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Liability Claims Files with Insurance Coverage Issues:
To Bifurcate or Not to Bifurcate, That is the Question

When a liability claim presents serious questions of insurance coverage, a carrier often will "bifurcate" or "split" the matter into two separate claim files: one file to address liability defense issues and another file to address coverage issues. The liability insurer often will assign a separate adjuster for each of those two files. Despite relatively common acceptance of this practice, very few if any court opinions (or statutes or regulations) actually require carriers to bifurcate their liability claims files or say when they should do so. Nevertheless, bifurcation of a liability claim into defense and coverage files can help an insurance company provide an effective defense for its insured, help protect against potential bad faith claims, and strengthen the carrier's ability to maintain its attorney-client privilege over communications with its coverage counsel. This paper and presentation will explore these issues in greater detail.

1. Almost all reported cases have not required bifurcation or have refused to find that a liability insurer committed bad faith by not bifurcating.

No reported decision appears to require a liability insurer to bifurcate a claim into liability and coverage files once an insurance coverage issue arises. One of the few appellate opinions to squarely address whether a liability insurer should bificurate its file in this situation is *State Farm Fire & Casualty Co. v. Superior Court*, 216 Cal.App.3d 1222, 265 Cal.Rptr. 372 (Cal. App. Ct. 1989). The underlying lawsuit at issue in *State Farm* concerned the insureds' alleged failure to disclose foundation defects in the sale of their home. The insureds' homeowners carrier chose to defend under reservation of rights and provided the insureds with independent counsel. The liability carrier did not bifurcate the file and instead had a single adjuster handle both defense and coverage. That adjuster supposedly informed the insureds that "not one penny would be offered in settlement, that State Farm was only obligated to provide ... a 'defense,' because, in his opinion, there was no coverage under the policy." The insureds later filed suit against their insurer and alleged that the carrier defended them in bad faith.

The California appellate court recognized that while a liability adjuster can become the agent of the insured in some situations ("most usually...when no issue as to coverage arises"), "[t]his does not constitute the adjuster the insured's agent for all purposes." Where coverage is in dispute, the court commented that it is "obvious that the adjuster's loyalties are divided and the insured and his counsel cannot reasonably expect that he represents only the interest of the insured." Rather than require bifurcation of the claims file, however, the appellate court held that the interests of the insured would

"adequately protected" by independent defense counsel. Indeed, the court explained that "it is to remedy this problem that the concept of the *Cumis* [independent] counsel has been created." The court concluded, "In these days of ever-increasing costs in the processing of insurance settlements, we conclude it would be unwise to impose yet another layer of administration."

It should be noted that *State Farm* opinion made clear that the insureds did not allege that defense counsel provided confidential information to the carrier relative to coverage or that the adjuster tried to have defense counsel do so. The appellate court emphasized that it was defense counsel's "obligation to guard against improvident revelations to the insurance company."

On the flip side, a federal district court in Indiana rejected a liability insurer's argument that it was not required to provide its insured with independent defense counsel because the insurer actually had bifurcated its file between defense and coverage. *See Armstrong Cleaners, Inc. v. Erie Ins. Exchange*, 364 F.Supp.2d 797 (S.D. Ind. 2005). The carrier argued that any potential conflict of interest between the insured and the insurer on coverage issues was lessened because of the "Chinese Wall" procedures it implemented in dividing its file, with one claims adjuster working on the defense of the action and another claims adjuster working the coverage issue.

The district court did not find the insurer's argument persuasive because the bifurcation "procedures [were] limited to the front-line adjusters." The court continued: "There is no indication that they apply to more senior supervisors of both adjusters, including those who would have to approve payment of the attorney fees and any settlement." The court also noted that the adjuster handling the defense issues had a copy of the reservation of rights letter and "must be presumed to understand the coverage issues." Similar to the California appellate court in *State Farm*, the Indiana federal court here concluded that only independent counsel would protect the insured's interests, not bifurcation of the insurance company's claims file.

