege.[39]

Strictly speaking, assertion of the advice of counsel defense should not impair an attorney's work product privilege. That is fundamentally the case because the work product privilege is owned by the attorney, not the client.[40] While the client may through its activities waive the right to maintain confidentiality in its communications with its counsel, it is only through the acts of the attorney himself that his own internal analytical processes can be subject to scrutiny by a third party. Assertion of the advice of counsel defense, however, invariably leads to a debate over what is and is not work product, and whether it is subject to discovery as a consequence of the client's assertion of that defense.

In addition to the factual uncertainties as to what is and what is not "work product," a split of authority exists as to whether raising the advice of counsel defense in a coverage case

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[39] *See, e.g.*, Mitchell v. Superior Court, 37 Cal. 3d 591, 602 (1985); Southern California Gas Company v. Public Util. Comm'n, 50 Cal. 3d 31, 42 (1990).

[40] *See, e.g.*, Hickman v. Taylor, 329 U.S. 495, 509-510 (1947).

tenders the work product material into issue, thus waiving the privilege. The better view is that attorney work product, particularly work product that includes and reflects the thoughts and opinions of counsel, still retains its privileged character.[41] That case held that communications from an insurer's attorney reflecting the attorney's opinion and evaluation of the case fell within the "absolute" protection of the attorney work product doctrine and was **not** discoverable, even where the carrier had raised the advice of counsel defense.[42] There is, however, reported case law to the contrary.[43]

Thus, sound bases exist for opposing the production of work product materials even where the advice of counsel defense has been raised. However, given the factual and legal uncertainties relating to the existence and scope of that privilege in a situation where the advice of counsel defense has been raised, the risk of disclosure of such information is one that must be carefully considered prior to deciding to raise the defense.

The message is clear. The advice of counsel defense does not provide a safe haven from claims of bad faith. To the contrary, and while it can have a positive effect under certain circumstances, it more often than not opens the door to any number of collateral issues and disputes which can detract from what is otherwise a much simpler coverage position. The advice

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[41] Aetna Cas. & Sur. Co. v. Superior Court, 153 Cal. App. 3d 467, 479 (1984).

[42] 153 Cal. App. 3d 467, 479.

[43] *See, e.g.*, Handgards, Inc. v. Johnson & Johnson, 413 F. Supp. 921, 931 (N.D. Cal. 1975) (allowing discovery of work product, including counsel's thoughts and impressions in an antitrust case where the advice of counsel defense had been raised); and Birth Center v. St. Paul Companies, Inc., 727 A.2d 1144 (Pa. 1999); Brown v. Superior Court, 670 P.2d 725, 735-736 (Ariz. 1983).

of counsel defense, if it is to be asserted, should be asserted only after complete consideration of all the possible negative consequences which can flow from it.

B. How Assertion of the Advice of Counsel Defense As Read by the *Lustig* Trial Court Did More Harm Than Good in the *Lustig* Case

The principal claim representative handling the Bank investigation and the two attorneys he in due course employed to assist him shared a love of fishing on the Gulf of Mexico. In fact, separately and together they went fishing so often that when the opportunity came to purchase a condominium at the “Friendship Oaks” condominium complex on the Gulf Coast, they did so. The claim representative purchased a one-third interest in the unit, the other two-thirds interest being shared between the attorneys. The Bank attorney seized upon this business deal, arguing that the attorneys, in effect, bribed the claim representative, thus making their business and personal dealings relevant to determine the credibility of the various witnesses. The Bank attorney also argued that this close relationship prevented the Insurers from relying on the legal advice, as such a close personal and financial relationship did not allow them to provide a truly objective, arms-length assessment of the claim to the Insurers, thus negating the benefit of the advice of counsel defense.

The Insurers correctly attacked this line of argument by the Bank. The following paragraph from one of the Insurers' brief at trial aptly sums up this position:

> Finally, from a policy standpoint, FNBL should not be allowed to question the independence of the [coverage] firm based upon the longtime friendship of [coverage counsel and the claim professional], and their personal decisions to purchase a vacation home together. Certainly no rule of law proscribes attorneys from developing friendships with their

> clients or prohibits people from placing legal business with an attorney who also happens to be a personal friend.[44]

The Insurers established that the condominium was purchased at public auction. Yet the personal and business relationship between the coverage attorney and the claim representative, according to plaintiffs, was relevant because that relationship was so close that the attorneys were bound to opine what their client "wanted to hear." While this argument ultimately failed, there was so much time and energy spent in dealing with it and so much needless fodder for accusations of wrongdoing made discoverable that whatever benefit came out of the advice of counsel defense was lost in the battle. It only takes a liberal-minded magistrate to allow an insured to expansively pursue discovery on all aspects of the advice of counsel defense. Absent unusual circumstances, it is a defense which is best left behind.

C. Reserves and Settlement Discussions

Although insurers can preserve the attorney-client privilege by staying away from the advice of counsel defense, there is little they can do to avoid a debate over reserves.

The Appendix filed by the Bank in opposition to the Insurers' unsuccessful Motion for Summary Judgment on the bad faith claim identifies a number of internal memoranda of the Insurers relating to reserves. An insured will simplistically argue that any time an insurer sets a reserve it acknowledges liability, at least to the extent of the amount set aside. This ill-founded argument, unfortunately, has been favorably received by a few courts, at least to the extent of allowing discovery of the information. Indeed, counsel for the Bank in *Lustig* specifically

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[44] Reply Memorandum in Support of Sureties' Motion in Limine to Exclude Admission of Evidence Pertaining to the "Friendship Oaks Condominium" at Trial, filed on or about February 19, 1993.

argued that a comparison of reserves set with offers made evidence an obvious strategy on the part of the Insurers to "lowball" the Bank and resolve its claims for a figure substantially less than their reasonable settlement value.[45]

These musings have been rejected by the overwhelming majority of courts that have considered them.[46]

Care should be taken to specifically address arguments that the insured will undoubtedly raise that have no actual bearing in the straight first-party policy context such as arises in a fidelity bond dispute. The insured will argue that the reserves set or not set will be irrelevant to the insurer's mental state in investigating and taking a coverage position with respect to the loss. This approach has been rejected. Reserve information is simply not relevant to the issue of whether the loss is covered or the insurer's "good faith" in making that determination.[47]

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[45] First Nat'l Bank of Louisville v. Lustig, (No. Civ. A. 87-5488) 1991 WL 236839 (E.D. La. 1991).

