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Neil, Dymott, Frank, McFall
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San Diego, CA
619-238-1712
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MARTHA (MARTY) J. STREEPER
11812 N 56th Street
Tampa, FL 33617
mstreeper@thefederation.org
813-983-0022
813-988-5837 Fax

LIAISON-QUARTERLY
James A. Gallagher, Jr.
Gallagher & Faller
New York, NY
jgallagher@ggfc-law.com

FDCC QUARTERLY EDITORIAL OFFICE
Marquette University Law School
Eckstein Hall, PO Box 1881
Milwaukee WI, 53201-1881
414-288-5375
414-288-5914 Fax
patricia.bradford@marquette.edu

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White and Williams, LLP
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2011-2013 DIRECTORS
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PUBLICATIONS
LATHA RAGHAVAN
Goldberg Segalla LLP
Albany, NY
lraghavan@goldbergsegalla.com

EDITOR-FLYER
GREGORY A. WITKE
Patterson Law Firm
Des Moines, IA
gwitke@pattersonfirm.com

CLE COORDINATOR
FRANCIE BERG
3714 22nd Avenue South
Minneapolis, MN, 55407
fberg@mahoney-law.com
612-339-5863
612-339-1529 Fax

VICE PRESIDENTS
BRUCE D. CELEBREZZE
Sedgwick LLP
San Francisco, CA
bruce.celebrezze@sedgwicklaw.com

WALTER DUKES
Dukes Dukes Keating Faneca PA
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Boehm, Brown, Fischer, Harwood,
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sbharwood@boehmbrown.com

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Kansas City, MO
kreamer@bscr-law.com

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elorell@gordonrees.com

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hm@psh.com

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W. MICHAEL SCOTT
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mscott@bmpllp.com

EDITOR-WEBSITE
DAVID M. FUQUA
Fuqua Campbell, PA
Little Rock, AR
dfuqua@fc-lawyers.com

FDCC HISTORIAN
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Fulbright & Jaworski ILP
Houston, TX
spate@fulbright.com

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Handling Liability and Coverage Claims: Splitting Files, the Duty to Defend, and Ethical Considerations for Lawyers

Edward "Ned" Currie, Jr.
Joseph W. Gill
John G. Farnan
Laura "Megan" Faust

I. Introduction

Liability insurers are contractually obligated to defend and indemnify their insured's covered claims,[1] but have no duty to indemnify or defend against claims that are clearly excluded by the insured's policy. The insurer's duty to defend is broader than its duty to indemnify.[2] Therefore, a prudent insurer will frequently defend its insured pursuant to a reservation of rights or non-waiver agreement, which permits the insurer to fulfill its duty to defend the insured without waiving its right to later dispute coverage.[3]

A reservation of rights defense virtually always creates a conflict of interest between the insurer and its insured.[4] For example, in the case of an automobile accident, coverage may or may not exist when an insured driver injures a third party. If the injury is caused by the

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[1] Douglas R. Richmond & Darren S. Black, *Expanding Liability Coverage: Insured Contracts and Additional Insureds*, 44 Drake L. Rev. 781, 792 (1996).

[2] *Id*. The duty to defend "is triggered by a complaint that alleges facts which, if established, would support liability." David N. May, *In House Defenders of Insureds: Some Ethical Considerations,* 46 Drake L. Rev. 881, 898 (1998).

[3] Reservation of rights and non-waiver agreements are discussed in Part II.C., *infra*.

[4] Karon O. Bowdre, *Enhanced Obligation of Good Faith: A Mine Field of Unanswered Questions After L & S Roofing Supply Co.*, 50 Ala. L. Rev. 755, 759 (1999).

Edward "Ned" Currie, Jr. is a founding member of Currie Johnson Gaines & Myers, P.A. which has offices located in Jackson and Biloxi, Mississippi. Mr. Currie is a former Adjunct Professor of Law at the Mississippi College School of Law. He is also a frequent lecturer on trial and insurance topics. Mr. Currie's practice covers the range of insurance defense matters. He has tried numerous significant cases in the fields of personal injury, large loss claims, insurance coverage matters, and bad faith. Mr. Currie has served in many leadership positions in local, state and national bar associations. He is currently the Vice President and a member of the Board of Directors of the National Lawyers Association. Mr. Currie is the past president of the Federal Bar Association, Mississippi Chapter and the Mississippi Defense Lawyers Association. He is also a member of the Federation of Defense & Corporate Counsel, the International Association of Defense Counsel, and the Council on Litigation Management. Mr. Currie is listed in The Best Lawyers in America and he was named Lawyer of the Year for 2012 for Insurance Law in the Jackson, Mississippi area.

driver's negligence, coverage probably exists. But if the driver ran the plaintiff off the road on purpose, coverage is excluded because the insured acted intentionally.[5] The insurer and the insured would both benefit from a finding that the insured is not liable. If the insured *is* found liable, however, the insured would prefer that he is liable for negligence—which is covered by the policy—while the insurer would prefer a finding that the insured acted intentionally—which is excluded by the policy—so that it does not have to indemnify the insured.[6] "Further, when defending covered and potentially non-covered claims, the insurance company through defense counsel representing the insured may learn confidential information from the insured that could affect the coverage question."[7]

When coverage is uncertain or disputed, insurers must address three overlapping considerations. First, the insurer must decide whether to "split the file." More specifically, the insurer must decide if and when it should have one claims adjuster investigate and handle the question of whether (and to what extent) the insured is liable to the plaintiff, while as-

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[5] *See, e.g.*, Lee R. Russ & Thomas F. Segalla, 7A COUCH ON INSURANCE. § 103:25 (3d ed. 2011) ("Many liability policies specifically exempt from coverage damage which is 'expected or intended.' Such exclusions are valid. In this context, 'expected' means 'considered more likely than not to occur' rather than 'foreseen as being possible.'").

[6] Bowdre, *supra* note 4.

[7] *Id*. at 759-760.

Joseph W. Gill is an associate in the Jackson, Mississippi office of Currie Johnson Griffin Gaines & Myers, P.A. He was admitted to practice in Mississippi after receiving his law degree from the University of Mississippi School of Law in 2007. While in law school, Mr. Gill was an Associate Editor for the Mississippi Law Journal, Vice Chairman of the Moot Court Board, and a member of Phi Delta Phi and the Christian Legal Society. Mr. Gill is a recipient of the Mississippi Bar Foundation Scholarship and American Jurisprudence Awards in Torts, Evidence, and Family Law. He is also a member of the Order of Barristers. Mr. Gill primarily practices in the areas of insurance coverage and personal injury defense.

signing another claims adjuster to investigate whether a successful coverage defense can be asserted by the insurer. Second, the insurance company must anticipate that someone may seek discovery of the insurance company's files if the insured (or the insured's assignee) files a bad faith claim or a similar type of lawsuit against the insurer. Third, attorneys who are involved in cases where coverage is unclear must be especially careful when assessing their ethical obligations in the context of the tripartite relationship between the insurer, the insured, and defense counsel. Duties of confidentiality and loyalty and obligations regarding client communications must be satisfied. Those goals can be more readily achieved if the insurance company makes good decisions regarding how and when to split files between indemnity and coverage and maintains adequate separation between the files as the claim progresses towards resolution.

Knowing how to effectively manage conflicts of interest is crucial because coverage questions can arise at any point between when the insurer first receives notice of a claim until the claim is resolved. The resolution of coverage issues may not occur until the insurer or insured seeks a declaratory judgment, a trial on the underlying claim occurs, or possibly even later when bad faith litigation against the insurer is concluded. Depending on the jurisdiction, an insurer who fails to effectively manage these inevitable conflicts may be estopped to deny coverage and forced to indemnify the insured, or could be held liable for damages for bad faith breach of the insurance contract.[8]

This Article will provide insurers and defense counsel with practical advice for how to effectively manage conflicts of interest. Part II of this Article will introduce the typi-

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[8] *See, e.g.,* Allan D. Windt, *Bad faith and punitive damages*, 2 Insurance Claims & Disputes § 9:26 (5th ed. 2011).

John G. Farnan is a partner in the Cleveland office of Weston Hurd LLP. His practice focuses largely on insurance coverage and related litigation as well as defense of significant personal injury and wrongful death matters and construction litigation. Mr. Farnan lectures and publishes frequently on insurance coverage matters. He is a board member and the current and past president of the National Lawyers Association. Additionally, he served the Ohio Association of Civil Trial Attorneys as a board member from 2003 to 2009 and served as Chair of the Insurance Section from 2004 to 2009. Mr. Farnan is a member of the Federation of Defense & Corporate Counsel. In addition to being named an Ohio Super Lawyer for Appellate Law in 2004 and for Insurance Coverage every year since 2007, Mr. Farnan has been listed in the Best Lawyers in America in 2011 and 2012 for Personal Injury Litigation.

cal conflicts of interest that arise when an insurer disputes coverage, and explain how the insurance company should handle its duty to defend the insured. Part III provides practical advice regarding splitting files and assigning duties to claims handlers so that one file contains information regarding the insured's potential liability and defenses and the other file contains information regarding coverage defenses that the insurer may assert. Part IV addresses discovery of the insurance company's files. Finally, Part V will provide an overview of ethical considerations for defense counsel and explains how splitting the file into an "indemnity/defense" file and a "coverage" file can prevent or at least minimize conflicts of interest.

