WHEN LIABILITY AND COVERAGE ISSUES COLLIDE: WHEN, WHY AND HOW TO SPLIT THE FILE

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I. Introduction: Importance of Managing Conflicts of Interest

It is axiomatic that the duty to defend is broader than the duty to indemnify, and whereas liability insurers have a duty to defend their insureds against claims that are potentially within the scope of coverage, insurers have no obligation to provide indemnification for non-covered claims. As such, an actual or potential conflict of interest may arise when an insurer agrees to provide its insured with a defense but there is a coverage issue regarding indemnity under the policy. Recognizing and managing these conflicts during the claims handling process is critical to satisfying a carrier's duties to its insured while also protecting the insurer from a future bad faith claim. Splitting the claim file so that "liability" and "coverage" issues are handled by separate claims professionals can be an effective tool as part of an insurer's overall strategy for managing conflicts of interest and minimizing potential extra-contractual exposures.

Considering the extent to which file splitting is employed as a means for handling conflicts, the case law on point is surprisingly limited. Moreover, many of the decisions that reference file splitting do so in passing with little or no substantive analysis. As a result, there are few if any "hard and fast" rules to be gleaned from the courts regarding best practices in this area, and opinions can vary widely. The objective of this roundtable is not to provide bright line rules, but rather, to offer practical tips concerning the circumstances under which file splitting may be advisable and the issues to be considered by claims professionals in developing and implementing protocols that effectively respond to conflict situations in a manner that protects the interests of the insured and the insurer.

II. Sources for Conflicts of Interest

A. Preserving the Right to Contest Coverage

In many cases, an insurer will not have sufficient time to conduct a thorough investigation to determine whether a claim against the insured is covered – this is especially true if a lawsuit against the insured is the first notice of a claim. Under these circumstances, the insurer will have to decide whether to provide a defense to the insured based on the allegations in the complaint. Moreover, an insurer that undertakes the defense of its insured without preserving its right to contest coverage generally waives the right to challenge coverage at a later date. To avoid such a waiver, insurers typically issue reservation of rights letters setting forth, among other things, the potential bases for disclaimer. Another option for preserving an insurer's right to contest coverage is a non-waiver agreement by which the insured acknowledges that the insurance company does not waive its right to challenge coverage. As a practical matter, reservation of rights letters and non-waiver agreements achieve the same goal: they provide the insurer with some breathing room to investigate claims while simultaneously defending the insured without foregoing the right to later deny coverage.

B. Judicially Recognized Conflict Concerns

Whenever an insurer asserts policy or coverage defenses and defends an insured subject to a reservation of rights or a non-waiver agreement, the potential for conflicts of interest arise. In that regard, courts have identified the following three potential conflicts of interest: (1) the insurer may steer the defense so as to make the likelihood of a plaintiff's verdict greater under an uninsured theory; (2) the insurer may offer a less than vigorous defense if the insurer knows that it can later assert non-coverage, or if it thinks that that the loss it is defending will not be covered under the policy; and (3) the insurer might gain access to confidential or privileged information, which it might later use to its advantage in litigation concerning coverage. *See Armstrong Cleaners, Inc. v. Erie Insurance Exchange*, 364 F. Supp.2d 797, 814-15 (S.D. Ind. 2005) (citing *CHI of Alaska, Inc. v. Employer's Reinsurance Corp*., 844 P.2d 113, 116, 118 (Alaska 1993)).

One of the mechanisms employed by some insurers to guard against the concerns identified above and to refute a subsequent allegation of bad faith is splitting the claim file. In such a case, the insurer typically establishes one file for the defense and investigation of the loss and a second file for the investigation and resolution of coverage issues, and assigns a different claims professional to each. Not every reservation of rights creates an actual conflict, however, and insurers do not always split the claim files under these circumstances. Policyholders, in turn, sometimes argue that an insurer's failure to split the file in such cases constitutes a breach of their duties to the insured and/or a violation of industry custom and practice and state laws governing unfair claim settlement practices. Accordingly, a threshold question arises as to whether an insurer has a legal duty to split the file in the first instance.

