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A Cautionary Tale – Should an Insurer Split the File Between Coverage and Liability?

by Andrew L. Smith

A sometimes forgotten issue in the world of insurance defense is whether an insurer should divide or "split" the claims file between coverage and liability issues, and if so, at what stage this decision should be made. Throughout the handling of a claim, insurers must remember: (1) to always act in the best interest of the insured; and (2) to avoid actual and potential conflicts of interest with the insured. The process of splitting the file and assigning two separate claims adjusters and multiple counsel can be burdensome and expensive. However, do not be surprised if more and more courts soon begin to hold the failure to do so amounts to bad faith on the part of the insurer.

No court in the United States has presently ruled an insurer is required to split the file between coverage and liability. Nevertheless, various courts are beginning to touch upon the issue of splitting the file in the context of bad faith allegations.

While many plaintiff's attorneys have yet to address this potential issue, do not be surprised if more and more savvy, tactful plaintiff's counsel begin to pursue bad faith, fraud, estoppel, violation of state consumer protection statutes, and other allegations against insurers for the alleged failure to split the underlying claims file between coverage and liability issues. This issue is certainly a potential consideration in many large property damage and personal injury claims, as well as in the complex world of construction defect litigation. In addition to pursuing affirmative claims, plaintiffs may also request a court to estop the insurer from raising viable coverage defenses.

Why is Failure to Split the File a Possible Problem?

Courts analyzing the issue have found three sources of conflict of interest when an insurer defends the insured under a full and mutual Reservation of Rights:

1. The insurer may maneuver its defense to increase the chances of the plaintiff's verdict under an uninsured theory;

2. The insurer may not offer the best defense if the insurer knows it can deny coverage later on, or the loss ultimately will not be covered under the policy; and

3. The insurer through discovery on the liability defense claim may gain access to privileged or confidential information that can later be used in its coverage defense.

See, e.g., Armstrong Cleaners, Inc. v. Erie Ins. Exchange, 364 F.Supp.2d 797, 814 (S.D. Ind. 2005); *CHI of Alaska, Inc. v. Employers Reinsurance Corp*., 844 P.2d 1113 (Alaska 1993); *Nandorf, Inc. v. CNA Ins. Co.*, 134 Ill. App.3d 134 (1st Dist. 1985); Steven Plitt & Steven J. Gross, Splitting Claim Files: Managing the

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Concern for Conflicts of Interest Through Use of Insurance Company Conflict Screens, 32 No. 6 Ins. Litig. Rep. 151 (Apr. 26, 2010).

To alleviate these potential concerns, many insurers have begun to split a claims file between coverage issues and liability issues and assign separate claims adjusters to handle each portion of the claim. Indeed, this step, if successfully undertaken in a timely manner, can avoid possible conflicts of interest between the insurer and the insured and also alleviate even the appearance of impropriety.

For instance, consider the following examples of investigation steps and actions taken in common claims and insurance defense litigation. Many times, a declaratory judgment action may be filed by the insurer based on coverage terms, conditions, provisions, or exclusions limiting coverage or obviating coverage for a claim completely. Once the decision to file such a declaratory judgment is made, a savvy plaintiff's attorney could contend a conflict of interest is created. Indeed, at that point the insurer is seeking to avoid coverage under the contractual policy of insurance to the detriment of the insured. The attorney could at the very least contend the insurer should have split the file between coverage and liability based on the appearance of a conflict of interest against the named insured. What matters is the potential for a perceived conflict of interest involving coverage under the policy, whether or not an actual conflict of interest exists at any point in time.

As another example, consider what questions should be permissible for the insurer to ask early on in the information gathering stage of any claim. Certainly insurers have a right to gather information and gain an understanding of the background facts of any incident. But at what stage is the insurer truly asking questions geared towards assessing liability versus assessing possible coverage defenses? What questions are truly relevant to benefit the insured as opposed to gathering information to file a declaratory judgment action or preparing a coverage decision letter to deny coverage? And at what stage in the claim investigation and this information gathering stage should the insurer consider splitting the file between coverage and liability passed on the possibility of a conflict of interest? These are very claim-specific and tricky issues insurers need to begin taking very seriously.

These are all issues that need to be carefully considered by the insurer and retained counsel. Knowledgeable insurers and insurance defense counsel need to consider the issue of splitting the file. At the very least, splitting the file when a conflict of interest becomes apparent constitutes a best practice and can avoid one possible avenue for plaintiff's counsel to allege bad faith down the road.

