2015 CLM Annual Conference

Palm Desert

To Split or Not to Split: Logistical and Ethical Issues of Splitting the Claims and Coverage Files in Traditional Coverage and Bad Faith Situations

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I. Basic Principles for Insurers and Counsel

In any situation where a coverage issue arises, insurers (and defense counsel retained by the insurer) must keep two guiding principles in mind: (1) acting in the best interests of the insured; and (2) avoiding conflicts of interest. This discussion is geared toward splitting the claims and coverage file and, in such a situation, a conflict of interest (either actual or potential) invariably has arisen between the insured and insurer as to whether a particular claim is "covered" under the policy. Nevertheless, in the scant case law addressing file splitting, courts are concerned with whether the carrier has acted in the best interests of its insured. In other words, the duty to act in the best interests of the insured always is in the background, as is the duty of counsel retained by the insurer to act in the best interests of the client.

When an insurer realizes that a certain claim may not be “covered” under the policy, and the insurer does not take steps to evidence that it still is acting in the best interests of its insured, there can be significant legal and financial consequences. The insured can sue the insurer for bad faith and/or fraud, the insurer may be estopped from raising coverage defenses, or the insurer may be in violation of state consumer protection laws. The incautious defense counsel retained by the insurer also may have exposure for ethics violations.

II. File Splitting

When a coverage issue arises, the insurer may take steps to insulate itself by splitting the file, usually between liability/defense issues and coverage issues. Practically, the insurer sets up one file to investigate and defend the loss and another file to investigate and resolve coverage issues. Usually, the insurer also assigns a different adjuster to each file.

Theoretically, splitting the file combats any subsequent allegations by the insured that the insurer acted in bad faith. Practically, though, the insurer still needs to proceed with caution and cannot simply assign two adjusters: one for coverage and one for liability/defense. As we discuss in more detail later, if the insurer decides to split the file, the insurer still must confront issues of how to set up an intra-company wall between the coverage adjuster and the liability adjuster, how high to build this wall, what communications, if any, are allowable between the liability

adjuster and the coverage adjuster, Moreover, the insurer needs to have clearly defined procedures and protocols in place on how to manage a claim once the file is split, and must ensure uniformity in the application of these procedures. "Best practices" are critical in this regard.

And sometimes, splitting the file may not be possible or practical, especially for a smaller third party administrator or carrier without the resources to split every file where there is a potential coverage issue. In these situations, does the carrier or TPA have options?

III. When to Split the File

During the life of a claim, coverage issues may arise at any time. Coverage issues may take many forms: who is an insured, notice of claim/late notice, applicability of exclusions, intentional acts, date of loss, non-coverage for certain claims, etc. The key is recognizing when the insurer must take action and decide what it must do to protect the interests of its insured. Equally important is for the claims professional to evaluate coverage as early as possible; it is prudent for coverage to be the first thing to evaluate. Usually, the standard practice is to identify coverage immediately at the outset of the claim.

A. No coverage issue: no problem

In many claims, coverage is not an issue. In this situation, there is no need to split the file into coverage and liability.

B. Pre-suit notice of incident from insured

At this early point in the life of a claim, often the insurer simply does not have enough information to know whether or not coverage is implicated. However, notice of incident should trigger at least some investigation by the claims professional. If that investigation, though preliminary, sheds light on a potential coverage issue, then the insurer should consider splitting the file.

C. Pre-suit notice of claim by claimant/claimant attorney

This is a target of undefined length. In some claims, the claimant's attorney will notify the insurer of the factual basis of the claim and submit a fairly detailed demand package in the hope of negotiating the claim pre-suit. In those cases, the insurer's investigation may unearth a potential coverage issue, at which point the insurer should consider splitting the file.

D. Suit is filed

What about those times when the first notice of claim is when suit is filed? In those cases, often the insurer does not have sufficient time to investigate the claim to determine whether it is covered or not. Because of an insurer's very broad duty to defend its insured, and because of the overwhelming authority resolving coverage doubts in favor of the insured, unless the bare

allegations of the complaint are crystal clear that the claim in no way would ever fall under the coverage of the policy, the insurer should defend the case for its insured.