C. Multiple Insureds

Another conflict of interest scenario occurs when there are multiple insureds involved in a liability claim and their respective interests are not aligned. In that case, assigning different

adjusters to each insured to protect the parties' conflicting interests is typical. In some cases, however, the existence of a conflict may not be readily apparent from the outset, and the insurer's handling of the claim (including whether and when the file was split) may be scrutinized at a later date in connection with an allegation of bad faith by an insured. In *Specialty Surplus Ins. Co. v. Second Chance, Inc*., 2006 WL 2459092 (W.D. Wash. 2006), for example, an insurer agreed to defend two insureds – an employer and the employer's employee – subject to a reservation of rights. At the beginning of the lawsuit, the insurer assigned a single adjuster to handle the claims. The employer asserted a defense to the suit on the basis that the employee acted outside the scope of his employment, creating a clear potential conflict of interest between the insureds. The insurer thereafter split the file, and the employee-insured subsequently filed a bad faith claim stemming from the conduct of the adjuster handling his defense after the split based on an allegedly improper comingling of the files. The court held that while the insurer had no duty to split the file earlier than it did, "cross-file communications" presented an issue of fact as to whether the insurer acted in bad faith. The court noted that while most of the internal communications at issue involved nothing more than "immaterial matter[s] of internal procedure," there was some evidence from the notes that the insurer used information garnered from both files to conclude that it was in the insurer's best interest not to settle the claim against the employee and to allow the matter to proceed to trial based on the strength of the coverage defenses. *Id.* at *16. Specifically, the adjuster for the employee concluded that the employer would likely receive a defense verdict based on a finding that the employee acted outside the scope of his employment which would render a judgment against the employee not covered based on a policy exclusion for just such conduct. *Id*. at *17.

Thus, while the *Second Chance* court did not specifically address the narrow issue as to whether an insurer has a duty to split the file, its holding stands for the proposition that even where an insurer does split the file, it may still be subject to bad faith if it later "crosses over" and uses information from one insured's defense file to build its coverage defenses against another insured in the same litigation. As discussed below, a few courts have squarely addressed whether there is a legal duty to file split in the face of a potential conflict.

III. Legal Duty to Split the Claim File

Although the case law on point is limited, it appears that while insurance companies may opt to split the claim file in appropriate cases, they have no *duty* to do so. *See, e.g., Employers Ins. Of Wausau v. Albert D. Seeno Constr. Co*., 945 F.2d 284, 286-88 (9th Cir. 1991) (ruling, under California law, that insurer had no duty to segregate liability and coverage activities, and the fact that other insurers chose to do so reflects a precautious decision to avoid later complaints of mishandling by the insured rather than an obligation to do so); *United Servs. Auto Ass'n v. Bult*, 183 S.W.3d 181, 187-188 (Ky. Ct. App. 2003) (concluding that insurer's failure to assign two adjusters to claim involving multiple insureds and a single loss did not support bad faith claim); *State Farm Fire & Cas. Co. v. King Sports, Inc*., 827 F. Supp.2d 1364, 1378 (N.D. Ga. 2011) (rejecting, in a case applying Georgia bad faith law, the insured's contention that the

insurer had a duty to split the file and noting that the insured had cited no authority in support of its contention); *Travelers Indem. Co. v. Page & Assocs. Constr. Co*., 2002 WL 1371065, *10 (Tex. App. Ct. June 25, 2002) (rejecting insurer's failure to split file as a basis for imposing liability under Texas Insurance Code and Deceptive Trade Practices Act). As discussed in a later section, however, one of the benefits of splitting the file is that it may avoid a waiver of the attorney client privilege.