A federal district court in Oklahoma recognized this same limitation in bifurcating a liability claims file between defense and coverage files. *See Trotter v. American Modern Select Insurance Company*, 220 F.Supp.3d 1266 (W.D. Okla. 2016). The insured in *Trotter* argued that the insurance company committed bad faith by allowing the defense adjuster and the coverage adjuster to communicate with one another about the claim. The district court rejected the insureds' argument because they did not demonstrate that the alleged communications negatively affected the carrier's handling of the defense of the case. Furthermore, the court recognized that "[b]ecause the insurer does not have to contribute to the settlement of noncovered claims, there has to be some communication between individuals handling the defense and coverage sides of a split file." As the district court put it, "The Chinese wall is not impenetrable."

A federal district court in Georgia similarly held that an insured failed to show that its insurance company committed bad faith by failing to bifurcate its liability claims file in a timely manner. *See State Farm Fire & Cas. Co. v. King Sports, Inc.*, 827 F.Supp.2d 1364 (N.D. Ga. 2011). In that case, the carrier's representatives testified that they believed that "an insurance file should be split to ensure that information received in defense of the case is not used to invalidate coverage." Nonetheless, the court held that the carrier's delay in doing so would not support a bad faith claim because the insured failed to articulate "how State Farm's decision to wait to split the file shows bad faith" and failed to "identify what sensitive information [the insurer] was able to gain and use against King Sports." Like many of the other cases on this issue, the federal district court in *King Sports* noted that the insured also "cite[d] no authority to support its argument that State Farm even had a duty to split the file."

Finally, a Kentucky appellate court held that an insurance company did not commit bad faith when it failed to assign separate adjusters even though the insurer's representatives testified that it was company practice to do so. The insured in *United Services Auto. Ass'n v. Bult*, 183 S.W.3d 181 (Ky. Ct. App. 2003), maintained an underinsured motorist claim against its auto insurer and a separate liability claim against another one of that carrier's insureds (and later against the carrier directly via assignment) under a separate policy. The insurer's representatives testified that it was the company's normal practice to assign separate adjusters in cases involving a collision among multiple vehicles for which it provides insurance. Although the Kentucky court commented that it "would most assuredly have been the better practice" for the company "to employ two separate adjusters to avoid even the appearance of a conflict of interest," the court found "no statutory or common law duty requiring an insurer to assign two separate claims adjusters under the circumstances presented in this case." It ultimately held that the insurer was not required to do so.

2. Washington provides limited support for the proposition that liability carrier must bifurcate.

The *Safeco Ins. Co. of America v. Butler* opinion out of the state of Washington is often cited for the proposition that a liability insurer's failure to bifurcate or split a claim into defense and coverage files can be evidence of bad faith. 118 Wash.2d 383, 823 P.2d 499 (1992); *see also Cincinnati Specialty Underwriters Insurance Company v. Milionis Construction, Inc.*, No. 2:17-CV-00341-SMJ, 2018 WL 6069002 (E.D. Wash. Nov. 20, 2018). Unlike many other states, Washington imposes an "enhanced obligation of fairness" upon insurance companies that goes "beyond that of the standard contractual duty of good faith."

In *Butler*, the insured alleged that the liability carrier committed at least eight acts of bad faith:

(1) Safeco decided to defend under a reservation of rights over two months prior to notifying the Butlers of its intent to do so;

(2) Safeco delayed the Butlers' attorney's investigation;

(3) Safeco used that delay to enhance its position on the coverage issue;

(4) Safeco did not conduct a timely and thorough investigation;

(5) due to Safeco's delay evidence was lost that would have been useful to the Butlers in the coverage suit;

(6) Safeco attempted to use the Butlers' attorney to obtain statements for use in the coverage action;

(7) at the regional level, Safeco commingled information from the tort defense and coverage action files; and

(8) Safeco exhibited greater concern for its financial risk than for the Butlers' interests.

The insurance company's supposed bad faith in failing to bifurcate the file was only one of eight acts alleged (and ranked only seventh on the list). Rather than commenting in any way on whether the failure

to bifurcate could be evidence of bad faith, the Washington Supreme Court simply concluded the insured generally had presented sufficient evidence to create a question of fact as to the carrier's alleged bad faith. While insurers should note the *Butler* decision, its impact outside of the state of Washington on the bifurcation issue may be limited.