[46] *See, e.g.,* Leksi v. Federal Ins. Co., 129 F.R.D. 99, 106 (D.N.J. 1989); Hoescht Celanese Corp. v. Nat'l Union, 623 A.2d. 1099, 1109 (Del. 1991); American Protection Ins. Co. v. Helm Concentrates, Inc., 140 F.R.D. 448, 449 (E.D. Cal. 1991) (recognizing the public policy requirements of the establishment of reserves and how such requirements weight against production, in addition to the questions of relevance); Rhone-Poulenc Rorer, Inc. v. Home Indem. Co., 139 F.R.D. 609, 614 (E.D. Pa. 1991) (holding that the case reserve figures revealed the mental impressions, thoughts, and conclusions of counsel in evaluating the legal claim and were thus privileged); Federal Realty Investment Trust v. Pacific Ins. Co., 760 F. Supp. 533, 540 (D. Md. 1991) (holding that reserve information was inadmissible at trial as its probative value was substantially outweighed by its prejudicial aspects, and noting that reserve decisions are mere guesses as to the potential outcome of litigation and are based on accounting principles rather than legal analyses).

[47] *See* American Protection Ins. Co. v. Helm Concentrates, Inc., 140 F.R.D. 448, 450 (E.D. Cal. 1991).

This having been said, at least some courts have allowed limited discovery of reserve information. For example, in *Sampson v. Transamerica Insurance Co.*,[48] the court allowed discovery of the posting of reserves in the context of a defense of a coverage dispute on a liability policy where the carrier had raised the defense of delayed notice. The insured in *Sampson* argued that the date at which Transamerica had posted reserves was certainly relevant to the date in which it had received actual notice of the claim against its insured. To this extent, the court allowed discovery of the reserve information.[49]

As any experienced insurance professional knows, the setting of reserves is undertaken to prudently manage the business affairs of the insurer and to comply with the requirements of insurance regulators.[50] To avoid confusion and prevent the otherwise inevitable "battle" over what the setting of a particular reserve "means," a prudent court will preclude discovery of reserve information or, at a minimum, exclude evidence of reserves from being received. Insurers, faced with new exposures for lawful compliance with their reserve-setting responsibilities, will be inhibited from setting reserves. The safe way out, where there is a dispute, would be to set no reserve. An insurance industry which under-reserves is an insurance industry in trouble. In fact, most insurance failures have been the product, in part, of under-reserving. The chilling effect that discovery and manipulation of reserve information can have

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[48] 30 Cal. 3d 220, 240 (1981).

[49] 30 Cal. 3d 220, 240 (1981).

[50] *See Federal Realty Investment Trust*, 760 F. Supp. 533 (D. Md. 1991); *Hoescht Celanese*, 623 A.2d 1099 (Del. 1991); and *American Protection Ins. Co.* 140 F.R.D. 448 (E.D. Cal. 1991)

on the industry, including insureds, by far outweighs any benefit that flows from a single bad faith case.

Reserve information is not generally and should not be discoverable, much less admissible in federal court. The case of *American Protection Insurance Co. v. Helm Concentrates, Inc.*[51] is directly on point. The defendant in *American Protection* sought to discover information relating to the reserves set by plaintiff in a first-party claim. Plaintiff objected on relevance grounds. The court in *American Protection* distinguished *Sampson*, holding that in a third-party case reserve information is relevant to the "potential for liability" and issue of good faith. The court in *American Protection* went on to state that the defendant could point to no case involving a first-party claim where reserve information is discoverable or admissible and that the relevancy for a third-party case does not apply in the first-party situation.

The discovery of reserves has been rejected in other first-party cases. In *Exchange National Bank of Chicago v. United States Fidelity & Guaranty Co.*,[52] the court determined that reserve information was neither relevant nor discoverable.

No case law has been found to support the proposition that reserves and communication with reinsurers in compliance with the requirements of a treaty of reinsurance is **admissible** evidence in first-party litigation. Indeed, as noted above, at least one court has held that they are **not** admissible.[53] Counsel for insureds occasionally rely on cases such as *Sampson v.*

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[51] 140 F.R.D. 448, 449-450 (E.D. Cal. 1991).

[52] No. 81 C 7119 1985 WL 1505 (N.D. Ill. 1985), *aff'd*, 1985 WL 1773 (N.D. Ill. 1985).

[53] *Federal Realty Investment Trust*, 760 F. Supp. 533, 540.

Transamerica Insurance Co.,[54] contending that reserves are discoverable and admissible on the theory that the fact that reserve had been set is relevant to the issue when the insurer received notice. On top of the fact that this is a California authority and a third-party case and only some authority at best, the correct statement in *Sampson* is:

> The mere fact that an insurance company established a reserve fund for defense of a case, as Transamerica did in this case, has been held to be an indication that the company was aware of its responsibility to defend the insured.

Sampson is totally irrelevant to the issues commonly found in a fidelity case and properly only applies to an issue of when an insurer has declined to defend its insured under a liability policy.

Likewise, reinsurance information is not generally discoverable in federal court, particularly where "bad faith" is not alleged. *Lipton v. Superior Court*,[55] cited by insureds, is not on point as it is also a third party bad faith action. The court in *Lipton* found reserve and reinsurance information relevant on the issue of whether the insurer had knowledge of the potential for coverage and thus a duty to defend. However, these issues do not apply to a first-party case which is simply a breach of contract claim on an insurance product.

The same analysis, although on different grounds, would apply with respect to communications between insurers and reinsurers. Insurers by contract owe an obligation to their reinsurers to provide a full and candid assessment of pending claims and exposures. Insurers are frequently called upon to communicate the substance of the opinions of coverage counsel.

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[54] 30 Cal. 3d 220, 240 (1981).

[55] 48 Cal. App. 4th 1599, 1618 (1996).