II.
DEFENDING THE INSURED WHILE RESERVING THE RIGHT TO DENY COVERAGE AT A LATER DATE: CONFLICTS OF INTEREST

Liability insurance companies owe their insured a duty to defend their insured against all potentially covered claims.[9] However, the scope of this duty may vary depending on the phase of the lawsuit. This section will discuss the insurer's obligations before and after a lawsuit has commenced, and tactics that protect insurers when conflicts of interest arise.

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[9] Insurers also owe their insured a duty to investigate all claims. *See, e.g.,* Lee R. Russ & Thomas F. Segalla, 14 COUCH ON INSURANCE § 198:28 (3d ed. 2011) ("An insurer's duty of investigation is generally construed to require sufficient investigation to determine coverage under the policy in question. The duty therefore requires that the insurer investigate before it denies or settles a claim, and before it makes a determination as to its duty to defend.").

Laura "Megan" Faust is a partner in the Akron office of Roetzel & Andress. Ms. Faust focuses her national practice on insurance coverage analysis; counseling and litigation, including first party and third party matters; employment matters; and construction, life, disability, and professional liability insurance issues. She has partnered with a wide-range of clients, including major corporations, nationwide and she also counsels and defends clients on bad faith cases. In addition to extensive trial work throughout Ohio, Ms. Faust has extensive experience handling appellate cases including advising trial counsel and briefing and arguing state appeals in Ohio and federal appeals before the Sixth and Eleventh Circuit Courts of Appeal. Ms. Faust is a member of the Federation of Defense & Corporate Counsel, the Council on Litigation Management, the Order of the Barristers, the Professional Underwriting Society (PLUS), USLAW Network, the Ohio Association of Civil Trial Attorneys, and the Ohio Women's Bar Association. She is a Board Member for The Arthritis Foundation, Great Lakes Region of Northeast Ohio; the College of Wooster, W Association; and the Greater Cleveland Council of Figure Skating Clubs. Ms. Faust has been selected as an Ohio Super Lawyer in Insurance coverage (2009-2012), Top 50 Female Lawyers in Ohio (2010-2011), Top 25 Female Lawyers in Cleveland (2009), Rising Star (2005-2006). She was also selected for inclusion in The Best Lawyers in America for Insurance Law and Professional Malpractice Law for 2007-2012.

A. *The Insurer's Obligations Before a Lawsuit Has Commenced*

Before being sued, an insured may notify the insurer of an accident that may give rise to a claim under a policy. At this point, there is no conflict between the insurer's obligation to defend and indemnify the insured and its position that the potential claim is not covered by the policy. The insurer may investigate the accident for the purposes of determining whether its insured is potentially liable for damages and whether its duties to indemnify or defend the insured will attach. One claims handler may be assigned to investigate all of these issues and that handler can inform the insured whether the claim is covered under the policy.

B. *The Insurer's Obligations After a Lawsuit Has Commenced*

Once a lawsuit is filed against the insured—especially if the complaint is the first notice of the claim—the insurer may not have sufficient time to investigate whether the claim is covered. Instead, the insurer will have to decide whether to provide a defense based on the

allegations in the complaint. As a practical matter, this means that the insurer will usually be obligated to defend the claim. "A liability insurer must . . . defend its insured if the plaintiff's allegations are even arguably or potentially within the scope of coverage."[10] Generally, any doubts regarding coverage are resolved in favor of the insured, and judicial decisions exhibit several rules of interpretation that illustrate this preference:[11]

> First, the complaint against the insured will be "liberally construed." Second, ambiguous language in the written insurance policy will be construed against the drafter of the policy - invariably the insurer. Third, where appropriate, an insurance policy may be viewed as an adhesion contract, and in such cases the reasonable expectation of the insured will prevail over the express terms of the policy. In any case, the final determination of the duty to defend is said to be a matter of law for the courts to decide.[12]

Therefore—unless it is absolutely clear that a particular claim is not covered—the prudent course of action is to undertake the defense of the insured, pursuant to a reservation of rights or non-waiver agreement.

C. *Reservation of Rights and Non-Waiver Agreements Can Protect an Insurer Both Before and After a Lawsuit Has Commenced*

Normally, an insurer who undertakes the defense of its insured waives its right to later contest coverage.[13] However, an insurer can preserve its right to contest coverage by having the insured sign a *non-waiver agreement* or by sending the insured a *reservation of rights* letter in a timely manner.[14] A reservation of rights letter informs the insured that the insurer will undertake the defense of the insured, but reserves its right to challenge coverage.[15] A reservation of rights is unilateral: in the typical case, the insurer sends a letter to the insured that explains the reason it disputes coverage, and in states requiring *Cumis* counsel, informs

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[10] *Id*.

[11] Guy William McRoskey, *The Rule in a Contribution Action Between Third-Party Insurers Wherein the Plaintiff Insurer Seeks Reimbursement of Defense Costs from the Defendant Insurer After a Collusive Fraud on the Plaintiff Insurer Under California Law*, 36 SAN DIEGO L. REV. 797, 810–811 (1999).

[12] *Id*.

[13] May, *supra* note 2, at 898 ("If an insurer silently accepts the duty to defend, that acceptance is generally seen as an acknowledgment of coverage." *Id.*).

[14] Gregory P. Deschenes & Kurt M. Mullen, 1-11 NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE 11.11[2] (2011).

[15] Bowdre, *supra* note 4 at 755 n.4.

the insured of its right to obtain independent counsel at the insurer's expense.[16] In contrast, a non-waiver agreement is a bilateral contract between the insurer and insured "in which the *insured acknowledges* that the insurance company does not waive its right to challenge coverage."[17] Both methods specifically delineate the reasons the insurer currently has doubts about coverage and notify the insured that it will be informed if other reasons to deny coverage are discovered in the future,[18] and both methods can be used either before or after a lawsuit is commenced.[19]

In general, non-waiver agreements and reservation of rights letters have the same effect[20] and serve the same purpose: they allow the insurer to investigate claims and provide a defense to the insured without foregoing its right to later dispute coverage. Both are favored by courts because they permit an expeditious resolution of tort litigation.[21] One court remarked that

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[16] *Id. Cumis* counsel refers to counsel chosen by the insured to represent its interests exclusively, where a conflict of interest exists, while being funded by the insurer under a reservation of rights. The term derives from *San Diego Navy Fed.Credit Union v. Cumis Ins. Society, Inc.*, 208 Cal. Rptr. 494 (Ct. App. 1984). A significant number of courts in other jurisdictions have followed the precedent set in *Cumis*. *See, e.g.,* CHI of Alaska, Inc. v. Employers Reinsurance Corp., 844 P.2d 1113, 1120 (Alaska 1993) (citing to *Cumis*, among other cases, as authority for the proposition that other jurisdictions require the insurer have the right to select independent counsel when the insurer represents the insured under a reservation of rights); Arden J. Olson, *When Will Oregon Courts Face the "*Cumis *Counsel" Question?: Insurance Counsel Conflict of Interest*, Or. St. B. Bull., August/September 2008, at 36 (stating that *Cumis* is the "leading case" on situations where the lawyer may have a conflict of interest by representing both the insured and the insurer). *See also* Gregory P. Deschenes & Kurt M. Mullen, 1-11 New Appleman Insurance Law Practice Guide 11.11[1][e] (2011).

[17] Bowdre, *supra* note 4 at 755 n.4 (emphasis added).

[18] It is important that the insurer provides thorough reasons for doubting coverage; giving incomplete reasons for doubting coverage could later be construed as a waiver of the coverage defenses that are not specified. *See, e.g*., Founders Ins. Co. v. Olivares, 894 N.E.2d 586, 594 (Ind. Ct. App. 2008); Royal Ins. Co. v. Process Design Assoc., Inc. 582 N.E.2d 1234, 1242 (Ill. App. Ct. 1991).

[19] For example, before an investigation begins, a cautious insurer will send the insured a reservation of rights letter explaining that the insurer's investigation of the facts reported by the insured is not a waiver or a relinquishment of the insurer's right to subsequently contend that the situation under investigation is not covered by the policy. Similarly, where an insurer must base its coverage decision on the allegations in a complaint, in most cases the insurer should provide the insured with a defense and can also reserve its right to deny coverage at a later date. The timing of the issuance of a reservation of rights or non-waiver agreement is critical. If an insurer delays in the issuance of a reservation of rights or assumes the defense absent a reservation it may be deemed to have waived its coverage defenses, particularly if an insured can later show prejudice thereby.