Indeed, at least one federal district court in Washington has questioned whether the *Butler* decision holds much precedence in Washington on this issue at all. *See American Capital Homes, Inc. v. Greenwich Ins. Co.*, No. C09-622-JCC, 2010 WL 3430495 (W.D. Wash. Aug. 30, 2010) ("The *Safeco* court never returned to the Butler's contention to affirm that any such duty to avoid commingling existed. Plaintiffs' authority is rooted in the summary of a party's arguments, not a judicial holding.")

3. Bifurcation allows the insurer to provide an effective defense for its insured and helps to protect against potential bad faith claims.

Most states do not require a claimant or insured to provide "direct evidence" of an insurance company's bad faith in order to maintain a claim for same. Instead, the claimant or insured often can prove that the insurer handled a claim or refused to pay a loss or demand in bad faith through the introduction of "circumstantial evidence." *See Nardelli v. Metropolitan Group Property and Cas. Ins. Co.*, 277 P.3d 789, 801 (Ariz. App. Ct. 2012); *Roldan v. Allstate Ins. Co.*, 149 A.D.2d 20, 37-38 (N.Y. App. Ct. 1989); *Johnson v. Allstate Ins. Co.*, 262 S.W.3d 655 (Mo App. Ct. 2008). In other words, an insurer's bad faith has been described as a "state of mind," which may be proven "by the insurer's acts and circumstances and can be proven by circumstantial and direct evidence." *Johnson*, 262 S.W.3d at 662. As the Arizona Supreme Court put it, "unless the defendant is willing to take the stand and admit its 'evil mind,' the plaintiff must prove [bad faith] with circumstantial evidence." *Hawkins v. Allstate Ins. Co.*, 733 P.2d 1073, 1081 (Ariz. 1987).

The evidentiary threshold for maintaining a bad faith claim against an insurer varies from state to state. Each particular claim is obviously fact-specific, and insurer conduct that might constitute bad faith in one situation may not qualify as such in another. Though by no means exhaustive, factors or circumstances that courts have found sufficient to sustain a bad faith claim include the following:

- Indifference to the facts obtained during the claims investigation, *see Nardelli*, 277 P.3d at 801;
- The failure to investigate a claim, *see id.*; *Johnson*, 262 S.W.3d at 662; *O'Neill v. Gallant Ins. Co.*, 769 N.E.2d 100, 107 (Ill. App. Ct. 2002); *Besel v. Viking Ins. Co. of Wisconsin*, 146 Wash.2d 730, 737 (Wash. 2002);
- The failure to evaluate a claim, *see Johnson*, 262 S.W.3d at 662;
- The failure to recognize the severity of a claimant's injuries and the probability that a verdict would exceed policy limits, *see Johnson*, 262 S.W.3d at 662; *Phelan v. State Farm Mutual Automobile Insurance Co.*, 448 N.E.2d 579, 585 (Ill. App. Ct. 1983);
- The refusal to negotiate or consider a settlement offer, *see Johnson*, 262 S.W.3d at 662; *Cernocky v. Indemnity Insurance Co. of North America*, 69 Ill.App.2d 196, 208, 216 N.E.2d 198, 205 (Ill. 1966);

- The failure to follow the advice of the insurance company's own adjusters, *see Phelan*, 448 N.E.2d at 585;

- The failure to follow the advice of defense counsel, *see Olympia Fields Country Club v. Bankers Indemnity Insurance Co.*, 906-07 (Ill. 1945); *Kinder v. Western Pioneer Ins. Co.*, 231 Cal. App. 2d 894, 42 Cal. Rptr. 394 (Cal. App. Ct. 1965);

- The failure to communicate with the insured, particularly with respect to the claimant's willingness to settle for the policy limits, *see O'Neill*, 769 N.E.2d at 107; *Besel*, 146 Wash.2d at 737.