IV. Alternatives to File Splitting: The Role of Independent Counsel

In a number of jurisdictions, an insurance company is obligated to pay for the cost of the insured's independent counsel where a conflict of interest arises such that the insurer's offer to defend the insured is subject to a reservation of rights. *See, e.g., San Diego Navy Fed. Credit Union v. Cumis Ins. Society*, 162 Cal. App.3d 358 (Cal. App. 4th 1984). In states requiring the hiring of so-called *Cumis* counsel, the insurer is typically required to inform the insured of its right to seek independent counsel whenever a potential conflict is present. In determining whether a potential conflict of interest is sufficient to require the insurer to pay for independent counsel of the insured's choice, courts will often frame the issue in terms of whether there is a reasonable possibility that the manner in which the insured is defended could affect the outcome of a disputed coverage issue. *See Armstrong Cleaners, Inc. v. Erie Ins. Exchange*, 364 F. Supp.2d 797, 808 (S.D. Ind. 2005).

A. Splitting File May Be Unnecessary If *Cumis* Counsel Is Provided

In theory, retaining independent counsel should adequately address each of the three potential concerns identified by the courts when an insurer defends an insured subject to a reservation of rights irrespective of whether the insurer decides to split the file. Vesting the insured with control of its own defense via independent counsel should fully eliminate the possibility, however remote, that insurer-appointed counsel might be tempted to either (1) steer the defense in the direction of a non-covered theory of liability, or (2) mount a less than vigorous defense under the belief that the loss ultimately will not be covered. Along the same lines, appointment of independent counsel should practically eliminate the possibility of the courts' third concern – i.e., the chance that the insurer will obtain confidential or privileged information that it can use to the insured's disadvantage in a coverage dispute – coming to fruition. Unless independent counsel chooses to betray the insured's confidence and to violate its ethical duties in the process, the risk that an insurer might obtain confidential information from defense counsel which it could then use to the insured's detriment appears practically non-existent where *Cumis* counsel has been retained.

In recognition of this fact, at least one court has rejected an insured's argument seeking to impose on insurers the duty to assign separate liability and coverage adjusters where *Cumis* counsel is involved. *See State Farm Fire & Cas. Co. v. Superior Court*, 216 Cal. App.3d 1222,

1226 (4th Dist. 1989). In finding that the interests of the insured were adequately protected by the presence of independent counsel, the *State Farm* court declined the insured's request to impose "a veritable wall … between the insurance company's administration of the two cases," noting that it would be unwise to impose yet another layer of administration in light of the increasingly high costs of processing insurance settlement.

B. Splitting the File Does Not Eliminate the Insurer's Duty to Provide Independent Counsel When a Conflict Is Present

While the existence of independent counsel may obviate the reasons for splitting the file, the duty to provide independent counsel in a jurisdiction that adheres to the *Cumis* rule may not be satisfied by splitting the file. *See Armstrong Cleaners, Inc. v. Erie Ins. Exchange*, 364 F. Supp.2d 797 (S.D. Ind. 2005). In *Armstrong*, the court held that the insurer's assignment of two adjusters to separately handle the liability and coverage issues and the construction of a Chinese Wall between these two aspects of the case was not an adequate substitute for providing the insured with independent counsel. In so ruling, the court noted that even though the adjusters were prohibited from interacting, there was no indication that supervisors "or others who would exercise final authority" on settlement or trial strategy were prohibited from interacting. *Id*. at 805. In support of its ruling, the court further noted that the defense adjuster had a copy of the reservation of rights letter laying out the coverage issues. Based on these facts, the court granted the insured's motion for summary judgment requiring the insurer to furnish independent counsel notwithstanding the absence of any evidence that any improper comingling of evidence had occurred.

V. Practical Reasons For Splitting the File

Even in the absence of a legal duty to do so, there are very good reasons why an insurer might, in the exercise of its business judgment, choose to split the file in appropriate cases. First, splitting the file may limit an insurer's exposure to bad faith claims and coverage by estoppel in jurisdictions recognizing this doctrine. Of course, no insurer has unlimited resources, and splitting the file to protect against every conceivable potential conflict is neither realistic nor feasible for most insurers. The administrative costs accompanying the decision to split the file must be weighed against the possibility of an allegation of bad faith if the file is not split as well as the cost of litigating and defending such a claim somewhere down the line.

Second, splitting the file avoids even the appearance of impropriety. As seasoned claims professionals and their counsel know, even the appearance of impropriety can result in a bad faith lawsuit. Splitting the file bolsters the argument that the insurer acted in good faith to protect the interests of its insured.