Although transmittal of otherwise clearly privileged attorney-client communications from insurers to reinsurers cannot under any reasonable analysis be deemed a waiver of such privilege, aggressive insureds have asserted to the contrary. Just as the policies which call for full and candid setting of reserves by far outweigh the benefits that an individual insured might gain from obtaining reserve information on a particular claim, the down side of disclosure of communications between insurers and reinsurers will inevitably be a "chilling effect" on such communications likely to lead to disruption and difficulty in the reinsurance industry. Problems in the reinsurance industry will only result in problems to insureds in general.

Returning to the *Lustig* case, the Bank got its hands on settlement, reserve, and reinsurance communications and attempted to depict virtually all of it as reflecting the insurers' alleged bad faith. Regarding settlement, the Bank argued that reserves, reinsurance communications, and communications with counsel relating to settlement discussion were all relevant both to show the insurers' recognition of the likelihood of coverage and to evidence the insurers' intent to "low ball" the Bank into an unfair settlement. To avoid such an argument, care should be taken in the conduct of any settlement discussions that such discussions are agreed to be "off the record" for all purposes. This is true whether the discussions occur before or after the commencement of litigation.[56] Courts have rationalized that evidence of such settlement discussions should not be admitted to show liability, but to show an effort to compromise a claim that should be paid in full and/or the unreasonableness of the insurer's coverage position and

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[56] *See, e.g.*, White v. Western Title Ins. Co., 40 Cal. 3d 870, 887 (1985); California Physicians Serv. v. Superior Court, 9 Cal. App. 4th 1321, 1330 (1992).

thus, its mental state.[57] Reserve and reinsurance information should likewise be kept "out of play" by aggressive assertion of privileges with respect to it and timely objection to discovery requesting it and/or use of it for any evidentiary purpose where the insured manages to get its hands on it.

There is, however, persuasive authority for the proposition that evidence of settlement discussions are inadmissible under all circumstances. Most federal courts who have addressed the issue have held that F.R.E. 408 bars the evidence of settlement negotiations for any purpose.[58] In the final analysis, evidence of reserves, reinsurance, and settlement negotiation rarely finds its way to a trier of fact. Every effort should be made to persuade the court that time and energy should not be expended in the pursuit of, in the production of, or in litigation over such information. It is not the stuff of what a bad faith case should be either made or unmade.

D. Motions for Summary Judgment on "Bad Faith" Claims

The Insurers in the second round of *Lustig* aggressively attacked the "bad faith" claims by way of pretrial motions, including a summary judgment or partial summary judgment, as reported at *First National Bank of Louisville v. Lustig*.[59] With regard to the "bad faith" claims, the Insurers made two primary arguments. First, they argued that the law of Kentucky, which controlled in that case, would not allow "bad faith" claims if it were determined that there was

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[57] *Id.*

[58] *See*, Clemco Industries v. Commercial Union Insurance Company, 665 F. Supp. 816, 829 (N.D. Cal. 1987), *aff'd* 848 F.2d 1242 (9th Cir. 1988). *See generally*, JUSTICE H. WALTER CROSKEY, JUSTICE MARCUS M. KAUFMAN (RET.), DAVID CASSELMAN, REX HEESEMAN, THOMAS JOHNSON, JR. & PATRICK M. KELLY, CALIFORNIA PRACTICE GUIDE, INSURANCE LITIGATION, § 12:985-12:1000 (The Rutter Group, 1997) (with updates).

[59] 832 F. Supp. 1065 (E.D. La. 1993).

no coverage under the bond.[60] That proposition of law makes perfect sense because the tort of bad faith must flow from a breach of the underlying insurance contract.

The Insurers secondly argued that there were at least three reasonable grounds which justified their refusal to honor the claim, as presented. They pointed out that there were legitimate disputes concerning DeWitt's claimed manifest intent to cause loss to the Bank, concerning the causal connection between his activities and the loan losses, and concerning potential termination of coverage on the bond as to DeWitt as a consequence of the Bank's knowledge of prior dishonest acts on his part. Most importantly, the Insurers pointed out that the Bank could not meet its burden to establish that the Insurers **knew** that they had no reasonable basis upon which to dispute coverage.[61]

The Insurers creatively argued that allowing the case to proceed on "bad faith" under these facts would violate the Insurers' constitutional rights to access to the courts. Under this argument, the extension of the tort of "insurance bad faith" to the facts of the *FNBL v. Lustig* case would effectively deny the Insurers access to courts for resolution of their civil disagreements with their insureds. In support of its arguments for summary judgment motion on the "bad faith claims" discussed above, on January 13, 1993, the Insurers pointed to the decision of the

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[60] *See* Motion by Defendants Aetna and Federal Insurance Company for Summary Judgment on Plaintiff's Kentucky Common Law Bad Faith Claims filed December 15, 1992, in *FNBL v. Lustig*, Civil Action No. 875488 (USDC E.D. La.).

[61] *Id.* at 7-21. *See generally* 832 F. Supp. 1065.

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Fifth Circuit in *Lustig I*,[62] which found a triable issue of fact as to coverage, precluded a finding of bad faith in *Lustig II*.[63]

The Insurers' summary judgment motion laid the legal groundwork for the ultimate position adopted by the court of appeals in 1996, reversing a jury finding of bad faith in the trial court and holding that the issue had no business being submitted to the jury. The Bank, per Kentucky law, had the burden of proving all three prongs of its bad faith claim. The Bank did not meet that burden.

The trial court was clearly confused in its handling of the motion for summary judgment. It correctly noted that the insured must establish: (1) that it was entitled to coverage under the applicable policy, (2) that the insurer did not have a reasonable basis for denying the claim, and (3) that the insurer knew there was no reasonable basis to deny the claim, or acted with reckless disregard for whether basis to deny the claim existed. The court, citing the opinion of the Fifth Circuit in the appeal in *Lustig I*,[64] decided that it was precluded from granting summary adjudication on the bad faith claims because there was a material issue of fact as to the first of the three cited prongs. Evidencing a lack of understanding of the standards applicable, the court stated as follows: "Because the first part of the three-part *Federal-Kemper* conjunctive test cannot be decided now, the court need analyze this matter no further. The court, accordingly,

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[62] 961 F.2d 1162.