[20] Draft Systems, Inc. v. Alspach, 756 F.2d 293, 296 n.2 (3d Cir. 1985).

[21] *Id.* at 296.

> [i]n many instances, the validity of policy defenses requires protracted investigation. If coverage is not determined at the time the claimant files suit, both the insured and the carrier are at a disadvantage. If the insurance company fails to provide a defense, the claimant may enter a default judgment against the insured. If, however, the company affords representation without some understanding with the insured, the carrier may later be estopped to assert an otherwise valid coverage defense. From the insured's standpoint, the prospect of a default judgment is unacceptable, as is the perhaps unnecessary expense of retaining competent counsel on short notice.
>
> To accommodate the concerns of both the insured and the carrier, the practice of using a non-waiver agreement has developed. This practice not only serves the interests of the parties to the insurance policy but is helpful to claimants and the courts as well because the claimant's tort litigation may proceed expeditiously. Indeed, in most instances, the coverage issues are amicably resolved along with the tort claims. It is unlikely that such settlements would be reached if the carrier could not reserve its right to ultimately disclaim liability.[22]

D. *The Insured's Right to Independent Counsel*[23]

When an insurer defends its insured under a non-waiver agreement or a reservation of rights, three conflicts of interest may potentially arise:

> (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.[24]

In some states, the insurer must permit the insured to select his or her own individual counsel with the fees and costs to be paid by the insurer whenever one of these conflicts is potentially present.[25] As noted above, independent counsel selected by the insured is commonly termed *Cumis* counsel.[26]

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[22] *Id.* (citations omitted).

[23] Note that not all states require insurers to provide independent counsel, *i.e.*, *Cumis* counsel, to their insureds when defending under a reservation of rights. As such, the information provided within this section relates only to those states requiring the hiring of *Cumis* counsel.

[24] 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)).

[25] Liberty Mut.Ins. Co. v. Tedford, 658 F. Supp. 2d 786, 794 (N.D. Miss. 2009).

[26] *See supra* note 16.

1. The Insurer Must Inform the Insured of its Right to Independent Counsel

In some states requiring the hiring of *Cumis* counsel, the insurer must inform its insured of the insured's right to seek independent counsel whenever a potential conflict is present. *Liberty Mutual Insurance Co. v. Tedford* illustrates this principle.[27] In *Tedford,* the district court denied the insurer (Liberty Mutual) summary judgment in its action to recoup defense costs paid under a reservation of rights. It was undisputed that the insurer never informed the insured about its right to independent counsel "or any conflicts of interest created by the insurer's defense pursuant to a reservation of rights."[28] The insured had an adverse judgment rendered against it in the underlying tort action,[29] and there was testimony that had Liberty Mutual advised the insured of his right to choose independent counsel, the insured would have selected a different attorney than the one appointed by Liberty Mutual.[30] These facts were sufficient to raise a question of fact regarding whether the insured was prejudiced by this lack of information. Thus, since the insurer failed to inform the insured of its rights to independent counsel, it would be estopped from denying coverage if the insured could demonstrate that it was prejudiced.[31]

If the reservation of rights or non-waiver agreement does *not* create a conflict of interest, the insurer may continue to control the defense. "For instance, if the basis for the reservation does not create any incentive for the insurer to encourage the establishment of liability on a non-covered ground, the independent counsel would be unnecessary."[32] But "[h]ow should courts, insurers, and policyholders distinguish between reservations of rights that create conflicts of interests requiring informed consent by the insured and those that do not?"[33] One court articulated the following standard:

> Whether the potential conflict of interest is sufficient to require the insured's consent is a question of degree that requires some predictions about the course of the representation. If there is a reasonable possibility that the manner in which the insured is defended could affect the outcome of the insurer's coverage dispute, then the conflict may be sufficient to require the insurer to pay for counsel of the insured's choice. Evaluating that risk requires close attention to the details of the underlying litigation. The court must then make a reasonable judgment about whether there is

[27] 658 F. Supp.2d 786, 795 (N.D. Miss. 2009).

[28] *Id.* at 796.

[29] *Id.* at 797.

[30] *Id.* at 798.

[31] *Id.* at 802.

[32] Deschenes & Mullen, *supra* note 14.

[33] Armstrong Cleaners, Inc. v. Erie Ins. Exch., 364 F. Supp. 2d 797, 807 (S.D. Ind. 2005).

> a significant risk that the attorney selected by the insurance company will have the representation of the insureds significantly impaired by the attorney's relationship with the insurer.[34]

III.
"SPLITTING THE FILE": BEST PRACTICES

Best practices for splitting a file are far from clear, especially due to the fact that there are very few cases that discuss file-splitting in detail, and the few that discuss the issue do not provide bright-line rules that are easy to apply.[35]

One principle is clear, however: in any case where a potential conflict of interest is present, the safer course of action for the insurer is to split the file. Although failure to split a file is not *per se* improper,[36] doing so is a developing standard practice in the insurance industry and is an appropriate mechanism for avoiding the appearance of impropriety.[37] "Insurers that

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[34] *Id*. at 808.

[35] *See, generally,* Steven Plitt & Steven J. Gross, *Splitting Claim Files: Managing the Concern for Conflicts of Interest Through the Use of Insurance Company Conflict Screens*, 32 No. 6 INS. LITIG. REP. 151 (April 26, 2010).

[36] *See, e.g.*, Employers Ins. of Wausau v. Seeno Constr., 945 F.2d 284 (9th Cir. 1991). In that case, the Ninth Circuit Court of Appeals held that the insured's

> argument that most other carriers in the California insurance industry choose to segregate their liability and coverage activities does not establish that it is Wausau's duty to do so. As stated above, the nature of Wausau's duty to its insured does not require such a segregation. The fact that other carriers may choose to segregate does not necessarily arise out of any duty to do so, but may arise from a precautious decision to avoid later complaints of mishandling from the insured.

Id. at 287. This case illustrates that failure to split a file is not *per se* improper; however, it is the position of this Article that the best practice for insurers is to split files to avoid liability whenever a potential conflict of interest is present.

[37] *See, e.g.,* Brent W. Huber and Angela P. Krahulik, *Bad Faith Coverage Litigation: The Insurer's Covenant of Good Faith and Fair Dealing*, 42 TORT TRIAL & INS. PRAC. L.J. 29, 47 (2006). *See, also, e.g.,* Harleysville Lake States Ins. Co. v. Granite Ridge Builders, Inc., No. 1:06-CV-00397, 2008 WL 4935974, at *11 (N.D. Ind. Nov. 17, 2008) ("Berklich had split the file with another adjuster because he felt it was improper for him to handle both the defense and the coverage issues, knowing that Harleysville needed a full reservation of rights and intended to file a declaratory judgment action."); World Harvest Church, Inc. v. Guideone Mut. Ins. Co., No. 1:07-CV-1675-RWS, 2008 WL 5111218, at *1 (N.D. Ga. Dec. 2, 2008) ("Defendant recognized that there may be coverage issues under the Policy so the file was split, with one claim handler assigned to address the liability issues and one claim handler assigned to the coverage issues."). It should be noted that the district court in *World Harvest* ultimately held that the insurance company was not estopped from denying coverage after defending its insured for eleven months without reserving its rights because insured was not prejudiced. However, this issue was appealed, and the Eleventh Circuit Court of Appeals certified the question to the Georgia Supreme Court. *See* World Harvest Church, Inc. 586 F.3d 950, 961 (11th Cir. 2009). The Georgia Supreme Court answered the certified question, holding that a showing of prejudice is not required for estoppel to apply. World Harvest Church, Inc. v. Guideone Mut. Ins. Co., 695 S.E.2d 6, 12 (Ga. 2010).

fail to establish an adequate conflict screen when their coverage position creates a conflict of interest . . . run the risk of subjecting themselves to significant bad faith liability."[38] Even if bad faith liability is not an issue, depending on the jurisdiction, an insurer that fails to split files runs the risk that it will later be estopped from raising any coverage defenses.[39]

This section will discuss strategies that insurers may employ to avoid potential bad-faith liability or coverage by estoppel, using case law to illustrate the types of situations that insurers frequently confront when a conflict of interest arises.

A. *Timing Issues*

The determination of *when* to split the file frequently depends on when the insurer received notice of the claim. Prior to suit being filed on a claim, there is generally no need to split a file between coverage and defense. If the insurer has advised the insured of potential coverage issues and reserved its rights in a timely manner, 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.

In contrast, after the suit is filed, the insurer's duty to defend may conflict with the insurer's position on coverage, resulting in the need to split the files. When an insurer's first notice of a claim is the complaint in the underlying action, the insurer may not yet recognize any potential conflict. Further, the insurer usually does not have enough time to make an informed decision on its duty to defend before the answer is due.