E. During claims investigation (when coverage issues identified)

Although it may seem obvious, if at any point during the investigation or the lawsuit, the claims professional identifies coverage issues, the insurer needs to consider at that point whether to split the file. Many times, this will be early in the investigation or suit, but sometimes, coverage-related facts only arise during discovery (and, presumably, after the insurer has retained defense counsel for the insured).

F. Reservation of Rights/Bilateral Non-Waiver issued by insurer

If a coverage issue is a possibility, the insurer should issue a reservation of rights letter or, in some instances, a bilateral non-waiver agreement outlining the bases of potential coverage issues, while affording the insured a defense. Failure to do so may result in the insurer being estopped from later contesting coverage.

At this point, there are a few things worth noting about reservation of rights letters. First, the issuance of a reservation of rights letter creates a potential conflict of interest between the insurer and insured. Thus, if the carrier issues a reservation of rights letter or non-waiver agreement, the carrier needs to make its decision on whether to split the file. Further, at least in some jurisdictions, the insurer needs to fully outline each and every potential basis for denial of coverage in its initial reservation of rights letter or risk being estopped from later disputing coverage on an issue not set forth in the reservation of rights letter. See Hoover v. Maxum Indem. Co., 291 Ga. 402, 730 S.E.2d 413 (2012), (insurer could not reserve its right to assert a lack of notice defense after denying coverage for employee's claim on other grounds).

On the flip side, an insurer might not raise a coverage issue, even though some coverage issue potentially may exist. There may be many reasons for doing this, such as the desire not to raise a speculative coverage issue to keep the goodwill and trust of the insured, to keep defense of the case with the insurer's panel counsel rather than with outside counsel, or simply to conserve resources in the cost-benefit analysis of raising a coverage issue (and the risks and costs that this involves) versus simply allowing the coverage issue to lie.

IV. Splitting the File: Always Between Liability and Coverage?

In some instances, a carrier may not split the file between liability and coverage. What if, for example, two insureds get in a finger pointing contest? Can one claims professional handle the entire file? In such situations, the carrier may elect to split the file not on a coverage/liability basis, but on an insured by insured basis.

This determination may be driven by the line of insurance. CGL and auto policies might be split more along the liability/coverage line, where some professional lines might be split more along the insured/insured line. As one might suspect, the decision on whether to split a file between coverage and liability, or between insureds, will be situational. As with every decision on

whether to split the file, the carrier should have in the back of its mind the two overarching priniciples of acting in the best interests of its insured(s) and avoiding conflicts of interest.

V. To Split or Not to Split

Once an insurer identifies a potential issue with coverage, it needs to quickly decide on its course of action: should it split the file or not? And if it decides the split the file, when should it split the file?

This can be a balancing act and the answer may turn on the specifics of the claim. If the insurer splits the file too soon (i.e., where coverage ends up not being an issue and there is no corresponding conflict of interest), it wastes needless resources and time, especially if coverage counsel is retained. But if the insurer waits too long, it can increase the chances that the insurer faces allegations of bad faith in allowing a conflict of interest.

The trigger point might be when the carrier issues the reservation of rights letter. But it also might be later, such as when the carrier determines that there is a reasonable chance of litigation arising out of the coverage issue. Another possible trigger point might be when a lawsuit actually is filed against the carrier. This issue also may come down to a telephone call by the claims professional to the insurer, at which time the insurer sets its expectations with the insured that the insurer might be getting coverage counsel involved. The insurer then can gauge the reaction of the insured (or the insured's counsel) to the coverage issues involved.

The question of when to split the file, practically, also may turn on the line of insurance involved. For example, a property insurer may have a different set of metrics and trigger points for splitting the file than a D&O or EPL carrier.

A. Three Concerns Courts Worry About

To better understand why carriers consider splitting the file between liability and coverage, it helps to know what the courts are worried about. Not surprisingly, these concerns all revolve around the two guiding principles: acting in the best interests of the insured, and avoiding conflicts of interest.

