DEFENSE AND COVERAGE CAN THEY CO-EXIST?

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Insurers, insurance defense counsel and coverage counsel are constantly faced with the dilemma of whether liability and coverage issues may co-exist in one claim file, what information and knowledge can be shared between the respective attorneys and claim-handlers, and whether the claims file should be "split." When and how to "split" the file will necessarily impact the insured. 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 to the insurer.

There are no easy answers to these sticky issues. The "correct" answers may vary, to some degree, by jurisdiction, and by the applicable standard for determining whether an insurer has handled a claim in "good faith." Understanding the issues is the first step to an insurer and an insured protecting oneself from future ethical and legal problems.

When investigating claims and/or defending an insured against them, insurers are oftentimes faced with both "defense" issues (pertaining to liability and damages) as well as investigating and determining whether, and to what extent, the insured has applicable coverage. These two issues may be in conflict and not in the insured's best interests. It is important that the insured, whether an individual or a corporation, understand this conflict and know how to ensure it is protected.

One such protection, is requiring the insurer to "split the file," assigning one claim-handler to tend to the insured's defense and another to tend to the insurer's coverage investigation and determination. Many insurers do this on their own accord – it is good claims handling practice and ensures a peaceful co-existence.

It is a basic principle of law – liability insurance companies owe a duty to defend and investigate any potentially covered claim, against an insured. The obligations of the insurer pre-suit, however can be different than post-suit. Pre-suit, generally, there is no conflict between coverage and defense interests. If there is no immediate or apparent conflict, an adjuster can investigate coverage and liability while reserving its rights. At this initial stage, the adjuster

can accept or deny the claims. If the insurer has timely advised the insured of potential coverage issues and reserved its rights, the insurer is entitled to request and use any information provided by its insured in order to investigate liability and coverage. The insured generally has a contractual duty to cooperate with its insurer's investigation.

It is when suit is filed that the conflict can occur. Liability insurance companies generally have an absolute duty to defend their insureds against claims where it is clear that the claims are covered under the language of the policy. Likewise, liability carriers have no duty to defend against claims that are clearly outside the coverage afforded under the insured's policy. However, when coverage is less than clear, such as "where the allegations of the complaint are covered by the liability policy, but the facts are such that it may very well develop at trial that the conduct of the insured was not covered by the policy, or where "the allegations of the complaint themselves are ambiguous so that read in one way there is no coverage, but read in another there is, "[u]nquestionably, the insurance carrier has a right to offer the insured a defense, while at the same time reserving the right to deny coverage even if a judgment is rendered against the insured." *Moeller v. Am. Guar. & Liab. Ins. Co.*, 707 So. 2d 1062, 1069 (Miss. 1996).

Where the carrier defends its insured under a reservation of rights, various conflicts of interest may arise between the insurer and its insured:

(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 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 Ins. Exch., 364 F. Supp. 2d 797, 814-15 (S.D. Ind. 2005) (citing *CHI of Alaska, Inc. v. Employers Reinsurance Corp.*, 844 P.2d 1113, 1116, 1118 (Alaska 1993)). If these conflicts of interest are not handled properly by the insurer, the result may be estoppel from denying liability coverage or even liability for bad faith claim handling. *See Twin City Fire Ins. Co. v. City of Madison, Miss.*, 309 F.3d 901, 907-09 (5th Cir. 2002) (Miss.). It is incumbent upon the insured to recognize these potential pitfalls and to take whatever steps it may legally to protect itself.

When the insurer defends the insured under a reservation of rights, it is important for the insured to recognize any potential conflict and for the insurer to promptly deal with these conflicts. It must be noted, that the assumption of a defense under a reservation of rights, is not in and of itself, in many states, considered to be a conflict of interest.

In states which require the insurer to afford the insured the right to select independent defense counsel, the insurer should promptly notify the insured accordingly. Some jurisdictions impose an additional requirement on the insurer to notify the insured of the conflicts of interests created by the insurer's defense pursuant to a reservation of rights. *Marilyn Cas. Co. v. Nestle*, 2010 WL 3735756 (S.D. Miss. 2010); *Liberty Mut. Ins. Co. v. Tedford*, 658 F.Supp.2nd 786 (N.D. Miss. 2009). Even in states which do not require the insurer to allow the insured the right to select independent defense counsel, the insurer nevertheless must relinquish control of the defense of the case to the insured's defense attorney. In order to avoid these conflicts many insurers "split" their files so that their coverage files are handled separately from their defense files. *See, e.g., Harleysville Lake States Insurance Company v. Granite Ridge Builders, Inc.*, No. 1:06-CV-00397, 2008 WL 4935974, at *11 (N.D. Ind. Nov. 17, 2008); *World Harvest Church, Inc. v. Guideone Mutual Insurance Company*, No. 1:07-CV-1675-RWS, 2008 WL 5111218, at *1 (N.D. Ga. Dec. 2, 2008)

A. Once suit is filed and the file is split, it is important to understand the roles each person is playing with respect to the claim, coverage and the suit. A lack of understanding of these roles can have potentially devastating results for the insurer and the insured alike.

The defense adjuster should not participate in coverage determinations, and the coverage adjuster should not participate in the direction of the defense of the underlying claims. However, the coverage adjuster may request information from the defense adjuster to the extent that such information is public or on the official record (e.g., court filings, deposition transcripts, expert reports, etc.). Assuming that independent counsel is employed, defense counsel should not disclose to the insurer (including the defense adjuster) confidential information that could result in a denial of coverage to the client, the insured. However, where the file is split, if defense counsel provides such confidential information to the defense adjuster, the defense adjuster should not pass the information along to the coverage adjuster. (That stated, where independent counsel voluntarily discloses such confidential information to the adjuster where a file is not split, the sole adjuster may not be precluded from using the information in formulating the insurer's coverage position). *See, e.g., Travelers Indem. Co. v. Page & Assocs. Const. Co.*, No. 07-01-0022-CV, 2002 WL 1371065, at *10 (Tex. Ct. App. June 25, 2002); *State Farm Fire & Cas. Co.*, 216 Cal. App. 3d 1222, discussed *supra*.

With respect to settlement negotiations in split file cases, the liability adjuster should make independent recommendations to the insurer for settlement authority. The coverage adjuster has the right and duty to either accept the liability adjuster's settlement recommendation or to modify or reject it consistent with the insurer's coverage analysis. Both adjusters can exchange opinions on settlement, but the coverage adjuster should have the ultimate responsibility to take an accurate position on coverage, be fair to the insured, and protect the insured's uninsured interests.

An insurer is charged with a duty of utmost good faith and fair dealing with its insured. However, that does not relieve the insured of its own obligations to protect itself. Coverage and defense can peacefully co-exist so long as the insurer and the insured are aware of the pitfalls and take an active role in avoiding the conflicts – split the file within the insurance company, retain independent counsel and know the roles of each player.

Ms. Faust, a partner at Roetzel & Andress, focuses her national practice on insurance coverage analysis, counseling and litigation, including first party and third party matters, employment liability coverages, construction, life and disability as well as professional liability issues. She counsels and defends clients on bad faith cases. She also has extensive practice handling appellate cases from advising trial counsel to briefing and arguing before the Ohio state and Federal Courts of Appeal. Ms. Faust has handled trial and appellate work in Ohio's state and federal courts. She has argued in courts of appeals throughout the country. She has partnered with a wide range of clients, including major corporations nationwide.