In these circumstances, the insurer should conduct an investigation for liability and coverage under a reservation of rights. An insurer may take one of two courses to manage potential conflicts of interest. First, the insurer can maintain one claim file and ask the insured's personal counsel (if such exists) to answer the complaint while the insurer continues to investigate coverage. Alternately, the insurer can retain defense counsel to answer the complaint and defend under a reservation of rights.[40] In the second situation, an insurer must decide whether it is prudent to split the file between coverage and liability/defense.

Regardless of when the insurer first receives notice of the claim, the safer course, if potential for no coverage exists, is to split the file. This course of action protects the interests of the insured and the insurer.

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[38] Huber & Krahulik, *supra* note 37, at 48-49.

[39] *See e.g.,* Twin City Fire Ins. Co. v. City of Madison, Miss., 309 F.3d 901, 908 (5th Cir. 2002).

[40] Defense counsel retained by the insurer to defend the insured under a reservation of rights must withdraw from the representation of the insured when the insured selects independent counsel in jurisdictions following *Cumis*. Moreover, to the extent that the defense attorney selected by the insurer represents both the insurer and the insured, "if during the representation of both parties a conflict of interest arises, defense counsel should withdraw from representation of either if there is any possibility that representing one and not the other may be injurious to the client the attorney ceases to represent." Moeller v. Am. Guar. & Liab. Ins. Co., 707 So. 2d 1062, 1070 (Miss. 1996).

B. *The Respective Roles of the Coverage Adjuster and the Defense Adjuster*

If an insurer determines that splitting a file is appropriate, the best way to accomplish this is by maintaining absolute separation between the coverage and defense files. Personnel working on the files should be prohibited from communicating with each other. In cases where a lawsuit is filed on an existing claim, a best practice is for the adjuster who had the file prior to suit to keep the liability/defense file, and for the insurer to appoint a separate adjuster to handle coverage issues. The separation between the files "must actually and sufficiently protect the policyholder's interest and must not be established as a mere formality."[41] Maintaining appropriate boundaries between the coverage adjuster and defense adjuster throughout all stages of the investigation of a claim is crucial.

1. Use of Information Obtained from the Insured

Whether the coverage adjuster may use information obtained from the insured prior to suit being filed often depends on whether the insurer has provided the insured with prompt, pre-suit notice of coverage issues. If notice has been provided, then the coverage adjuster may access pre-suit information from the insured (or elsewhere) to determine coverage and to plan the defense of the coverage claim. However, the failure to timely reserve rights, as previously discussed, may, depending on the jurisdiction, be deemed a waiver of certain coverage defenses by the insurer.

Once suit is filed and the file is split, 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.[42]Assuming that the insurer hires *Cumis* counsel, 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. If defense counsel provides such confidential information to the defense adjuster, the defense adjuster should not pass the information along to the coverage adjuster.[43]

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[41] Huber & Krahulik, *supra* note 37, at 48. *See also* Armstrong Cleaners, Inc. v. Erie Ins. Exchange*,* 364 F. Supp. 2d 797, 817 (S.D. Ind. 2005) (addressing insufficiency of "Chinese wall" erected between front-line adjusters).

[42] 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.

[43] Where *Cumis* 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) (holding that sole adjuster in an un-split file did not act inappropriately by using information [requested and] voluntarily provided by defense counsel in his coverage analysis); State Farm Fire & Cas. Co. v. Superior Court, 216 Cal. App. 3d 1222, 1227-28 (Ct. App. 1989) (holding that *Cumis* counsel was not required to provide "privileged materials relevant to coverage disputes" to sole adjuster in an un-split file and that defense counsel "must have assumed that communications to [the adjuster] were the same as communications to [the insurer] itself").

2. Settlement Negotiations

Settlement issues can pose a delicate problem in split-file cases. At some point in the settlement process, a decision-maker for the insurance company must have the opportunity to review all the relevant information—including both coverage and defense issues—to determine whether the case should settle.[44] One commentator described the dilemma as "an all or nothing situation":

> The insurance company's inherent duty to give equal consideration to its insured's interests does not resolve this dilemma. . . . Either coverage exists and, therefore, the insurance company has an obligation to protect the insured's interest within the boundaries of policy limits, or, if no coverage exists, the insurance company has no obligation to indemnify the insured. Because the nature of the competing interests present in an "all or nothing" fashion, a strict all encompassing conflict screen militates against the insurance company's ability to settle a potentially covered liability claim.[45]

There are no hard and fast rules regarding when, and at what level, a decision-maker for the insured should review all of the available information to make a settlement decision.[46] However, some basic guidelines can help insurers navigate this potentially difficult decision in split file cases.

First, with respect to the function of liability adjusters in settlement negotiations in split file cases, a best practice is for the liability adjuster to evaluate the exposure and settlement value of the claim as to the insured without regard to any coverage issues. Once this evaluation is made, the liability adjuster can make independent recommendations to the coverage adjuster for settlement authority.

Second, with respect to the function of coverage adjusters in these cases, the coverage adjuster should accept the liability adjuster's assessment or evaluation of the liability and exposure to the insured without question. The coverage adjuster should then review and analyze the claims against the insured which are being settled for determination of coverage. Once this evaluation has taken place, the coverage adjuster should provide whatever settlement authority is appropriate to the liability adjuster in light of the value of the case and 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, to be fair to the

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44 Plitt & Gross, *supra* note 35.

45 *Id.*

46 *See id.*

insured, and to protect the insured's uninsured interests. A division of these responsibilities helps in the defense against a claim that the final decision by the insurance company was unreasonable.[47]

3. Some Crossover May be Acceptable

Although an insurer should ideally maintain absolute separation between the files, some crossover may be acceptable.[48] For example, in *Flynn's Lick Community Center & Volunteer Fire Department v. Burlington Insurance Co.*, a Tennessee court held that an insurance company did not behave improperly despite the fact that there was some technical overlap between the defense and coverage aspects of the claims.[49]

In *Flynn's Lick*, three lawsuits were filed against the insured (Flynn's Lick Community Center) stemming from an accident at a Halloween hay ride event. Flynn's Lick Community Center then filed a claim with its insurer (Burlington).[50] Due to doubts regarding coverage, Burlington defended the Community Center under a reservation of rights.[51] Burlington decided to split the file, and it assigned one adjuster and one attorney to the coverage issue and another adjuster and attorney to the defense of the Community Center.[52]

Coverage counsel determined that there was no coverage, and in turn, the *defense* adjuster informed the Community Center of Burlington's coverage position, and that Burlington intended to file a declaratory judgment action that it had no duty to defend the Community Center.[53] Later, the coverage adjuster and the defense counsel attended a settlement conference in which a settlement agreement was reached.[54] After the conference, the Community Center sought to have the declaratory judgment action dismissed, and in response, the *defense* adjuster submitted an affidavit stating reasons why there was no coverage for the Community Center's claim.[55] The declaratory judgment action was dismissed, and the Community Center's request for attorney fees related to the declaratory judgment was denied.[56]

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[47] *Id.*

[48] The term "crossover" refers to the coverage adjuster's and/or the defense adjuster's "'cross[ing] over' the wall between the defense and coverage aspects of the claim[]." *See* Flynn's Lick Cmty. Ctr. & Volunteer Fire Dep't. v. Burlington Ins. Co., M2002-00256-COA-R3CV, 2003 WL 21766244, at *9 (Tenn. Ct. App. July 31, 2003).

[49] *Id.* at *1. The court was analyzing whether the insurer's conduct complied with the Tennessee Consumer Protection Act. *See generally* Tenn. Code. Ann. § 47-18-101 *et seq*. (2011). It is important to note that insurers may be held to different standards of conduct, depending on the jurisdiction.

[50] *Flynn's Lick*, 2003 WL 21766244, at *1.

[51] *Id.* at *2.

[52] *Id.*

[53] *Id.*

[54] *Id.* at *3.

[55] *Id.* at *4.

[56] *Id.* at *3.

As a result, the Community Center filed a lawsuit against Burlington, alleging that Burlington acted in bad faith and in an unfair or deceptive manner by allowing the defense and coverage agents to "cross over."[57] First, the Community Center argued that it was improper for the *defense* adjuster to send a letter stating that Burlington was denying coverage.[58] Burlington responded by saying that the adjuster was simply sending an updated reservation of rights letter, which was a common practice.[59] The Community Center also argued that it was improper for the *coverage* counsel to attend the settlement conference with the accident victims.[60] Burlington responded by saying that this action "constituted a type of 'crossing over' from the coverage side to the defense side of the proverbial 'wall,'" but that it was permissible since the coverage counsel "was essentially waiving the coverage defense by agreeing to pay Flynn's Lick's claim and, thus, was justified in breaching the wall."[61] Finally, the Community Center argued that it was improper for the *defense* adjuster to file an affidavit in the declaratory judgment suit stating that coverage did not exist and that this action was "irreconcilable with her duty to represent the interests" of the Community Center.[62]

A jury found for Burlington and the Tennessee Court of Appeals upheld this finding.[63] The court held that Burlington had introduced enough evidence to provide "a cogent explanation for its actions and decisions."[64] Although the court does not give any further insight into why it upheld the jury's action, or what it would consider to be an improper cross over, the case does give an initial starting point to determine what actions are permissible by the coverage and liability representatives.