1. Insurer defends case to set up no coverage

2. Insurer puts up half-hearted defense if it thinks loss ultimately won't be covered

3. Insurer gets confidential information of insured that it uses to its advantage

Realistically, a prudent insurer is not doing any of these three things. But as the old saying goes, appearances matter, and appearances of bad faith are the basis of allegations in lawsuits against insurers by claimants who are dissatisfied with a coverage decision. Thus, the consideration of

splitting the file on some level is an attempt by the insurer to insulate itself against even the appearance of bad faith, much less actual bad faith.

B. Legal Duty to Split?

Does an insurer have a duty (either legal or ethical) to split a file at all? The short answer is, at this time, there does not appear to be any court that has set forth a bright-line rule that insurers have a duty to split a file. To be sure, there is not a whole lot of case law addressing the splitting of files. Recently, one appellate court almost addressed this issue, but eventually dodged it by focusing on the lack of evidence that: (1) coverage counsel and defense counsel ever shared any privileged information; and (2) that any failure to split the file caused the insurer or defense counsel to abdicate their responsibility to act in the best interests of the insured. State Farm Fire & Cas. Co. v. King Sports, Inc., 489 Fed. Appx. 306 (11th Cir. 2012).

Instead of addressing the duty to split head-on, most courts seem more willing to address the effect of the insurer's alleged misconduct on the coverage determination. In other words, courts seem to be willing to look at the evidence of alleged bad faith (as a violation of the insurer's duty to its insured) rather than erecting a bright line duty to split a file. And in fact, there is at least one case where a court rejected the notion that an insurer had a duty to split a file, although central to that court's determination was the fact that the insurer had provided the insured with independent defense counsel paid for by the insurer (Cumis counsel) and the insurer retained a separate law firm to prosecute the coverage issues. State Farm Fire & Cas. Co. v. Superior Court, 216 Cal. App. 3d 1222, 265 Cal. Rptr. 372 (Ct. App. 1989). Interestingly, the State Farm Court recognized the economic burden on insurers "to impose yet another layer of administration" on insurers.

C. Factors Courts Look At

In considering whether to split the file, insurers also should keep in mind the factors that courts have looked at in deciding whether bad faith exists (or whether the court will allow the bad faith claim to go to a jury).

1. Was the claims adjuster involved in both the liability/claims analysis AND the coverage analysis, and was the insured prejudiced by any conflict of interest?
2. Did the insurer adequately separate liability handling and coverage analysis?
3. Did the claims adjuster inform the insured about conflicts of interest while simultaneously developing possible coverage defenses?
4. Did the claims adjuster induce defense counsel to divulge confidential information that adversely affected the coverage analysis?
5. Did the insurer rely on any confidential information about the insured from defense counsel in formulating coverage defenses?
6. Did the insurer use defense counsel's activities to develop coverage defenses?

Twin City Fire Ins. Co. v. City of Madison, 309 F.3d 901, 909 (5th Cir. 2002). If proved, any of these allegations could support a verdict against the insurer for a breach of its duty to its insured.

In a recent coverage decision by the Fifth Circuit, the Court rejected an insured school district's allegation that the carrier acted in bad faith by failing to provide counsel retained by the carrier "indemnity settlement authority" at a mediation to settle not just claims on behalf of the school district, but also on behalf of the carrier. The Court rejected this argument, noting that, unlike Twin City, there was no allegation that the carrier improperly had used the insured's privileged information to develop any position of "non-coverage." Acadia Ins. Co. v. Hinds Co. Sch. Dist., 582 Fed. Appx. 384 (5th Cir. 2014). The Court further noted that the school district's theory would vest defense counsel retained by the insurer with authority to make binding decisions on behald of the carrier, whose interests might be adverse to those of the insured. What is clear from the Acadia decision is that courts are indeed concerned about whether a carrier might use confidential information from the insured to make an adverse coverage decision.