Third, splitting the file may provide the insured with a measure of additional assurance that he or she is being treated fairly, and may cultivate an atmosphere in which defense counsel is willing to share information with the liability adjuster freely and openly thereby enhancing the insurer's ability to successfully defend the case.

Fourth, in the event of litigation with the insured, splitting the file may in some jurisdictions enhance the insurer's ability to successfully assert the attorney-client privilege or work product immunity over coverage-related communications with the insurer's in-house lawyers or outside coverage counsel.

Fifth, in most of the reported bad faith cases discussing file splitting, the focus of the court's inquiry tends to be not whether the insurer actually split the file, but rather, whether an insurer accessed confidential defense information to assist it in avoiding coverage. For example, one court identified the following factors in assessing whether bad faith exists or whether a bad faith claim should go to a jury:

- Whether the claims adjuster involved in both the liability/claims analysis and the coverage analysis, and whether the insured was prejudiced by any conflict of interest;
- Whether the insurer adequately separated the liability handling and the coverage analysis;
- Whether the claims adjuster informed the insured about conflicts of interest while simultaneously developing possible coverage defenses;
- Whether the claims adjuster induced defense counsel to divulge confidential information that adversely affected the coverage analysis;
- Whether the insurer relied on any confidential information about the insured from defense counsel in formulating coverage defenses; and
- Whether the insurer used defense counsel's activities to develop coverage defenses.

See Twin City Fire Ins. Co. v. City of Madison, 309 F.3d 901, 909 (5th Cir. 2002). Evidence by the insured that one or more the above occurred could support a verdict against the insurer for a breach of its duty to its insured. Splitting the file, if done properly, could go a long way toward mitigating these concerns and reducing the risk of extra-contractual exposure.

VI. Practical Considerations in File Splitting

Once an insurer decides to split a file, consideration must be given to a host of practical and logistical issues regarding the most efficient and effective way to implement the split, and a well thought out set of policies and procedures which are clearly communicated and consistently followed is advisable. Some of the most basic questions include when should the adjuster

bifurcate or split the liability and coverage issues and how high should the screen go? Should it extend just to the adjusters? Are any communications between the liability and coverage adjusters permissible? How long does the decision to maintain a screen between claims handling and coverage handling remain in effect and when does the screen come down? There are no bright line rules, and the answers to these and related questions depend, in part, on the specific claim at issue and the circumstances of the individual insurer.

Other factors to be considered include the extent to which the insurer maintains paper files, whether the insurer has fully migrated to a paperless environment, or whether the insurer utilizes some combination of the two. An insurer's information technology and records management systems can likewise impact the implementation of a file split and therefore must be given due consideration. In addition, the hierarchy within a claims organization for handling, reserving and settling claims, including the extent to which an insurer may rely on a third-party administrator to support its claims function, can have an impact on file splitting as well. Similarly, the extent to which an insurer's adjusters and managers may be specialized and whether an insurer has different departments for different types of claims are also important factors. All of these issues must be carefully considered both when developing policies and procedures for file splitting and when implementing file splits on individual claims.

A. When to Split the File

Deciding when to split the file and set a screen between liability and coverage issues is not subject to a one size fits all answer. If an insurer splits the file too soon, resources may be expended needlessly in the event there are no coverage issues or conflicts of interest, especially where separate coverage counsel has been retained. On the other hand, if the insurer waits too long, it may open itself up to an allegation of bad faith on the ground that it stood by idly and allowed a conflict of interest to develop unabated.

There can be various trigger points in the life of a claim which dictate the timing of a split and the need to erect a screen. When an insurer is placed on notice of an occurrence or potential claim before litigation against an insured has commenced, one adjuster can usually conduct an investigation of the circumstances surrounding the loss and make preliminary evaluations about liability and coverage. In some cases, the issuance of a reservation of rights letter might be the impetus to split the file. Another possible trigger point might be when a lawsuit is filed against the insurer. As a practical matter, when to split the file may also turn on the type of insurance involved, as insurers may rely on different sets of metrics for triggering a file split depending on the line of insurance involved (e.g., property versus professional lines).