C. *Splitting the File: The Role of Independent Counsel*

When determining whether to split a file, one relevant consideration is whether the insured will be provided with independent counsel. As the following discussion demonstrates, providing *Cumis* counsel is a wise—and frequently, required—move whenever a potential conflict of interest is present. Although splitting a file will not relieve the insurer's duty to provide independent counsel, providing independent counsel may render splitting a file unnecessary. Where an insurer neither provides independent counsel *nor* splits a file when a conflict of interest is present, the insurer may face a risk of being estopped from denying coverage—or even bad-faith liability, depending on the jurisdiction at issue.[65]

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[57] *Id.*

[58] *Id.* at *5.

[59] *Id.*

[60] *Id.*

[61] *Id.* at *5.

[62] *Id.* at *4.

[63] *Id.* at *9.

[64] *Id.*

[65] *See, e.g.,* Windt, *supra* note 8.

1. Splitting a File Does Not Eliminate the Insurer's Duty to Provide Independent Counsel When a Conflict of Interest is Present

Splitting a file is not an adequate substitute for providing the insured with appointment of independent counsel if the situation and the laws of the particular state at issue so require. For example, in *Armstrong Cleaners, Inc. v. Erie Insurance Exchange*, when the insurer agreed to defend the insured under a reservation of rights, the court held (1) that the insurer was required to pay for an independent attorney and (2) that the insurer's internal policy of constructing a "Chinese Wall" between the two aspects of the case was insufficient to provide the insureds a meaningful defense.[66] The Armstrongs (the insureds) tendered the defense of the underlying liability action to Erie (their insurer). Erie accepted the defense under a reservation of rights but "insist[ed] on using counsel of its own choice to defend the Armstrongs in the underlying lawsuits."[67] The Armstrongs wanted to force Erie to pay for independent counsel, arguing that any counsel hired by Erie would not provide a meaningful defense because some of the issues that would be litigated in the underlying lawsuit were covered by the reservation of rights.[68] Erie argued that splitting the file had adequately addressed any conflict of interest.[69]

The court rejected Erie's argument, noting 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. For example, the court noted that the defense adjuster had a copy of the reservation of rights letter that identified the coverage issues."[70] Based on these facts, the court granted the Armstrongs' motion for summary judgment, and required Erie to pay for independent counsel to represent their insureds.[71] Thus, even without any indication that any commingling did in fact occur, the court upheld the insureds' right to obtain independent counsel.

2. One Jurisdiction Held that Splitting the File May Be Unnecessary if *Cumis* Counsel is Provided

In *State Farm Fire & Casualty Company v. Superior Court*,[72] the court held that as long as the insurer hired independent counsel to represent the insured's interests in the underlying action, the insurer could employ a single claims adjuster to handle both the defense and coverage issues.[73] At the time State Farm accepted the defense of its insureds under a

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[66] 364 F. Supp. 2d 797, 817 (S.D. Ind. 2005).

[67] *Id.* at 801.

[68] *Id.*

[69] *Id.* at 817.

[70] *Id.* at 805.

[71] *Id.* at 817.

[72] 265 Cal. Rptr. 372 (Ct. App. 1989).

[73] *Id.* at 375.

reservation of rights, it agreed to pay the defense costs for their *Cumis* counsel.[74] State Farm then retained its own counsel to pursue an action for a declaratory judgment "to establish the lack of coverage."[75] However, State Farm assigned a single adjuster to manage both cases, and the adjuster "maintained only one file."[76] The adjuster "served in a dual capacity, assisting and communicating with counsel defending [the insureds] in the liability case, and at the same time communicating with and assisting the State Farm counsel asserting lack of coverage in the declaratory relief case."[77] The adjuster communicated State Farm's coverage position to the insured's defense counsel, advising "that not one penny would be offered in settlement, [and] that State Farm was only obligated to provide . . . a 'defense,' because, in his opinion, there was no coverage under the policy."[78] In response to the adjuster's dual role, the insureds argued that merely hiring *Cumis* counsel was insufficient to protect their interests in the liability action.[79]

The court disagreed with the insured, and declined to impose "a veritable wall . . . between the insurance company's administration of the two cases."[80] The court reasoned that the adjuster can be an agent of both the insurer and the insured.[81] When the insurance policy clearly covers the insured, the adjuster becomes an agent of the insured.[82] But when coverage is questionable, the adjuster has divided loyalties.[83] In this situation, *Cumis* counsel is appointed to provide the insured impartial representation.[84] The court rejected the insured's contention that separate adjusters should be assigned for the coverage issue and for insured's interests, stating that because of the increasingly high costs of processing insurance settlements, "it would be unwise to impose yet another layer of administration."[85]

In addition to administrative and cost considerations, the court also noted "recent legislation which affirms the principle stated in *Cumis* that 'privileged materials relevant to coverage disputes' need not be reported to the insurance company."[86] The court held that it is *Cumis* counsel's "obligation to guard against improvident revelations to the insurance

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[74] *Id*. at 373.

[75] *Id.*

[76] *Id.* at 374.

[77] *Id.*

[78] *Id.*

[79] *Id.*

[80] *Id*. at 374.

[81] *Id.* at 375.

[82] *Id.*

[83] *Id.*

[84] *Id.*

[85] *Id.*

[86] *Id*. at 375. (citing CAL. CIV. CODE § 2860(d) (1988)).

company" and that *Cumis* counsel must assume that communications to the insurer's adjuster are the same as communications to the insurer itself.[87] So long as *Cumis* counsel is acting in accordance with these legislative and judicially imposed obligations, it is sufficient to protect the insured's interests.

D. *Multiple Insureds*

In *Specialty Surplus Insurance Company v. Second Chance, Inc.*,[88] the court held that an insurer may have acted improperly when, after it split its file between the defense of one of its insureds [employer] and another [employee] as a result of a potential conflict of interest between the two, the insurer engaged in "crossover" using information obtained in one defense file to build coverage defenses against the other insured. In this case, the insurer agreed to defend both insureds under a reservation of rights.[89] At the beginning of the lawsuit against its insureds, the insurer assigned a single adjuster to represent the employer and the employee.[90] The employer's defense to the suit was based on its allegation that the employee acted outside the course and scope of his employment. As noted above, the file was split later so that two defense files existed, one for each insured, due to a potential conflict of interest between the insureds.[91] The employee insured subsequently made a bad faith claim stemming from the conduct of the adjuster handling his defense after the insurer split the defense files of the insureds.[92]

Applying Washington law,[93] the district court held that the "commingling of files of two *defendant-insureds*" had no "bearing on the existence of a conflict of interest between the *insurer* and the *insured [employee]*," nor did it demonstrate that the insurer showed greater concern for its own monetary interests than for its insured's.[94] The court denied the insured's motion for summary judgment with respect to its bad faith claim against the insurer based on its failure to split the file earlier.[95]

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[87] *State Farm,* 265 Cal. Rptr. at 375.

[88] 412 F. Supp. 2d 1152, 1169 (W.D. Wash. 2006).

[89] *Id.* at 1154-55.

[90] *Id.*

[91] *Id.*

[92] *Id.* at 1160–61.

[93] Washington law imposes a duty upon insurers in a reservation of rights defense to "retain competent defense counsel for the insured, and both retained defense counsel and the insurer must understand that only the insured is the client." Johnson v. Cont'l Cas. Co., 788 P.2d 598, 600 (Wash. Ct. App. 1990) (citing Tank v. State Farm Fire & Cas. Co., 715 P.2d 1133, 1137 (Wash. 1986)). It should be noted that it is not entirely clear whether Specialty Surplus retained independent *Cumis* counsel for its insureds.

[94] *Specialty Surplus*, 412 F. Supp. 2d at1169.

[95] *Id.*

Months later, the district court re-examined the insurer's bad faith relating to splitting the file, and held that although the insurer had no duty to split the file earlier than it did, the subsequent "cross-file communications" presented an issue of material fact on whether the insurer acted in bad faith.[96] The court noted that most of the communications at issue were nothing "more than . . . immaterial matter[s] of internal procedure," and that there were also "notes indicating that the separation between the files was occasionally functional."[97] On the other hand, there was evidence that the insurer "improperly used the information garnered from both files to come to the conclusion that it was in Specialty Surplus's best interests to allow the underlying matter [to] proceed to trial, because of its coverage defenses."[98] The notes indicated that the insurer no longer wanted to settle the claim against the employee, since it likely would be able to "assert an effective coverage defense and disclaim coverage after the underlying trial."[99] Thus, *Second Chance* indicates that even if an insurer initially satisfies its duty to avoid conflicts of interest by splitting a file at the appropriate time, a court may refuse to grant the insurer's summary judgment motion if the insurer later "crosses over" and uses information from one insured's the defense file in order to build its coverage defenses with respect to *another* insured in the same litigation.