Splitting the file, if done properly, could go a long way toward mitigating these concerns. Really, splitting the file is about managing conflicts of interest (and managing bad faith risk).

D. Factors Insurance Companies Evaluate

What about carriers? What sorts of things do carriers look at when splitting files? Some of the major concerns are as follows, though this list is far from exhaustive.

1. Satisfying duty of good faith and fair dealing with insured
2. Resources available to handle split files
3. Protecting privileged information in claims file

E. Privilege when Bad Faith Alleged

Is the claims file privileged when the insured raises a claim of bad faith in the underlying lawsuit? Take this case out of New Jersey where the plaintiff/insured of GEICO made a UIM claim and then asserted a bad faith claim against GEICO. Although the trial court bifurcated the bad faith claim against GEICO from the underlying liability claim and held the bad faith claims in abeyance, the court nevertheless allowed discovery to go forward on all claims. The plaintiff/insured wanted GEICO's entire claims file, among other things. The New Jersey appellate court reversed, holding that the proper course of action would be to hold the entire bad faith claim in abeyance, including discovery in the bad faith claim, until the conclusion of the underlying claim. Procopio v. Gov't Employees Ins. Co., 433 N.J. Super. 377, 381, 80 A.3d 749, 751 (App. Div. 2013). The court wrote that this approach promotes judicial economy and efficiency by "holding in abeyance expensive, time-consuming, and potentially wasteful discovery on a bad faith claim that may be rendered moot by a favorable ruling for the insurer in the UM or UIM litigation. This procedure also avoids the premature disclosure of arguably privileged materials to the prejudice of the insurer's defense while, at the same time, preserving the insured's pursuit of its bad faith claim." Id. The Procopio court noted that this approach has been followed by Arizona, Alabama, Florida and Texas.

F. Why Split File

Although there does not appear (yet) to be a bright-line duty for an insurer to split the file, there are, nonetheless, some good reasons to consider splitting the file.

1. Splitting the file avoids the appearance of impropriety.

2. Splitting the file may give the insured an assurance of fair treatment.

3. Splitting the file may cultivate an atmosphere where defense counsel is more willing to share information with the liability adjuster.

4. Cost-benefit: splitting the file, though it takes more resources, may be less than the resources expended in defending a bad faith suit. But an insurer also has limited resources: can it feasibly split every file at the first whiff of a conflict of interest with its insured?

G. Alternatives to File Splitting

1. Coverage Counsel

Some insurers, rather than split the file between a coverage adjuster and a liability adjuster, will assign the coverage portion of the case to outside coverage counsel. In these situations, the insurer will have one adjuster handling the file but will have coverage counsel. As with the decision to split the file, the insurer still must address the question of when to involve coverage counsel. One factor to consider is discoverability of the claims file materials once a bad faith suit ensues. There is good authority that, so long as an insurer has advised its insured of a conflict of interest due to coverage issues, and the insurer has retained coverage counsel to represent the insurer's sole interests, the claims file should be protected from disclosure by attorney-client privilege.

2. Cumis Counsel/Independent Counsel Selected by Insured

For purposes of the file splitting dilemma, it is worthwhile to note some things about assigning independent defense counsel. The most obvious, of course, is that this is legally required in some jurisdictions once the insurer reserves its rights under the policy and thereby creates a potential conflict of interest. Another benefit is that the insurer's paying for defense counsel selected by the insured usually is persuasive (and sometimes dispositive) evidence of an insurer's good faith, regardless of whether the insurer split the file or not. This is so because the insurer has no right to control the insured's defense if the insured is entitled to representation by independent counsel.

Remember the three things that courts worry about?

1. **Insurer defends case to set up no coverage**

2. **Insurer puts up half-hearted defense if it thinks loss ultimately won't be covered**

3. Insurer gets confidential information of insured that it uses to its advantage

These risks, theoretically, should be virtually eliminated by representation of the insured by independent counsel. The first two concerns should evaporate because the insurer effectively and practically has given the insured control of its own defense. The third concern, of independent counsel sharing confidential and potentially detrimental information with the insurer, should be minimal if independent counsel simply adheres to their ethical duty to not disclose their client's confidential information.