[63] For reasons that are not clear from the transcript or the reported record, this argument did not make much headway with the district court. As one can appreciate, however, its logic is compelling. Counsel faced with a similar procedural environment should strongly consider making a similar argument.

[64] 961 F.2d at 1163 (court found that there was a material issue of fact as to bond coverage).

cannot grant summary judgment on FNBL's common law bad faith claim for either failure to pay or mishandling the claim."[65] The court's mistake is evident from the fact that it failed to understand that summary judgment was proper where, as a matter of law, the insured could not meet its burden on any of the separate and conjunctive prima facie requirements it faced per Kentucky law.

The court did go on to address briefly the second prong, namely the obligation of the insured to show a lack of a reasonable basis for the insurer's coverage position. The court found that there was a material issue of fact as to the applicability of the Insurers' defenses. The court thereupon leaps to the conclusion that there is a material fact regarding the reasonableness of the denial of the claim.[66] To make things worse, the court failed to address the third prong, namely, the requirement of the insured to show that the insurer either knew that there was no reasonable basis for denying the claim or acted with reckless disregard for whether such basis existed.[67] The trial court misunderstood burdens and prima facie case responsibilities. It should have **granted** the Insurers' summary judgment because the insured had failed to raise a material issue of fact as to the lack of reasonableness on the Insurers' position. Instead, the court wrongly decided that since there was a coverage dispute, bad faith would need to be resolved with the trier of fact. The court clearly erred in this assessment of the law.

The Insurers' motion for summary judgment on bad faith claims, though unsuccessful at the trial court level, reflects a theme begun early in the case and reappears in the second round at

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65 *Lustig*, 832 F. Supp. at 1069.

66 *Id*. at 1069.

67 *Id.* at 1068.

809 F. Supp. 444 (E.D. La. 1992), where the Insurers filed a Rule 12(b)(6) motion attacking the "bad faith" claims. While this strategy met with limited success at the trial court level, it was ultimately successful before the court of appeals.

Counsel defending "bad faith" cases should draw from *Lustig*'s lessons and attack bad faith claims aggressively at the pretrial stage. For example, if the only act of "bad faith" alleged in the complaint is that of the denial of the claim and if there is factual background stated in the complaint related to the facts of the claim and the claim handling, an F.R.C.P. 12(b)(6) motion (or demurrer in state practice) is a useful tool for educating the court. Courts are increasingly willing to dispose of the "bad faith" claims and punitive damage allegations, at a pretrial level. As is shown below, there is ample appellate authority supporting this practice.

Lustig then went to trial. Following a trial on coverage issues where the jury found for the Bank, the case went to trial on the so-called "bad faith" issues. At the conclusion of that case, the district court denied the Insurers' motion for judgment as a matter of law on these bad faith claims and the jury found bad faith and awarded consequential damages to the Bank. The trial court then compounded the problem by awarding to the Bank attorneys' fees of $5.85 million.[68]

As next discussed, the *Lustig* trial court overlooked a fundamental principle of summary judgments, which is that a defendant need merely reasonably establish that the plaintiff cannot meet any one of the several required prima facie elements of its case. Courts can and should grant motions for summary judgment on claim-handling causes of action.

E. "Bad Faith" Claims May be Resolved as a Matter of Law

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[68] First Nat'l Bank of Louisville v. Lustig, 832 F. Supp. 1058 (E.D. La. 1993).

As is shown in *Lustig II*, and below, ample law in modern insurance litigation supports the contention that bad faith and punitive damage claims are susceptible to resolution as a matter of law. The simple fact that an insurance claim is denied should not lead to an inevitable jury deliberation of the insurer's bona fides. The trial judge can and should take bad faith and punitive damage claims away from the jury by resolving them, as a matter of law, prior to the commencement of trial.

The "implied covenant of good faith and fair dealing," as an implied part of insurance contracts under the law of California and many other states, is intended to prevent the parties to the insurance contract from doing "anything which will injure the right of the other to receive the benefits of the agreement."[69]

There are "at least two separate requirements to establish a breach of the implied covenant: (1) benefits due under the policy must have been withheld; and (2) the reason for withholding benefits must have been unreasonable or without proper cause."[70]

1. "Bad Faith" Claims Must Fail Where No Benefits are Owed Under the Policy

"Where benefits are fully and promptly paid, no action lies for breach of the implied covenant -- no matter how hostile or egregious the Insurers conduct towards the insured may

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[69] Waller v. Truck Ins. Exch., 900 P.2d 619 (Cal. 1995); *see also* Hanson v. Prudential Ins. Co. of Am., 783 F.2d 762, 766 (9th Cir. 1985); Tibbs v. Great Am. Ins. Co., 755 F.2d 1370, 1375 (9th Cir. 1985).

[70] Love v. Fire Ins. Exch., 271 Cal. Rptr. 246, 255 (Cal. Ct. App. 1990); *see also* Staefa Control-System Inc. v. St. Paul Fire & Marine Ins. Co., 847 F. Supp. 1460, 1475, *modified on other grounds*, 875 F. Supp. 656 (N.D. Cal. 1994); New Hampshire Ins. Co. v. Fox Fire Inc., 820 F. Supp. 489, 498 (N.D. Cal. 1993).

have been prior to such payment. i.e., absent an actual 'withholding' of benefits due, there is no breach of contract and likewise no breach of the insurer's implied covenant."[71]

The rationale for this rule has been recently stated by the California Supreme Court as follows:

> In essence, the covenant is implied as a supplement to the express contractual covenants, to prevent a contracting party from engaging in conduct that frustrates the other parties' rights to the benefits of the agreement. . . . Absent that contractual right, however, the implied covenant has nothing upon which to act as a supplement, and "should not be endowed with an existence independent of its contractual underpinnings."[72]

In *Bogard v. Employers Casualty Co.*,[73] the court held that an insured failed to state a cause of action for breach of the implied covenant of good faith and fair dealing where it could

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[71] *Love*, 271 Cal. Rptr. at 255 (quoting GUY KORNBLUM, MARCUS M. KAUFMAN & HARVEY LEVINE, CALIFORNIA PRACTICE GUIDE: BAD FAITH, Section 4:28 at pp. 4-9); *see also* Bernstein v. Consolidated Am. Ins. Co., 43 Cal. Rptr. 2d 817 (Cal. Ct. App. 1995) ("[b]ecause a prerequisite to an actionable breach of the implied covenant of good faith and fair dealing is the denial of benefits due under the policy, the trial court's grant of summary adjudication was proper"); Reagen's Vacuum Truck Serv., Inc. v. Beaver Ins. Co., 37 Cal. Rptr. 2d 89, 96 (Cal. Ct. App. 1994) ("[a] 'bad faith' claim cannot be maintained unless policy benefits are due").