E. *Splitting the File is the Safer Course of Action*

Splitting the file may limit the insurer's exposure to bad faith claims and coverage by estoppel in jurisdictions recognizing this doctrine. Ultimately, the insurance carrier will be judged with hindsight with respect to (1) if it did not split the file, whether its decision was improper, and (2) if it did split the file, whether it was able to maintain complete separation between the coverage and defense aspects of the case. If a court finds the insurer's actions to be improper under either situation, the insurer may be liable because it failed to defend its insured, may be liable under a theory of bad faith, or may be estopped from denying coverage, depending on which jurisdiction's laws apply. To prevent liability, the best course for the insurer is to split the file and to maintain separation between the coverage and liability aspects of the case.

IV.
Discovery of the Insurer's File Materials

Regardless of whether the file is split, the discovery of claim file materials is routinely an issue in coverage litigation, and jurisdictions vary on what materials are discoverable. The

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[96] Specialty Surplus Ins. Co. v. Second Chance, Inc., No. C03-0927C, 2006 WL 2459092, at *15–17 (W.D. Wash. Aug. 22, 2006).

[97] *Id.* at *16.

[98] *Id.* Specifically, the adjuster for the employee defense file concluded that the employer probably would receive a defense verdict based on a finding that the employee was acting outside the course and scope of employment which would cause a judgment against the employee to have no coverage under the policy. *See id.* at *17.

[99] *Id.* at 16.

following section will explain each of the principles that apply to discovery of an insurer's claim file in coverage disputes:

- In general, in an action to determine whether the insured is liable, the insurer's claim file is not discoverable.
- In an action to determine the insured's coverage under the policy, the insurer's file is considered work product and is not discoverable.
- In bad faith actions against the insurer, some jurisdictions take the position that entire claim file is discoverable, while other jurisdictions find that all or part of the file is protected by attorney-client privilege or the work product doctrine.

A. *Discovery of Claims Files in Underlying Liability Actions*

The discovery of the insurer's claim file generally is not allowed in the underlying liability action against the insured, even where the insurer is joined as a party to the action.[100] According to one commentator,

> [w]hile the claims and underwriting files may be discoverable in the bad faith action, they may not be discoverable during the litigation of the underlying actions. Therefore, the practitioner should seek a bifurcation of the actions and a resolution of the actions separately. It may be preferable to have the underlying action resolved first, but this should be analyzed case by case.[101]

B. *Discovery of Claims Files in Coverage Actions*

Several courts have held that discovery of the insurer's claim file is not allowed in actions to determine whether coverage exists under the policy at issue. The general rule is that "while a coverage issue is pending," discovery of the insurer's claim file is improper.[102] Discovery is improper "because the claims file is the insurer's work product. Moreover, the contents of the file are irrelevant to the question of whether the policy obligates the

[100] *See* Kraus v. Maurer, 740 N.E.2d 722, 725 (Ohio Ct. App. 2000) ("It is abundantly clear that the claim file being sought is protected by both the 'attorney-client privilege' and the 'work product doctrine.' The file is not being sought in concert with a bad faith claim and, therefore, is not discoverable.").

[101] Lee R. Russ & Thomas F. Segalla, 17A COUCH ON INSURANCE § 250:29 (2010).

[102] *See, e.g.*, United Servs. Auto. Ass'n v. Kindl, 49 So.3d 807, 808 (Fla. Dist. Ct. App. 2010).

insurer to defend or indemnify the insured for some particular loss or liability."[103] "When a litigant files claims for both coverage and bad faith in the same action, the insurer's claim file is not discoverable until the issue of coverage has been resolved."[104] For example, the court in *Garg v. State Auto Mutual Insurance Company*[105] held that although insureds were entitled to discovery of certain of the insurer's documents for purposes of their bad faith claim, such materials were not discoverable for purposes of insureds' breach of contract and unfair claims practices claims.[106] Therefore, the court bifurcated the bad faith claim from other claims, and the court stayed discovery in the bad faith claim until resolution of other claims,[107] holding that to require the insurer "to divulge its otherwise privileged information prior to a resolution" of breach of contract and unfair claims practices claims would have unquestionably impacted insurer's ability to defend against them.[108]

C. *Discovery of Claims Files in Bad Faith Actions*

When an insured asserts bad faith claims against its insurance carrier after all coverage issues have been resolved, the insured is generally entitled to discover at least some portions of the insurer's claim file.[109] However, the scope of the documents discoverable is often a source of litigation and varies from jurisdiction to jurisdiction.

1. Position that All Claim File Materials Are Discoverable in Bad Faith Actions

Some jurisdictions hold that all claim file materials are discoverable in bad faith actions. For instance, in *United Services Automobile Association v. Jennings*,[110] the court held that

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[103] Scottsdale Ins. Co. v. Camara De Comercio Latino-Americana De Los Estados Unidos, Inc., 813 So. 2d 250, 252 (Fla. Dist. Ct. App. 2002). *See also* Fed. Ins. Co. v. Exec. Coach Luxury Travel, Inc., Nos. 1-09-17, 1-09-18, 2009 WL 3720556, at *8 (Ohio Ct. App. Nov. 9, 2009) (holding that intervenors failed to demonstrate that underwriting and claims files were relevant to interpretation of insurance contract in declaratory judgment action over coverage), *rev'd on other grounds*, 944 N.E.2d 215 (Ohio 2010).

[104] GEICO Gen. Ins. Co. v. Hoy, 927 So. 2d 122, 125 (Fla. Dist. Ct. App. 2006). *See also* Imperial Cas. & Indem. Co. v. Bellini, 746 A.2d 130, 134–35 (R.I. 2000) (holding that judgment creditor's bad-faith claim against debtor's alleged liability insurer did not entitle the creditor to discovery of the entire claim file prior to resolution of statutory, reformation, estoppel, and waiver claims, as the creditor's need for information in the claim file to prove its bad-faith claim was outweighed by the insurer's need to defend itself).

[105] 800 N.E.2d 757 (Ohio Ct. App. 2003).

[106] *Id.* at 763-64.

[107] *Id.*

[108] *Id.* at 764.

[109] *See* U.S. Fire Ins. Co. v. Clearwater Oaks Bank, 421 So. 2d 783, 784 (Fla. Dist. Ct. App. 1982) (stating that "[i]n a bad faith suit against an insurance company for failure to settle within the policy limits, the plaintiff may obtain discovery of the original claim file").

[110] 707 So. 2d 384, 385 (Fla. Dist. Ct. App. 1998).

an injured third-party claimant who stands in the shoes of the insured with respect to its bad-faith action against the liability insurer[111] is entitled to discover the liability insurer's *entire* claim file on the underlying tort claim up to the date of entry of an excess judgment against the insured or a *Cunningham* stipulation.[112] According to the court in *Jennings*,

> [n]either the settlement agreement between respondents and the insured nor the *Cunningham* stipulation specifically addressed whether respondents would be entitled to discovery of the entire claims file during the third party bad-faith action, notwithstanding any attorney-client or work-product privileges. When respondents sought discovery of the entire claims file during the bad-faith case, petitioner objected on grounds that the requested material was protected by both the attorney-client and work product privileges. The trial court compelled production of the entire claims file over petitioner's objection.
>
> Generally, the third party in a third party bad-faith action stands in the shoes of the insured and is entitled, therefore, to discovery of the insurer's entire claims file on the underlying tort claim up to the date of an excess judgment, notwithstanding any objections from the insurer based on the attorney-client or work product privileges.[113]

The court did not believe the rule would be any different in light of the existence of a *Cunningham* stipulation, but certified the question to the Florida Supreme Court. The appellate court's decision was ultimately approved.[114]

2. Claim File Materials Protected by the Attorney-Client Privilege

Where the attorney in the underlying action represents both the insured and the insurer as joint clients, there is an argument that the attorney-client privilege is inapplicable as between them in a bad faith case. However, with respect to the adjuster's communications with coverage counsel who represents the interests of the insurer exclusively, courts have held that such information is not discoverable. For instance, the discovery of the insurer's com-

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[111] Note that not all jurisdictions allow third-party claimants who are not insureds to bring "bad faith" claims against the putative tortfeasor's insurer absent an assignment from the tortfeasor.

[112] A *Cunningham* stipulation, taking its name from *Cunningham v. Standard Guar. Ins. Co.*, 630 So. 2d 179 (Fla. 1994), is a stipulation in a settlement agreement whereby the insured agrees that the settlement serves as the functional equivalent of an excess judgment and specifically grants the third-party claimant the right to pursue a bad faith claim against the insured's liability carrier in the absence of an actual excess judgment.

[113] *United Services*, 707 So.2d at 384-85.