Overview of Existing Case Law

Thus far, the majority of cases addressing the subject have rejected to impose a duty on the part of the insurer to split the file. In *State Farm Fire & Casualty Co. v. Superior Court*, 265 Cal. App.3d 1222 (Cal. Ct. App. 1989), a California court of appeals held as long as the insured was provided independent counsel, a single claims adjuster could handle both the defense and coverage claims. Under a homeowner's policy, the insured argued State Farm should be required to create a "veritable wall" between the coverage and liability claims. The court disagreed and held no such duty was required and the independent counsel provision in the policy adequately protected the interests of the insured. Further, the court noted the costs to State Farm of such separation "would be unreasonable and impractical." *Id.* at 1228.

Likewise, in *Employers Ins. of Wausau v. Albert D. Seeno Constr. Co.*, 945 F.2d 284 (9th Cir. 1991), the Ninth Circuit Court of Appeals held no California cases have ever required an insurer to split the file, and the fact other insurers

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voluntarily choose to split the files does not create a requirement for all insurers. *See also Flynn's Lick Comm. Center & Volunteer Fire Dept. v. Burlington Ins. Co.*, 2003 WL 21766244 (Tenn. Ct. App. 2003) (insurer did not act in an unfair or deceptive matter where insurer split the file, but there was still crossover between coverage and liability files).

Other courts have found the failure to split the file may amount to evidence of bad faith on the part of the insurer. By way of example, in *Twin City Fire Ins. Co. v. City of Madison*, Mississippi, 309 F.3d 901 (5th Cir. 2002), the Fifth Circuit Court of Appeals held the insurer's denial of coverage could be estopped due to its actions during the claims handling process and the failure to split the file could constitute evidence of bad faith. On appeal, after the trial court ruled there was no coverage for the claim at issue, the appellate court accepted the question of whether there was a conflict of interest since counsel appointed by the insurer represented the insured in the coverage dispute, but the insurer also sought to avoid coverage. Additionally, counsel reported to both the insurer's adjuster and the insured's adjuster. Thus, the insured argued that the insurer "improperly utilized information from [the defense counsel's] claim file to develop Twin City's position of non-coverage." *Id.* at *18.

The court in *Twin City* ultimately held this conflict of interest "may rise to estoppel or liability for breach because it concerns the duty to defend." *Id.* at *10. The court found there were genuine issues of material fact in regards to both the coverage dispute and the bad faith claim.

Again in *Armstrong Cleaners, Inc. v. Erie Ins. Exchange*, 364 F. Supp.2d 797 (S.D. Ind. 2005), the U.S. District Court for the Southern District of Indiana ruled even if the file was split at the beginning of the case, if the separation failed to extend past the front-line claims adjusters, this may be evidence of improper claim handling and bad faith. In this case, the insurer appointed two claims adjusters for both the coverage and defense files after agreeing to defend under a Reservation of Rights. Instead of allowing the insureds to choose independent counsel, the insurer insisted on choosing defense counsel.

The *Armstrong Cleaners* court held the insurer's procedure of separation of the adjusters did not go far enough as the separation did not extend to senior supervisors of the adjusters, thus failing to avoid the possible conflict of interest. The court further noted the adjuster of the defense claim had the Reservation of Rights letter and was presumed to understand the coverage issues. For these reasons the court reasoned the files were not adequately split between coverage and liability.

Conclusion

Be on the lookout for a new, trending issue of whether or not to split the claims file between liability/defense and coverage issues. When evaluating whether to split the file, insurers should consider the following factors courts have considered in assessing bad faith allegations:

1. Was the claims adjuster involved in both the liability/claims analysis, as well as the coverage analysis?
2. Did the insurer take appropriate precautionary measures to separate liability handling and coverage analysis?
3. Did the claims adjuster inform the insured about conflicts of interest while also developing possible coverage defenses from the same information?
4. Did the claims adjuster induce, request, or permit defense counsel to disclose confidential information adversely affecting the coverage analysis?

5. Did the insurer rely on any confidential information about the insured from defense counsel in its analysis of coverage defenses?

6. Did the insurer use defense counsel's information and analysis to develop coverage defenses?

7. How late in the game did the insurer first consider splitting the file? Upon notifying the insured of the claim investigation? Upon issuing the Reservation of Rights letter? After suit was filed?

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