CLM CLAIMS & LITIGATION MANAGEMENT ALLIANCE™

ADVANCING ETHICS, COOPERATION AND EDUCATION

2014 CLM Annual Conference

April 9, 2014 – April 11, 2014

Boca Raton Resort
501 E. Camino Real
Boca Raton, FL 33432

Roundtable 1: Thursday, April 10, 2014 (10:10 am – 11:10 am)

To Split or Not to Split: Avoiding Bad Faith - When Defense and Coverage Collide"

I. Overview:

Knowing how to effectively manage conflicts of interest between indemnity and coverage in claim handling is crucial in avoiding a subsequent allegation of bad faith. Key to that management is an effective strategy of when, why and how to split the file, because conflicts can arise at any time between first notice of a claim until the claim is resolved.

Even as insurers toil over this dilemma, best practices for splitting a file are far from clear, most especially since there are few cases that discuss it in detail, and those that do come without easy to apply rules. This roundtable offers practical advice regarding splitting files and assigning duties to claim handlers to prevent or minimize conflicts of interest and bad faith exposure.

II. Potential problems and obstacles to splitting

Sooner or later, all adjusters will find themselves examining claims that pose coverage issues. These controversies may pertain to the date of loss, additional insureds, applicability of exclusions, intentional acts, breach of policy conditions, late notice, non-coverage for certain counts, or punitive damages.

Consequently, insurers and retained counsel are faced with the dilemma of when and how to split a file – between liability and coverage – and what information and knowledge can be shared between the respective attorneys and claim-handlers. Failing to split a file, when appropriate, or failing to correctly handle a split file, can impact both the liability and coverage issues, and result in ethical problems and bad faith exposure.

It is considered a best practice for adjusters to assess coverage as one of the first steps in handling any claim. If there is no coverage, then liability and damages may be moot. Having decided that a claim poses a coverage issue, however, new decision points loom.

The claim may be denied outright. Typically, a reservation of rights letter may be sent. But the key decision point is this: Should the claims department now split the staffing so that one adjuster handles the

liability claim while a separate staffer handles coverage? This is the "screen," split, or bifurcation of the claim file.

III. Bifurcation of the claim file or "setting the screen"

The determination of whether and when to split the files may depend on when the insurer received notice of the claim. If it is a ―first notice‖ lawsuit the insurer, due to timing issues, may not yet recognize any potential conflict. Under these circumstances, the file might not be split until much later when a conflict arises regarding defense and coverage.

The insurer should issue a reservation of rights, and retain defense counsel to respond to the complaint. Regardless of the timing, the safer course, if potential for coverage exists, is to split the file.

How soon should a screen be erected? If done too soon, time and resources are arguably wasted. If done too late, bad faith may be alleged by the insurer seemingly having allowed a conflict of interest to arise and be maintained. The best suggestion is to err on the side of caution and split the file sooner rather than later – and better late than never.

What kind of communication does a screen prohibit? Does a screen bar all communications or just those which could inure to a policyholder's disadvantage? Does a "gag order" prevent the liability adjuster and the coverage adjuster from talking at all? If they discuss the case status or the progress of settlement negotiations, does that breach the screen? Screens are porous; they allow air – and sound waves – to pass through. Even the Great Wall of China extends only so high up into the air.

Do *all* coverage questions require a screen? Perhaps not. For example, a naïve or clueless insured files an auto claim with the homeowner's carrier. Or a retailer submits what is clearly a workers' compensation loss to its general liability insurer. In both cases, the adjusters view coverage (or no coverage) as a slam dunk. Is the adjuster – under penalty of a bad-faith lawsuit – to split the file? Do these scenarios differ from a question whether the insured's late notice materially breached the policy conditions?

How high up the organizational chart does a screen go? For example, the insurer splits or bifurcates the claim file, with one adjuster handling liability and the other coverage, but both report to the same claims manager. Is that legitimate? Is there still a bad faith risk by having both adjusters report to the same boss? Does this taint or compromise the screen? How high up the organizational chart – vertically – must a screen extend?

IV. Intersection of defense and coverage functions

While splitting the file may assist the insurer in handling conflicts of interest so that the interests of its insured are protected, courts have held that the failure so split the file arguably is not per se improper. More often than not, this result occurs when the insurer hires independent *Cumis* counsel solely to represent the interest of the insured in the underlying action even though a single claims adjuster is employed to handle both the defense of the liability case as well as the coverage action.

But insurers do not always split files, and their failure to do so gives rise to bad faith. Policyholders' lawyers insist that insurers that do not split claim files in appropriate cases breach their duties to their insureds, violate industry custom and practice, and violate state unfair claims settlement practices acts. They base these arguments on case law holding that insurers cannot employ the same defense counsel representing the insured to develop coverage defenses or use information wrongfully obtained by a defense lawyer to deny coverage.

For example, the Fifth Circuit has held,

> "In addition to the issues of fact concerning breach of the duty to defend discussed above, [the insured] has demonstrated a number of other issues of fact: whether [the adjuster] was involved in both claims analysis and coverage analysis, prejudicing the insured with a conflict of interests; whether [the insurer] adequately separated claim-handling responsibility from coverage analysis; whether [the adjuster] remained silent about a conflict of interests while developing a strategy of non-coverage; whether [the adjuster] ever told [defense counsel] that she and [another adjuster] were involved in coverage, though she instructed him to send them both status reports containing confidential information received from the client, detrimental to coverage; whether [the other adjuster] relied on confidential information from [defense counsel's] status reports to develop a coverage defense or in deciding to hire independent coverage counsel; whether coverage counsel conducted any investigation besides the one performed by [defense counsel]; whether the entire claims file was forwarded to [coverage counsel] to formulate its non-coverage position; (and) whether third-party defendants relied on [defense counsel's] legal defense against the underlying claims to formulate a strategy to defeat coverage in this action .
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> "A fact finder might consider that coverage analysts having unfettered access to privileged information from appointed defense counsel in the presence of an undisclosed conflict support the tort claims asserted herein."
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> *Twin City Fire Insurance Company v. City of Madison, Mississippi*, 309 F.3d 901 (5th Cir. 2002)

What constitutes "independent counsel" has not been clearly resolved. In some cases, an attorney hired by the insurer with no prior connection with the insurance company may qualify as independent. In others, mere instruction from the insurer that the attorney is to represent the insured only and not the insurer and should not be involved in the coverage question sufficed. Still other courts recognize independent counsel only as counsel of the insured's choice.

Even the method for selection of independent counsel varies among jurisdictions. Some courts hold that the insured has the absolute right to select independent counsel. Even courts recognizing the insured's right to select independent counsel, however, acknowledge that the right is not unbridled. The obligation of good faith, which the insured also bears, requires that the insured "act reasonably in selecting as independent counsel an experienced attorney qualified to present a meaningful defense and willing to engage in ethical billing practices susceptible to review at a standard stricter than that of the marketplace."