[72] *Waller*, 11 Cal. 4th at 10 (quoting *Love*, 221 Cal. App. 3d at 1153); *see also* McMillin Scripps N. Partnership v. Royal Ins. Co. of Am., 23 Cal. Rptr. 2d 243, 247 (Cal. Ct. App. 1993).

[73] 210 Cal. Rptr. 578 (Cal. Ct. App. 1985).

not show "how they were deprived of their right to receive the benefits of the agreement by [the insurers'] actions and what benefits they did not receive."[74]

"Bad faith" claims must also fail as a matter of law where insureds cannot show any damages or economic loss. The California Supreme Court has held that "breach of the implied covenant is actionable in the insurance context because such conduct causes financial loss to the insured, *and it is that loss which defines the cause of action*."[75]

2. As the Court Found in *Lustig*, Insurers Should Not be Found Liable for "Bad Faith" Unless the Insured Establishes That There Was No Reasonable Basis for the Coverage Determination

Even where the insured raises sufficient material factual issues to prevent summary judgment on coverage, insurers still should be exonerated from claims for "bad faith" where the insured cannot establish the lack of a reasonable basis for the insurer's coverage position.

It is well established that the mere denial of a claim under an insurance policy does not constitute bad faith.[76] Even if a denial of benefits under the Policy is erroneous, the insured

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[74] *Id.* at 615. In particular, the *Bogard* court held that by alleging that the insurer did not properly investigate the claim to determine its true value, the insured had only alleged the breach of the duty to defend and that since the insurer did in fact settle the underlying claim, it appeared that there was no breach of the covenant of good faith and fair dealing for failure to settle. *Id. See also* Gasnik v. State Farm Ins. Co., 825 F. Supp. 245, 250 (E.D. Cal. 1992) (dismissing bad faith claim where insurer offered to pay all benefits due under the written policy).

[75] Gourley v. State Farm Mut. Automobile Ins. Co., 822 P.2d 374, 379 (Cal. 1991) (emphasis added).

[76] *E.g.*, Safeway Inc. v. National Union Fire Ins. Co., 805 F. Supp. 1484, 1491 (N.D. Cal. 1992); Opsal v. United Services Auto Ass'n, 2 Cal. App. 4th 1197, 1205-1207 (1991).

must prove that the denial was in bad faith for it to be actionable.[77] The ultimate test of liability is whether the withholding of policy benefits was "unreasonable" or "without proper cause."[78]

Accordingly, "[a] court can conclude as a matter of law that an insurer's denial of a claim is not unreasonable, even if the court concludes the claim is payable under the policy terms, so long as there existed a genuine issue as [sic] the insurer's liability."[79] Put differently, so long as the position adopted by the insurer is not so unreasonable as to be a "mere pretext" for avoiding its duties under the contract, a "genuine issue" concerning its liability will be sufficient to deny a bad faith claim as a matter of law.[80]

3. Punitive Damage Claims

Punitive damage claims, generally sought as an adjunct to a bad faith claim, are subject to separate pre-trial dismissal motions. In those jurisdictions allowing punitive damage awards in bad faith cases, an effort should be made to eliminate such claims from the case by summary judgment or other pre-trial proceedings. The standards and burdens relevant to a punitive damage claim are separate and distinct from those applicable to a bad faith claim. For this reason, a bifurcated motion for summary judgment seeking dismissal of both bad faith and

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[77] Hanson v. Prudential Ins. Co. of Am., 783 F.2d 762, 766 (9th Cir. 1985).

[78] Aceves v. Allstate Ins. Co., 827 F. Supp. 1473 (S.D. Cal. 1993) *aff'd in part and rev'd vacated and dismissed in part*, 68 F.3d 1160 (9th Cir. 1995).

[79] Franceschi v. American Motorists Ins. Co., 852 F.2d 1217, 1220 (9th Cir. 1988); Safeco Ins. Co. of America v. Guyton, 692 F.2d 551, 557 (9th Cir. 1982); *Staefa Control System*, 847 F. Supp. at 1475; *Safeway*, 805 F. Supp. at 1491 ("[w]here a disputed insurance policy involves a 'genuine issue concerning legal liability,' the insurer's refusal to pay claims cannot, as a matter of law, constitute bad faith.")

[80] Brinderson-Newberg v. Pacific Erectors Inc., 971 F.2d 272, 283 (9th Cir. 1992).

punitive damage claims or, in the alternative, dismissal of the punitive damage claim alone is viable.

Under California law, "punitive damages are not available for breaches of contact no matter how gross or willful."[81] Section 3294 of the California Civil Code provides that punitive damages are available only under the following exceptional circumstances: “In an action for the breach of an obligation not arising from contract, *where the defendant has been guilty of oppression, fraud, or malice*, the plaintiff, in addition to the actual damages, may recover damages for the sake of example and by way of punishing the defendant.[82] (Emphasis added).

As the Ninth Circuit observed, "[t]here must be *substantial evidence* of intent to vex, injure, and annoy, before punitive damages may be awarded."[83] In *Slottow*, the court found insufficient evidence to establish bad faith where the insurer was "perfectly up front" regarding its differing interpretation of the insurance contract.[84] The court found no malice on the part of the insurance company where the record established that it had merely been aggressive in advancing its coverage position. In this regard, the *Slottow* Court stated:

> Disagreement over insurance coverage–so long as the issues disputed are bona fide–is an ordinary cost of doing business. Nothing in California law suggests a refusal to provide coverage as requested by an insured, when the refusal is

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81 *Tibbs*, 755 F.2d at 1375; Consolidated Data Terminals v. Applied Digital Data Systems, Inc., 708 F.2d 385, 399 (9th Cir. 1983).