- The insurer's threat to take an inappropriate coverage position, such as rescission, in order to coerce a settlement, *see Fletcher v. Western National Life Ins. Co.*, 10 Cal. App. 3d 376, 392 (Cal. App. Ct. 1970);

- Accusing an insured of insurance fraud without evidence to back up the charge, *see Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 575–576, 108 Cal. Rptr. 480, 486–487, 510 P.2d 1032 (Cal. 1973);

- Harassment of an insured or witness, *see Rios v. Allstate Ins. Co.*, 68 Cal. App. 3d 811, 817, 137 Cal. Rptr. 441, 444 (Cal. App. Ct. 1977);

- An adjuster's contemptuous attitude toward an insured, *see Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 821, 169 Cal. Rptr. 691, 697, 620 P.2d 141 (Cal. 1979);

- Misrepresentation of a facts or policy coverages, *see Pistorius v. Prudential Insurance Co.*, 123 Cal. App. 3d 541, 547, 176 Cal. Rptr. 660, 664 (Cal. App. Ct. 1981);

- Unreasonable delay in paying a claim in an effort to avoid doing so, *see Richardson v. Employers Liab. Assur. Corp.*, 25 Cal. App. 3d 232, 102 Cal. Rptr. 547 (Cal. App. Ct. 1972); and

- Conduct that would demonstrate a greater concern for the insurer's monetary interest than for the insured's financial risk, *see Besel*, 146 Wash.2d at 737.

The failure to bifurcate a liability claim into defense and coverage files is notably not included in this list. Nonetheless, just as in *Butler*, insureds are increasingly arguing that the failure to bifurcate could be considered as evidence of bad faith. Though not necessarily indicative of bad faith itself, having a single adjuster handle both defense and coverage aspects of a claim can lead insureds to argue the carrier's adjuster did not focus properly on the defense or settlement of the case. For example, insureds may argue that the adjuster improperly tried to influence the defense of the case in a direction that would result in no coverage. They could argue that the adjuster improperly tried to influence the insured or defense counsel to provide information that would defeat coverage. Insureds could argue that the adjuster spent far more time trying to defeat coverage than to provide a defense to the case and thus did not properly investigate or defend the matter. All of these arguments, of course, can be made even if the carrier bifurcates the file. However, bifurcation allows an adjuster assigned to the defense of the case to largely focus his or her attention of the defense of the lawsuit. It also makes it more difficult for the insured to

argue that the adjuster had a personal motivation for using the defense of the case to defeat the insured's coverage.

4. Bifurcation allows the insurer to better preserve its attorney-client privileged communications with its coverage counsel.

Insureds are increasingly arguing that a liability insurer's failure to bifurcate its claims file allows the insured to access the carrier's communications with its coverage counsel. For example, in *State ex rel. Shelter Mutual Insurance Company v. Wagner*, 575 S.W.3d 476 (Mo. App. W.D. 2018), a Missouri appellate court considered whether communications between a liability carrier and its coverage counsel regarding whether to accept a plaintiff's settlement demand were protected by the attorney-client privilege. The insured argued that he was entitled to the communications under *Grewell v. State Farm Mut. Auto. Ins. Co.*, 102 S.W.3d 33 (Mo. banc 2003), a case that had recognized "an insured's right of access to his or her liability insurance claims file." The insurance company in *Wagner* notably did not bifurcate its file between coverage and liability defense, but rather, commingled the privileged communications in a single file.

The Missouri appellate court held, however, that *Grewell* did not apply because that case did not involve a claim of an insurer's attorney-client privilege. The appellate court in *Wagner* clarified that *Grewell* "holds that an insured is entitled to his or her claims file but does not hold that the entitlement to the file extends to documents protected by privilege." The court in *Wagner* accordingly held that *Grewell* did not require disclosure of the communications at issue.

A California appellate court rejected a very similar argument in the aforementioned *State Farm* decision. *See* 216 Cal.App.3d at 1228 ("The principle espoused by Durants would require that counsel representing an insurance company make sure, before discussing coverage concerns, that the individual in the company with whom he was talking was not also involved otherwise in the investigation of the claim. We believe such a requirement would be unreasonable and impractical. We find that the communications between coverage counsel [and the adjuster] are privileged...and are not discoverable.")

Although Missouri and California appellate courts have held that an insurer's commingling of defense information and attorney-client privileged coverage communications in the same claims file did not waive the carrier's privilege, the fact that they were commingled gave rise, in part, to the insureds' argument that they should have access to these communications. Bifurcation of the claim into separate defense and coverage files, and storing privileged coverage communications in the coverage file only, surely provides a liability insurer with a stronger position for maintaining the privilege.