[114] *See* United Servs. Auto. Ass'n v. Jennings, 731 So. 2d 1258 (Fla. 1999).

munications with coverage counsel was the issue addressed in *State Farm Fire & Casualty Company v. Superior Court*.[115] The court summarized the insureds' argument as follows:

> Their contention, broadly put, is that the adjuster aiding in defense of the liability action is the agent of the insured and the insured's *Cumis* counsel, that the [insureds] and their counsel are entitled to know everything their agent learns, and that they are hence privileged to see everything in the file.[116]

The insureds argued that because the adjuster was their agent, the insurance carrier waived "any attorney-client privilege which might otherwise be available" for communications between it and its coverage counsel.[117] The court reasoned that where the insurer had advised its insured of the conflict of interest resulting from the presence of coverage questions and hired independent counsel of the insured's own choosing, the adjuster was solely acting as the agent of the insurer and not the insured.[118] Thus, the court held that in this insurance bad faith case, the insurer was not required to produce to the insured any communications between the insurer and its coverage counsel as such communications were subject to an attorney-client privilege that had not been waived.[119]

Similarly, in *Lexington Insurance Company v. Swanson*, the district court held that the production of documents was not required.[120] In *Swanson*, the insurer filed an action seeking a declaration of no coverage under its policy, and Sandra Swanson (the injured third-party claimant to whom the insured assigned all of its claims against the insurer) counterclaimed for bad faith.[121] The insurer had not split the file and had not appointed *Cumis* counsel to the insured.[122] With respect to her counterclaim, Swanson argued that she was entitled to discover the sole adjuster's file materials relating to the adjuster's communications with coverage counsel.[123] As in *State Farm Fire & Casualty Company*, the district court held that production of such documents was not required. The court stated the following:

> [The adjuster] was employed as a claims handler by Lexington [the insurer]. In essence, Lexington and its employees had a dual role: (1) they acted on behalf of [the insured] in providing a defense to the underlying tort claim against ICC; and

[115] 265 Cal. Rptr. 372 (Ct. App. 1989).

[116] *Id.* at 374.

[117] *Id.*

[118] *State Farm,* 265 Cal. Rptr. at 375.

[119] *Id.* at 376.

[120] 240 F.R.D. 662, 670–71 (W.D. Wash. 2007).

[121] *Id.* at 665.

[122] *See id.* at 666.

[123] *Id.* at 668–69.

> (2) they acted on behalf of Lexington in retaining coverage counsel to ascertain Lexington's coverage obligations. As noted earlier, Lexington may assert attorney-client privilege for its communications with coverage counsel. Ms. Swanson provides no authority indicating that this privilege may be defeated because the same Lexington employee acted in the "dual roles" served by the company as a whole. Ms. Swanson cites no case law suggesting that an insurer must have different employees interact with "coverage counsel" and counsel in the underlying tort action in order to preserve its privileges.[124]

Despite the fact that communications with coverage counsel are generally protected from discovery, there are still ways for insureds to obtain the otherwise privileged material. For instance, some insureds have had success with the argument that an insurer's bad faith constitutes fraud such that the attorney-client privilege does not apply when the insurer communicates with an attorney in order to perpetuate a fraud upon the insured.[125] Moreover, despite the protection afforded to communications between the adjuster and coverage counsel, "there is authority that this privilege does not apply to notes and memoranda prepared by a liability insurer's claims supervisor for himself and his supervisor, where the supervisor was not acting at the direction of or for the insurer's attorney and where the documents contained no confidential communications to counsel."[126]

3. Claim File Materials Protected by the Work Product Doctrine

Courts have taken a variety of positions on the question of how much of the claims file is discoverable in light of the work product doctrine. Some courts reject the application of the work product doctrine altogether with respect to bad faith claims against the insurer and thus allow discovery of the insurer's claims file.[127] Other courts apply a case-by-case

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[124] *Id.* at 671.

[125] *See, e.g.,* Hutchinson v. Farm Family Cas. Ins. Co., 867 A.2d 1, 11 (Conn. 2005) (holding that attorney-client privilege would not apply where insured established probable cause to believe that insurer sought advice of counsel to facilitate or conceal its bad faith, even though plaintiffs in the case had not established probable cause); United Servs. Auto. Ass'n v. Werley, 526 P.2d 28, 32–33 (Alaska 1974) (holding that plaintiff could defeat claim of attorney-client privilege between insurer and its counsel where plaintiff made prima facie showing that insurer engaged in bad faith conduct with assistance of counsel).

[126] Russ & Segalla, *supra* note 101 (citing Athridge v. Aetna Cas. & Sur. Co., 184 F.R.D. 181 (D.D.C. 1998); Birth Ctr. v. St. Paul Cos., Inc., 727 A.2d 1144 (Pa. Super. Ct. 1999)).

[127] *See, e.g.,* Diamond State Ins. Co. v. Utica First Ins. Co., 829 N.Y.S.2d 465, 466–67 (N.Y.App.Div. 2007) (stating that "this Court has held that an insurer may not use attorney-client, litigation or work product privileges to shield it from disclosing relevant information in an action predicated on bad faith").

analysis.[128] For example, the Utah Supreme Court acknowledged the various approaches used in analyzing work product doctrines, and found the case-by-case approach best. The court explained,

> in determining whether documents in an insurance claim file were prepared in anticipation of litigation[, t]he trial court should consider the nature of the requested documents, the reason the documents were prepared, the relationship between the preparer of the document and the party seeking its protection from discovery, the relationship between the litigating parties, and any other facts relevant to the issue.[129]

Some courts hold that unless a particular document in the claims file was prepared at the specific direction or request of counsel, the document is discoverable.[130] For instance, the Colorado Supreme Court applied this standard, which was to be applied using a case-by-case approach:

> Because a substantial part of an insurance company's business is to investigate claims made by an insured against the company or by some other party against an insured, it must be presumed that such investigations are part of the normal business activity of the company and that reports and witness' statements compiled by or on behalf of the insurer in the course of such investigations are ordinary business records as distinguished from trial preparation materials. This is not to say, however, that under appropriate circumstances an insurance company's investigation of a claim may not shift from an ordinary business activity to conduct "in anticipation of litigation[."] Admittedly, there is no bright line which will mark the division between these two types of activities in all cases. On the one hand a document may be prepared "in anticipation of litigation" prior to the actual commencement of litigation and, on the other, the commencement of litigation is not sufficient by itself to confer a qualified immunity from discovery on a document thereafter prepared. The general standard to be applied is whether, in light of the nature of the document and the factual situation in the particular case, the party resisting discovery demonstrates that the document was prepared or obtained in contemplation of specific litigation.[131]

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[128] State ex rel. Allstate Ins. Co. v. Gaughan, 508 S.E.2d 75, 92 (W. Va. 1998).

[129] Askew v. Hardman, 918 P.2d 469, 474 (Utah 1996).

[130] *See, e.g.,* Hawkins v. Dist. Court, 638 P.2d 1372, 1377 (Colo. 1982) ("Courts generally have held that reports made and statements taken by an insurance adjuster for an insurance company in the normal course of investigating a claim are prepared in the regular course of the company's business and, therefore, not in anticipation of litigation or for trial.").

[131] *Id.* at 1378-79 (citations omitted).

Several courts have held that the work product doctrine has no application to documents created or gathered prior to suit being filed. For example, in *Goodrich Corp. v. Commercial Union Insurance Company*,[132] the court held the insured was entitled to discover even those claim file materials containing attorney-client communications related to coverage that were created prior to the insurer's denial of coverage. The rationale for this decision was that prior to the coverage denial, the claim file materials would not have contained work product, or things prepared in anticipation of litigation, as litigation was not anticipated between the insured and the insurer due to the fact that no position had been taken on coverage.[133]

V.
Ethical Considerations

A defense attorney who is retained by an insurer pursuant to a reservation of rights walks a very fine line. Defense counsel is in a tri-partite relationship with the insurer and the insured.[134] This section will discuss three aspects of the defense attorney's ethical duties: communication within the tri-partite relationship, confidentiality, and loyalty. While both the insurance company and the insured are clients of the defense counsel,[135] defense counsel must protect the insured and is ultimately controlled by the insured's best interests. A lawyer may avoid potential conflicts at the outset, however, by specifically delineating the scope of his or her representation as early as possible in the litigation. The carrier may avoid or minimize the conflicts of interest internally and for its lawyer by splitting files within the insurance company.

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[132] Nos. 23585, 23586, 2008 WL 2581579, at *26 (Ohio Ct. App. June 30, 2008).