The takeaway is that potential conflicts can arise at any time after receipt of notice, and claims that initially appeared to be free and clear of coverage issues may present thorny coverage questions as the investigation begins and develops. The best approach may be to err on the side

of caution based on the principle that it is better to create a screen and not need it than to forego building one only to learn that it would have been crucial in defending a bad faith claim. A corollary to this approach is, when in doubt, split the file sooner rather than later and better late than never.

B. How High Does the Screen Go?

File splitting inevitably raises questions regarding how far up the organizational chart a screen should go. Does the assignment of separate liability and coverage adjusters adequately address any potential conflict concerns or does an insurer need to consider doing even more to protect itself from a future claim that it failed to protect its insured's interests? Should an insurer consider using not only separate adjusters, but different lawyers also? This too is an issue with few, if any, easy answers.

In making staffing decisions on a split claim file, it is critical to keep in mind one of the primary reasons for splitting the file and using separate adjusters where there is coverage issue in connection with the underlying claim: to avoid giving the insured a basis for asserting in a bad faith action that the insurer obtained confidential defense information which was used to deny coverage. At a minimum, adjusters and managers concerned with the defense of the underlying claim should not be involved in either coverage determinations or analyses of bad faith claims. The possibility of assigning separate liability and claim supervisors, if feasible, is another consideration. Although one court found that splitting the file did not suffice where the same supervisor oversaw both the liability and coverage adjusters, the specific issue before the court in that case was not how high up a screen should extend, but rather, whether splitting the file satisfied an insurer's duty to provide independent counsel. *See Armstrong Cleaners, Inc. v. Erie Ins. Exchange*, 364 F. Supp.2d 797, 817 (S.D. Ind. 2005). As is often the case in this area, the case law provides little guidance, and deciding how far the screen should extend requires a balancing of interests.

C. Communications between Liability and Coverage Adjusters

Another issue is what communications, if any, are permissible between liability and coverage adjusters once a screen is in place. It seems clear from the *Armstrong* case that a liability adjuster should not have access to the relevant coverage documents such as any coverage opinions prepared by coverage counsel and possibly even the reservation of rights letter. 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. Not all communications are necessarily off limits, however, once a screen has been set. In *Specialty Surplus Ins. Co. v. Second Chance, Inc*., 2006 WL 2459092, * 16 (W.D. Wash. 2006), for example, the court did not object to communications between adjusters relating to purely "internal procedures." When it comes to intra-company communications, thought should be

given to whether the communication creates the perception that confidential defense information was sought or transmitted for the purpose of building a coverage case against the insured.

D. Implementing Screening Procedures

If an insurer decides to split a file, what should its policies and protocols regarding screening be? This is an important question because, in the event of a bad faith suit, an insurer may have to defend why it erected the screen, how it erected the screen, and why it believes the screen adequately protected the insured's interests. A screening procedure that is thoughtfully designed and consistently applied has the best chance of withstanding a bad faith challenge. Indeed, one court has suggested that an insurer's failure to follow its own internal rules regarding conflict screens can be evidence of wrongdoing. *See Aetna Cas. & Sur. Co. v. Mitchell Bros. Inc*., 814 So.2d 191, 199 (Ala. 2001) (Moore, C.J. concurring in part and dissenting in part).

Whereas some insurers may have written policies and procedures governing file splitting, other insurers may rely on good managers to instruct adjusters on best practices when it comes to making decisions about whether to split the file and, if so, how to implement the screen. To the extent that specific training programs are utilized, consideration should be given to making the system as streamlined and user-friendly as possible. In that regard, technology and, more specifically, claims software might facilitate the incorporation of a system of automatic prompts that guide an adjuster's actions once a potential coverage issue has been identified. To the extent that an insurer relies on third-party administrators to handle claims, ensuring compliance with the insurers own internal procedures and standards is yet another consideration.