V. What to do After You've Split the File

A. Intra-Company Screens

If the insurer does decide to split the file between liability and coverage, it should assign each file to a different adjuster. In doing so, the insurer also should erect an intra-company screen or firewall between adjusters so that they do not feed or share information with each other that could be detrimental to the insured. Once again, this addresses the concern of acting in the best interest of the insured. And again, this is an attempt to address the 3 concerns that courts have.

B. How High Up Does Screen Go

This is an issue with no real clear answers. However, there is at least one reported decision where an insurer was required to pay for independent counsel (though not held to be in bad faith) when it set up a firewall that only extended to the adjusters working on liability and coverage. Armstrong Cleaners, Inc. v. Erie Ins. Exchange, 364 F. Supp. 2d 797 (S.D. Ind. 2005). In Armstrong Cleaners, despite splitting the file, the insurer still had the same supervisor over both the liability and claims adjuster. Moreover, the liability adjuster had a copy of the reservation of rights letter and the court assumed that the liability adjuster therefore understood the coverage issues.

At the end of the day, someone from the insurer must make a decision on whether to settle a case. If it's the same supervisor over both the claims and liability adjusters, the case law suggests that the insurer may be asking for a conflict of interest. Going higher up the organizational chart seems to be a safer choice for the insurer. It is prudent for the insurer to not have the same person making initial decisions on settlement valuation as the initial decision on whether the insurer will decline coverage.

C. Communications Between Coverage and Liability Adjusters

Another issue is what communications are permissible between coverage and liability adjusters once the screen is in place. Clearly, as set forth in the Armstrong Cleaners case, the liability adjuster should not be privy to or have access to the relevant coverage documents, such as the reservation of rights letter or the coverage memo from coverage counsel. The same rationale applies if defense counsel shares confidential information about the insured with the liability adjuster; the liability adjuster should not share this information with the coverage adjuster.

What about if a case is going to mediation or is ripe for settlement? It would seem that the coverage and liability adjusters could, at the very least, share information about settlement discussions and mediation, although substantive discussions about the pros and cons of particular facts bearing on coverage should not be discussed. Of course, the safest route is to prohibit any discussion about the particular claim file, but practically speaking, this may not always be possible.

D. Policy/Protocol on Screening Procedures

If an insurer decides to split a file, what should its policies and protocols be on screening? This is a concern because, if the insurer must defend a bad faith lawsuit, it presumably will have to defend why it erected the screen, how it erected the screen and what methods it used to ensure that the liability adjuster was not "contaminated" by the coverage adjuster.

Insurers may have specific training on these procedures. Insurers may have a portion of their claims manual devoted to splitting files and how to handle them. On the other hand, some insurers do not have written procedures and instead will rely on good managers to instruct the adjusters on how to handle a file once it is split (or perhaps especially if the file is not split). If the insurer does decide to split the file, it also should take steps to ensure uniformity in application of its procedures.

A possible ally is the claims software. If the insurer is considering enacting procedures on splitting the file, then it should look into whether it can configure its claims software to automatically prompt the adjuster on whether he/she will split the file once he/she identifies a coverage issue.

The insurer also must consider when to take down the screen. Although there does not appear to be any guidance from the courts, the reasonable approach would seem to be to keep the screen in place until the insurer closes the claim file.

VI. Differences Between Third Party Administrators, Self-Insured Entities and Insurers in Deciding to Split Files

Another concern in splitting the file is the nature of the entity that is involved. If the entity is a third-party claims administrator, is that entity even involved in the coverage process or does the coverage question get returned to the carrier, thus resulting in de facto file splitting? What about large companies who are self-insured and use third party claims administrators? And finally, any entity involved in coverage decisions—regardless of size—is going to have to decide whether/when to split a file. Although not addressed by the courts, the insurer's/self-insured's limited resources certainly is at least a practical consideration in deciding when/if to split a file.