[133] *Id. See also* Hurtado v. Passmore & Sones, LLC, No. 10-cv-00625, 2011 WL 2533698, at *4 (D. Colo. June 27, 2011) ("Because there was no actual claim pending when the investigation was undertaken here, nor had Defendant been contacted by Plaintiffs or their counsel about filing a potential claim, I find that the documents and information derived therefrom [in the claim file] are not protected by the work product privilege."); Lawyers Title Ins. Corp. v. U.S. Fid. & Guar. Co., 122 F.R.D. 567, 568 (N.D. Cal. 1988) (holding that handling of claim ceases to be a part of the insurer's "normal course of business" and becomes anticipation of litigation only when lawsuit is filed); Boone v. Vanliner Ins. Co., 744 N.E.2d 154, 156–57 (Ohio 2001) (holding that insured was entitled to discover claim file documents containing attorney-client communications related to the issue of coverage that were created before the denial of coverage).

[134] *See, generally, e.g.,* Douglas R. Richmond, *Walking a Tightrope: The Tripartite Relationship Between Insurer, Insured, and Insurance Defense Counsel*, 73 Neb. L . Rev. 265 (1994).

[135] *See* Moeller v. Am. Guar. & Liab. Ins. Co., 707 So.2d 1062, 1070 (Miss. 1996) ("The attorney selected and employed by the insurance carrier, of course, has an ethical and professional obligation to represent the company. That attorney is the carrier's attorney. This attorney also has an ethical and professional obligation to represent the insured in the defense of the claim, thus representing two separate and distinct clients.").

The attorney's conduct in relation to the client is guided and controlled by the Rules of Professional Conduct. Model Rule 1.2 provides for the scope of representation and allocation of authority between the client and the lawyer: "a lawyer shall abide by a client's decisions concerning the objectives of representation and, as required by Rule 1.4, shall consult with the client as to the means by which they are to be pursued."[136] Rule 1.4 concerns client communications:

(a) A lawyer shall:

(1) promptly inform the client of any decision or circumstance with respect to which the client's informed consent, as defined in Rule 1.0(e) is required by these Rules;

(2) reasonably consult with the client about the means by which the client's objectives are to be accomplished;

(3) keep the client reasonably informed about the status of the matter;

(4) promptly comply with reasonable requests for information; and

(5) consult with the client about any relevant limitation on the lawyer's conduct when the lawyer knows that the client expects assistance not permitted by the Rules of Professional Conduct or other law.

(b) A lawyer shall explain the matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.[137]

When a defense lawyer is in a tri-partite relationship, the ethical obligations set forth above may conflict as between duties owed to the insurer client and the insured client. This conflict becomes even more apparent when one considers Rule 1.6(a), which provides that "a lawyer shall not reveal confidential information relating to the representation of the client unless the client gives informed consent."[138]

1. Duty of Confidentiality

Two common issues involving defense counsel's duty of confidentiality are (1) what information should be provided to the insured and the insurer, and (2) what information should be withheld from either. For example, imagine a situation where defense counsel learns something about the insured's actions that may provide a defense for the insurer in

[136] Model Rules of Prof'l Conduct R. 1.2.

[137] *Id.* at 1.4.

[138] *Id.* at 1.6(a).

a coverage action. Model Rule 1.2 generally requires the lawyer to promptly respond to reasonable requests for information and keep the client (insurer) informed; while Model Rule 1.6 states that the lawyer shall not reveal information relating to the representation of a client (the insured) unless the client gives informed consent. Thus, in this situation, is the lawyer bound to inform the insurer of the insured's conduct based on the duty to keep the client (insurer) informed? Alternatively, is the lawyer prohibited from informing the insurer of the insured's actions based on the lawyer's duty of confidentiality to the insured?

There is a split among jurisdictions regarding the disclosure of this type of confidential information between the insurer and the insured. In some jurisdictions, such as Alabama and Minnesota, the policyholder and the insurer have been considered "dual" or "joint" clients.[139] Joint clients generally have no expectations of confidentiality between themselves with respect to matters on which they are jointly represented.[140] Other states take a different view of the relationship and find that the insured is the "primary" client.[141] But in other states, such as Texas, Montana, Michigan and Connecticut, the law is clear that the policyholder is the only client.[142] These states are referred to as "one-client states"[143] and often there is substantial friction between the insurance carrier's demand for file information and the client's expectation of confidentiality.

2. Duty of Loyalty

In addition to the duty of confidentiality, the attorney also owes a duty of loyalty to his or her clients. Model Rule 1.7 sets forth the attorney's duty of loyalty. "An attorney shall not represent a client if the representation involves a concurrent conflict of interest."[144] The Rule sets forth various scenarios in which a conflict may occur, including one where "there

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[139] *See, e.g.,* Mitchum v. Hudgens, 533 So.2d 194, 200 (Ala. 1988); Shelby Mut'l Ins. Co. v. Klenman, 255 N.W.2d 231, 235 (Minn. 1977).

[140] *See* Austin T. Fragomen, Jr. & Nadia H. Yakoob, *No Easy Way Out: The Ethical Dilemmas of Dual Representation*, 21 Geo. Immigr. L.J. 621, 626 (2007) (stating that "[t]he standard and more reasonable approach has been to view communications with either client as not privileged because consent to disclose has been impliedly authorized by virtue of the agreement to joint representation").

[141] *See, e.g.,* Paradigm Ins. Co. v. Langerman Law Offices, 24 P.3d 593, 602 (Ariz. 2001) (although the insurer was not the "client," the defense lawyer nonetheless owed a duty to the insurer); *State Farm Mut'l Auto v. Federal Ins. Co.*, 86 Cal. Rptr. 2d 20, 24 (Ct. App.1999).

[142] *See, e.g.,* Safeway Managing Gen. Agency, Inc. v. Clark & Gamble, 985 S.W.2d 166, 168 (Tex. App. 1998) (no attorney-client-relationship exists between an insurance carrier and the attorney it hired to defend one of the carrier's insureds); Bradt v. West, 892 S.W.2d 56, 77 (Tex. App. 1998); State Farm Mut'l Auto Ins. Co. v. Traver, 980 S.W.2d 625, 628 (Tex. 1998) (the attorney owes unqualified loyalty to the insured).

[143] *See, e.g.,* Denise Purpura, *Should Insurers in Texas Be Prohibited from Using Staff Attorneys to Defend Third Party Claims Brought Against Insureds?: A Closer Look at American Home Assurance,* 13 Conn. Ins. L.J. 177, 185 (2007).

[144] Model Rules R. 1.7(a).

is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to . . . a third person."[145] If a conflict of interest arises, the attorney must withdraw from representation unless the conflict is one to which a client validly may consent under the requirements of Rule 1.7(b) and each client affected gives informed consent in writing. The lawyer should "proceed in the best interests of the insured . . . and, if applicable, consistent with the lawyer's duties to the insurer as co-client."[146] Under Rule 1.7, if the lawyer cannot work under the direction of the insurer while still advancing the best interests of the insured, then the lawyer must withdraw from representation. He or she may not abide by any insurer instructions that adversely and materially impact the insured.[147]

3. Communications within the Tri-Partite Relationship

As a practical matter, the personnel on the coverage side of the file must know at least as much as the personnel on the defense side or the insurance company can be sued for bad faith if it denies the claim. In this situation, the lawyer is caught on the quintessential "tight-rope" of his or her client loyalties. Information must be shared between the two sides of the file—but it is crucial to do so without the "appearance of impropriety." Sharing information, which may be harmful to the policyholder/client, must be done with care. For example, if the lawyer elicits harmful testimony in depositions, the lawyer should not highlight that testimony to the carrier—he or she should report on the liability aspects of the case. The deposition transcript may be provided to the carrier and the personnel on the coverage side may review it independently.

VI.
Conclusion

Ultimately, the insurance carrier will be judged with hindsight with respect to whether it adequately addressed any conflicts of interest when defending its insured under a reservation of rights or non-waiver agreement. An insurer who fails to properly handle those conflicts that prejudice the insured and favor the insurer may be estopped from denying coverage or held liable under a theory of bad faith.[148] However, these negative outcomes may be avoided by using the best practices discussed in this Article. Insurers with appropriate procedures for monitoring conflicts of interest—including providing their insured with independent counsel where required; splitting-files; and addressing discovery and ethical issues—can rest assured that they are fulfilling all legal obligations to their insured, while also looking out for their own interests.

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[145] *Id.* at 1.7(a)(2).

[146] Restatement (Third) of Law Governing Lawyers § 134, illus. 5 (2000).

[147] *Id.*; Model Rules R. 1.8.

[148] *See* Twin City Fire Ins. Co. v. City of Madison, Miss., 309 F.3d 901, 907-09 (5th Cir. 2002).

The Federation of Insurance Counsel was organized in 1936 for the purpose of bringing together insurance attorneys and company representatives in order to assist in establishing a standard efficiency and competency in rendering legal service to insurance companies, and to disseminate information on insurance legal topics to its membership. In 1985, the name was changed to Federation of Insurance and Corporate Counsel, thereby reflecting the changing character of the law practice of its members and the increased role of corporate counsel in the defense of claims. In 2001, the name was again changed to Federation of Defense & Corporate Counsel to further reflect changes in the character of the law practice of its members.

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