82 CAL. CIV. CODE § 3294 (1994).

83 *Tibbs*, 755 F.2d at 1375 (emphasis added); *accord* Slottow v. American Cas. Co. of Reading, 10 F.3d 1355, 1361 (9th Cir. 1993); Tomaselli v. Transamerica Ins. Co., 31 Cal. Rptr. 2d 433, 444 (Cal. Ct. App. 1994).

84 *Id.*

supported by a reasonable, good faith argument, can form the basis for punitive damages.[85]

Punitive damages are not available in all states. For example, cases in Louisiana, Massachusetts, Nebraska, New Hampshire, and Washington State do not allow them absent a specific statutory authorization.[86]

Other states limit punitive damages. For example, Michigan allows punitive damages as extra compensation for injured feelings or a sense of outrage but rejects the theory that such damages are a form of punishment.[87] Connecticut limits punitive damages to the expenses of litigation, less taxable costs.[88] Other states have statutory limits or caps on punitive damages. These include Alabama, Connecticut, Colorado, Florida, Georgia, Illinois, Indiana, Kansas, Maryland, Minnesota, Montana, Nevada, New Jersey, North Dakota, Ohio, Oklahoma, Texas, and Virginia.[89]

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[85] *Id.*

[86] *See, e.g.*, Killibrew v. Abbott Laboratories, 359 So. 2d 1279 (La. 1978); Burt v. Advertising Newspaper Company, 151 Mass.238, 28 N.E. 1 (1891); Miller v. Kingsley, 194 Neb. 123, 230 N.W.2d. 472 (1975); NEW HAMPSHIRE REVISED STATUTES ANNOTATED § 507:16 (1999); and Maki v. Aluminum Building Products, 73 Wash.2d 23, 436 P.2d 186 (1968).

[87] *See generally* Riggs v. Fremont Mutual Ins. Co., 270 N.W.2d 654 (Mich. 1978) (allowing exemplary damages to be awarded only as compensation for humiliation or indignity that is maliciously or wantonly inflicted).

[88] *See* Triangle Sheet Metal Works, Inc. v. Silver, 222 A.2d 220 (Conn. 1966).

[89] *See* WILLIAM SHERNOFF, SANFORD GAGE, HARVEY LEVINE, INSURANCE BAD FAITH LITIGATION, Sections 8.01, and 8.03, citing JAMES GHIARDI & JOHN KIRCHNER, PUNITIVE DAMAGES: LAW AND PRACTICE, Sections 21.12-21.23 (Matthew Bender, 1999).

An award of punitive damages is not automatic. For example, the Ninth Circuit has held that punitive damages should generally not be awarded in the commercial insurance context where the insured is a large and solvent insured, absent a clear showing of malice on the part of the insurer.[90] Other courts are in accord.[91] Other jurisdictions allow punitive damages to be awarded where the acts are found to be fraudulent, malicious, or oppressive as a punishment to the defendant and a deterrent to the defendant and others.[92]

It is the responsibility of litigation defense counsel to explain to the court the many and substantial burdens an insured faces in establishing a right to recover punitive damages. As in the case with a bad faith claim, it is the burden of the insurer to meet specified and generally disjunctive prima facie elements of a punitive damage claim, the failure to meet any one of which should lead to judgment, as a matter of law, in favor of the insurer. Since insureds frequently add bad faith and punitive damage claims to what should be a simple breach of contract claim, for the express purpose of obtaining additional settlement value or other leverage, the insurer must be prepared to attack such claims in the early going and allow the coverage issues to be litigated without the distractions of bad faith and punitive damage claims.

F. The Bank's Opposition to the Insurers' Attack on the Bad Faith Claims

Not surprisingly, the Bank pulled out all stops in its opposition to the Insurers' motion. In opposition to their presentation, the Bank filed an Appendix of what it called "'bad faith"

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[90] *See generally* Slottow v. American Cas. Co. of Reading, 10 F.3d 1355 (9th Cir. 1993).

[91] *See* Gurle v. Illinois Mut. Life & Cas. Co., 734 P.2d 85 (Ariz. 1987).

[92] *See, e.g.*, CAL. CIV. CODE § 3294; Lynn Scott v. Rainier Nat'l Life Ins. Co., 606 P.2d 958 (Idaho 1980); Anderson v. Continental Ins. Co., 85 271 N.W.2d 368 (Wisc. 1978); INSURANCE BAD FAITH LITIGATION, *supra*, Section 8.01.

evidence. This purported evidence included matters relating to the guilt of DeWitt and Lustig in the underlying loan fraud. Significantly, the list does not appear to include the initial "confession" of DeWitt in which he denies that he intended to cause the Bank a loss although he admitted to acting fraudulently and improperly.

The Appendix identifies internal memoranda of the Insurers relating to reserves in which one of the Insurers purportedly stated its settlement strategy for compromise of the hotly disputed claims. The Bank argued that the memorandum evidenced an intent to "lowball" its insured.

Next, the Bank attacked the correspondence of the outside counsel for the Insurers and its discussions regarding settlement recommendations as evidence of a lack of the Insurers' belief in the coverage defenses that they had asserted. The Bank argued that other letters from counsel to the Insurers during the claims phase regarding potential counter arguments to the defenses raised by the Insurers evidenced the Insurers' lack of belief in their legal defenses.

The Bank then resorted to true minutia. It attempted to argue that lapses of memory in a deposition equated to evidence of "bad faith." Much was made of the fact that the claim personnel for the Insurers frequently did not answer questions posed to them at deposition on the ground that they "did not recall." Naturally, in the context of a deposition, these personnel could not be expected to recall every detail of the myriad transactions at issue in the case. The Bank attempted to exploit this as a sign of the Insurers' lack of knowledge of the claim.

Next, the Appendix attacked the various legal defenses raised by the Insurers, as well as its assessment of credibility of various Bank personnel, particularly regarding issues relating to the early discovery of the dishonesty of DeWitt by the Bank.