VII. Discovery of Claim File Communications in Bad Faith Actions

One of the potential benefits of splitting the file in the absence of an affirmative duty to so is that, in some jurisdictions, doing so may enhance the insurer's ability to successfully assert the attorney-client privilege or work product immunity over coverage-related communications with the insurer's in-house lawyers or outside coverage counsel. The extent to which the materials in an insurer's claim file are discoverable in a bad faith action varies from jurisdiction to jurisdiction and continues to be a hot topic.

Although a comprehensive discussion of these issues is beyond the scope of this presentation, several noteworthy decisions highlight the potential for waiver of the attorney-client privilege in some jurisdictions where counsel is involved in the "quasi-fiduciary" tasks of "investigating, evaluating and processing" claims. *See Cedell v. Farmers Ins. Co. of Washington*, 295 P.3d 239 (Wash. 2013). In *Cedell*, an insurer retained counsel to assist in making a coverage determination in connection with a first-party fire loss. The insured filed suit alleging that the insured acted in bad faith in handling his claim. In response to the insured's discovery request, the insurer produced a heavily redacted claims file, asserting that the redacted information was not relevant or privileged.

In a case that was eventually decided by the Washington Supreme Court, the *Cedell* court held that, in a first-party bad faith action over the handling and processing of claims (other than UIM claims), "there is a presumption of no attorney-client privilege." *Id*. at 246. The court clarified that the insurer may, however, assert the attorney client privilege "upon a showing in camera that the attorney was providing counsel to the insurer and not engaged in a quasi-fiduciary function." *Id*. Because the insurer retained counsel for the purpose of advising it on the issue of coverage, it could seek to overcome the presumption in favor of disclosure by showing, for example, that the attorney was not acting "in a quasi-fiduciary way toward its insured" with respect to any legal opinions prepared by counsel regarding coverage for the claim. *Id*. at 247. The court noted that the insurer hired counsel to do more than simply give legal opinions – he also assisted in the investigation of the claim by taking the sworn statements of the insured and another witness and by corresponding with the insured. Counsel also assisted in the adjustment of the claim by negotiating directly with the insured. The court noted that it was the attorney's performance of these tasks "investigating, evaluating, negotiating and processing" the claim to which the insurer's quasi-fiduciary duty to the insured attached. Notably, the court cautioned in a footnote that "[w]here an attorney is acting in more than one role, insurers may wish to set up and maintain separate files so as not to co-mingle different functions." *Id*. at 246, n.5.

At least one court has cited and applied the principles articulated in *Cedell* in the context of a third-party matter where counsel retained by the insurer served in a "mixed role" and provided coverage advice while also investigating the claims along with the insured's defense counsel. *See Stewart Title Guaranty v. Credit Suisse*, 2013 WL 1385264 (D. Idaho Apr. 3, 2013). In that case, the court repeated the *Cedell* court's suggestion regarding maintenance of separate files. *Id*. at *4. It should be noted that in a decision issued just five months after *Cedell*, however, a Washington district court openly questioned whether the maintenance of separate files provided a workable solution in many cases. In *Palmer v. Sentinel Ins. Co*., 2013 WL 3448128 (W.D. Wash. July 9, 2013), the court stated as follows:

> … Although *Cedell* seeks to offer a workaround for attorneys who may act in a dual capacity by suggesting in the footnote cited above … that attorneys who engage in mixed roles should keep separate files for actions taken in each capacity, that suggestion is likely not to be workable in many cases. The *Cedell* court's suggestion will likely *not* provide a practical solution for many attorneys working in dual capacities because the file containing counsel's legal advice is very likely to contain the mental impressions directly at issue in the information contained in the other file where the attorney stores the information gathered in the course of executing his or her quasi-fiduciary duties.

Id. at *2.

The district court's commentary raises a question concerning the extent to which coverage-related communications may be fully protected in some jurisdictions where the

insurer's counsel acts in a dual capacity and not only provides coverage advice, but also acts in an investigative capacity. Although this is an issue that warrants close monitoring, splitting the file and screening the liability and coverage adjusters would appear to reduce the risk, in many cases, that the insurer's communications with its coverage counsel would be discoverable in a future bad faith action.