The Bank then attempted to attack the insurers on a fundamental claim-handling technique, namely, the interview of the principal. Naturally, the Insurers wanted to attempt to interview the alleged principal outside the presence of his employer, as is consistent with common practice in this regard. The Bank characterized that tactic as evidence of conspiracy between the Insurers, and DeWitt and Lustig. The Bank made hay out of a reference in an internal Insurer memo to such meeting as being "clandestine" in the sense that the Bank was not told of or invited to the meeting.[93]

The interview of the alleged principal outside the presence of his former employer is a well-recognized technique of fidelity claims handling. Cases which confirm the insurer's right to examinations under oath give the insurer broad leeway in structuring those examinations. For example, California courts have long held that compliance with provisions requiring the insured to submit to an examination under oath such as that contained in the bond are a valid condition to recovery under policies insuring against losses from fire, casualty or theft.[94]

In Hickman v. London Assurance Corp., the insured sued on a fire policy that contained condition that the insured could be required to submit to an examination under oath as a condition to recovery under the policy.[95] The insured refused to answer all substantive questions

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[93] Bank's Appendix, pages 37-39.

[94] *See, e.g.,* Hickman v. London Assurance Corp., 184 Cal. 524, 534 (1920) (fire); Robinson v. Nat'l Auto. Ins. Co., 132 Cal. App. 2d 709, 712 (1955) (theft); Globe Indemnity Co. v. Superior Court, 6 Cal. App. 4th 725, 730, 731 (1992) (uninsured motorist, following Hickman v. London Assurance Corp.); West v. State Farm Fire & Casualty, 868 F.2d 348, 351 (9th Cir.1988) (theft policy, applying California law and following Hickman v. London Assurance Corp.); State Farm Fire & Cas. v. Tan, 691 F. Supp. 1271, 1272, 1273 (S.D. Cal.1988) (theft, applying California law and following Hickman v. London Assurance Corp., also finding clause identical to the instant clause was unambiguous).

[95] *Hickman*, 184 Cal. at 527.

in the examination as he was still a suspect in an arson investigation into the fire that was the subject of the claim.[96] The court noted that other jurisdictions had long held similar provisions to be enforceable. It concluded that the insured's failure to submit to a full examination precluded his recovery under the policy.[97]

In *West v. State Farm Fire and Casualty Co.*,[98] the plaintiff sued for breach of contract and for bad faith as a result of State Farm's refusal to pay under a homeowners policy for losses allegedly suffered by the insured as a result of theft.[99] The insured had given a preliminary interview but had refused to submit to a thorough examination under oath.[100]

The policy stated that the insured had a “duty” to “submit to examinations under oath” as might be reasonably required by the insurer. The insured had only submitted a very general written statement as to what items had been missing and their worth.[101] He had not submitted any documentation establishing the ownership or value of the allegedly stolen items and had refused to submit to an examination under oath.[102]

The Court upheld the trial court's entry of summary judgment in favor of the insurer. In doing so the court noted that "[f]or West to claim that the scheduled examination under oath was

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96 *Id.* at 529.

97 *Id.* at 534.

98 *West*, 868 F.2d at 348.

99 *Id.* at 349.

100 *Id.*

101 *Id.*

102 *Id.* at 351.

unreasonable is tantamount to a claim that insurance companies are always required to pay claims at their face value on the basis of a preliminary interview. Besides being patently illogical, this argument is controverted by the insurance policy and by California law. . . . [In *Hickman*] the California Supreme Court expressly approved the reasonableness of an examination under oath as a means of 'cross-examining' other statements of the insured." [Citations omitted].[103]

The courts have long recognized the need to give insurers broad leeway in interviewing witnesses, particularly in claims related to alleged criminal activity. "As the facts with respect to the amount and circumstances of a loss are almost entirely within the sole knowledge of the insured, and the opportunity and temptation to perpetrate a fraud upon the insurer is often great, it is necessary that [the insurer] have some means of cross-examining [the insured as to its claim]."[104]

Additional modern cases further emphasize the fact that the insurer is allowed a good deal of discretion in the manner in which it conducts its examinations. In *State Farm Fire & Cas. Co. v. Tan*,[105] the insurer sought to take separate examinations under oath of its insureds who had submitted claims for theft under a homeowners policy. The court ruled that, as a matter of contract, the insurer had a right to conduct examinations under oath as reasonably necessary. The contractual nature of the examination gives the insurer the right to insist upon such an

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[103] *Id.*

[104] *Hickman,* 184 Cal. at 529.

[105] 681 F. Supp. 1271 (S.D. Cal. 1988).

examination, even in the face of the claim of a privilege, such as the privilege against self-incrimination.

Cases such as *State Farm v. Tan*, provide strong authority for the proposition that the insurer may conduct its examinations in a reasonable manner as it deems most effective to discover the truth. To the extent that presence of a **former** employer might inhibit the principal's candor, it may, if it believes prudent, exclude the employer.

The Insurers in the *Lustig* summary judgment proceeding raised scores of objections to the purported evidence set forth in the Bank Appendix. Fundamentally, the Insurers pointed out that the matters set forth in the Appendix had little to do with the court's determination of whether the Insurers had a "reasonable basis" to support their coverage position. It was instead an indictment of sorts, the evident purpose of which was to persuade the court that somewhere, somehow within the myriad of accusations, there must be a basis upon which to keep the bad faith claims in the case. That tactic apparently succeeded at the trial court level, but not on appeal.

G. FNBL's Motion to Strike Insurers' Affirmative Defenses Relating to Bad Faith and Failure to State a Claim for Punitive Damages

The Bank filed a motion to strike at least two of the Insurers' affirmative defenses, namely those relating to "comparative bad faith" and "failure to state a claim for punitive damages." These sought adjudication of the defenses sounding in comparative bad faith as well as due process under the Federal Constitution. On October 5, 1993, at Docket No. 2161, the

court denied these motions. However, the court ultimately ruled against the bonding companies on the constitutionality argument.[106]

The availability of an affirmative defense or a claim for affirmative relief against an insured by an insurer sounding in comparative bad faith is one of considerable debate in the courts and in the secondary literature. The issue of whether insureds can be held liable for "bad faith" or to what extent the insured's "bad faith" impacts an insurer's bad faith is one of considerable interest to the defense bar and is still in a state of flux. Some authorities have implied that it is at least effective as an affirmative defense.[107]

Other jurisdictions have rejected comparative bad faith.[108] Even if the jurisdiction is one in which the defense of "comparative bad faith" is not recognized per se, arguments relating to the insured's lack of candor in the presentation of a claim should be used, if legally and factually supportable, to support the reasonableness of the insurer's investigation and ultimate coverage determination. Surely any effort by the insured to thwart an investigation is relevant to the reasonableness of that investigation.

H. The Use and Abuse of Guilty Pleas

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[106] *See* First Nat'l Bank of Louisville v. Lustig, 832 F. Supp. 1065, 1069 (E.D. La. 1993).

[107] *See* California Cas. Gen. Ins. Co. v. Superior Court, 173 Cal. App. 3d 274, 283 (1985); Flemming v. Safeco Ins. Co., 160 Cal. App. 3d 31, 45 (1984); *but see*, Kransco v. American Empire Surplus Lines Co., 54 Cal. App. 4th 1171 (1999). (This case is presently on review before the California Supreme Court. Per California Rules of Court 976, 977, the opinion is not citable in court.).

[108] *See* Stumpf v. Continental Cas. Co., 794 P.2d 1228 (1990) (Oregon Court of Appeals opinion); Nationwide Property & Cas. Ins. Co. v. King, 568 So. 2d 990 (Fla. Dist. Ct. App. 1990). *See generally* Patricia Thompson, Alicia Kirshenbaum, "Insureds' Bad Faith and Fraud – What's a Fidelity Insurer to Do?" (unpublished paper presented at Surety Claims Institute Meeting, Miami, Florida, June 1998).

As discussed above, the guilty plea of the principal, DeWitt, became the centerpiece of allegations of wrongdoing on both the part of the Bank and the Insurers. The Bank contended that the guilty plea essentially put the coverage issues to rest, mandating that the Insurers acknowledge coverage. The Insurers responded by suggesting that the guilty plea was the product of overt manipulation and misconduct on the part of the Bank and its counsel such that the entire case should be thrown out of court. DeWitt had entered into a guilty plea in a criminal case brought against him in the U.S. District Court for the Western District of Kentucky. The sentencing judge in that criminal case had rejected the guilty plea, finding that the sentence agreed to was too lenient.[109] During the pendency of the appeal in the case commonly known as *Lustig I*,[110] DeWitt entered into a similar plea agreement that was ultimately accepted by the district court.[111]

Lead counsel for the Bank interacted with the Assistant U.S. Attorney, handling the criminal prosecution to craft language in the charging information and, by incorporation, the guilty plea, to track the insuring requirements of Insuring Agreement A. According to the reported decision reviewing this issue:

> Taft [the Assistant U.S. Attorney] testified that an attorney for FNBL, . . . wanted language in the charging paragraph of the information that connected DeWitt's statements to the Bank's reliance upon them. Taft said that he already had placed that language in the information but included it

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109 *Lustig II,* 96 F.3d 1554, 1561.

110 961 F.2d at 1162, 1169 (5th Cir. 1992).

111 96 F.3d 1554, 1561.

> again at FNBL's request. He testified that he initially inserted the "relied upon" language to avoid a later legal challenge. Taft testified that the language of the information and the decisions about which language and charges to include or exclude were solely his. He admitted, however, that he consulted with the employees of the U.S. Attorney's Office and representatives of FNBL because it was the victim in this case. . . .[112]

The Insurers sought to have the plea excluded because of this involvement by the Bank in the plea process. The Fifth Circuit court held that the Insurers were required to establish by "clear and convincing evidence" that the manipulation of the criminal process by FNBL was so severe as to prevent them from "fully and fairly presenting their defense." The Fifth Circuit, utilizing an abuse of discretion standard, refused to second guess the trial court decision on that issue. In explaining its view, the Fifth Circuit stated as follows: "The actions of FNBL and its representatives do not amount to fraud on the court even if, as the insurers allege, FNBL was successful in adding charges and language to the superseding information and failed to acknowledge its role in doing so. While the court believes that the conduct of FNBL and its representatives has been less than exemplar [sic], it cannot find that such conduct rises to the level of a fraud on the court. . . ."[113]

Next, the insurers challenged the plea as inherently unreliable because the sentencing judge owned a financial interest in the holding company of the Bank. It additionally appeared that the sentencing judge's father had sat on the Board of Directors of the Bank. The court held

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[112] First Nat'l Bank of Louisville v. Lustig, 832 F. Supp. 1058, 1061 (E.D. La. 1993).

[113] *Id*. at 1063.

that, because the sentencing judge had disclosed these facts, the judge's participation did not affect the reliability of that plea.[114] The court then concluded that the pleas fell within the hearsay exception established by F.R.E. 803(22).

Finally, the court concluded that the admissibility of the pleas would not unfairly prejudice the Insurers as the Insurers would be free to raise all the arguments they had presented in their attack against them in attacking their weight.[115]

Guilty pleas, like criminal convictions, will continue to play a significant role in the handling of fidelity claims and in litigation over fidelity claims.[116]

V. CONCLUSION.

Can it be said that, at the end of the day, justice was done in the *Lustig* case? While the same bank claim, handled by a more reasonable bank, would likely have led to an early and reasonable compromise, the confluence of a very aggressive team of outside and in-house counsel resulted in years of litigation, millions of dollars in expense, and untold disruption of the business affairs of both the Bank and the Insurers. While the Bank ultimately prevailed on its coverage claims, its true net recovery was perhaps not worth the expense and disruption it endured. At the end of the day, the Insurers were pleased to have been vindicated with respect to claim-handling issues, but that vindication was costly indeed. In the final analysis, *Lustig*

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[114] *Id*. at 1064.

[115] *Id*. at 1064, 1065.

[116] An excellent and further overview of the topic is found at Robert Leslie's paper entitled, "Use and Misuse of Confessions in Fidelity Cases" (American Bar Association Fidelity and Surety Law Committee Mid-Winter Meeting, January 29, 1982).

suggests that temperance in the handling and prosecution of insurance claims, on the part of both the insurer and the insured, will in virtually all cases benefit both parties.

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