2019 Annual Conference
March 13 -15 2019
Orlando, FL

The Great Divide – When Does a Claims Adjuster Have a Duty to Divide the File and What Communications and Ethical Considerations are There with the Reinsurer

I. Dividing the Claims File – When Required and When Prudent

Much has been said by commentators and, at times, policyholder attorneys about whether a claims file needs to be divided and when. In certain circumstances it is prudent for the insurer or its third party administrator to divide the claims file. The obvious example is when the insurer is defending the insured but has filed a declaratory relief action regarding coverage or to rescind the insurance policy. The claims file should be divided between defense and coverage, with separate adjusters handling each file, to prevent use of information obtained in the defense of the insured being used against the insured in the coverage action.

Whether or not a claims file has been divided may impact a "bad faith" lawsuit down the road. Whether or not the claims file was divided when it most likely should have been can either be evidence of "bad faith" or "good faith" claims handling conduct by the insurer. Also, dividing the file where appropriate will fulfill all ethical obligations to the insured to handle the claim in a proper and reasonable manner.

A. Overview of cases on splitting a claim file, treatise discussion and insurer perspective

There are limited published cases across the nation which have specifically discussed the "duty" to divide a claims file. A sampling of those cases is:

1. *State Farm v. Superior Court, 265 Cal.App.3d (1989).* The California Court of Appeal held that if the insured was defended through independent counsel, a single claim adjuster could handle both the defense and the coverage. There was a declaratory relief action filed by the insurer, and the insurer stated "not one penny would be offered in settlement" as the insurer was only defending under a reservation of rights. The same adjuster handled both coverage and defense. The policyholder pressed for a "wall" between defense and coverage, but the court held there was no duty to divide

the claims file because the insured was adequately protected by the insurer agreeing to defend the insured through the insured's independent counsel.

2. *Employer's Insurance of Wausau v. Albert D. Seeno Constr. Co.,* 945 F.2d 284 (9th Cir. 1991). Seeno, a real estate developer and general contractor built several thousand homes and 400 homeowners made claims regarding construction defect and soil movement. Some lawsuits were filed, others were claims. Wausau reserved the right to deny coverage. Independent counsel was appointed to defend the claims in litigation. Seeno declined Independent Counsel to oversee the unlitigated claims and requested Wausau to handle these claims. Wausau filed a declaratory relief action and hired coverage counsel for the unlitigated claims and the declaratory relief action. Seeno argued Wausau used the investigation and settlement of the unlitigated claims to gather information for the coverage dispute. Seeno filed a counter-claim requiring Wausau to segregate its liability claims handling from its coverage investigation. The Ninth Circuit in *Seeno* observed a difference between choosing to divide files and legally mandating the division of the defense and coverage files. Relying on California's Independent Counsel statute and the *Durant* case, the Ninth Circuit held the fiduciary-like relationship between the insurer and the insured does not mandate division of files. The industry practice to divide liability and coverage files did not establish that it was the insurer's legal duty to divide the files. The court concluded the state of the law in California did not require the division of liability and coverage files.

3. *State Farm Fire & Cas. Co. v. King Sports, Inc.,* 489 Fed.Appx. 306 (11th Cir. 2012). The insured was sued for trademark infringement and other offenses. State Farm defended the actions under reservations of rights. State Farm also filed a declaratory relief action regarding the duty to indemnify. The underlying plaintiff and the insured entered into a consent judgment and the insured assigned rights to sue State Farm for "bad faith." In the "bad faith" case, the assignee argued that State Farm delayed for three months in dividing the claims files which enabled State Farm to obtain information from the defense which bore on coverage. The Eleventh Circuit held:

> "Cleveland Golf argues that by not immediately splitting the file, State Farm allowed information obtained in the defense of Chang and King Sports to be used against them in the coverage action. Although it is clear that State Farm deviated from its own policies, Cleveland Golf fails to articulate exactly how State Farm's decision to wait to split the file shows bad faith. Cleveland Golf does not identify what sensitive information Williams was able to gain and use against King Sports and Chang due to her handling of the entire file. Moreover, Cleveland Golf cites no authority to support its argument that State Farm even had a duty to split the file."

4. *Armstrong Cleaners, Inc. v. Erie Insurance Exchange*, 364 F.Supp.2d 797 (S.D. Ind. 2005). A dry-cleaning business was sued for dumping environmental pollutants. The insurer agreed to defend under a reservation of rights and appointed defense panel counsel.

The insured demanded a right to independent counsel. The insurer refused but divided the file between coverage and defense. The insured sued the insurer demanding that the insurer pay for independent counsel. The insurer argued that independent counsel was not necessary because the coverage adjuster and defense adjuster were prohibited from discussing the matter or sharing file information by a Chinese Wall. The court noted that this "Chinese Wall" was not adequate:

> "The argument is not persuasive here. The procedures are limited to the front-line adjusters. There is no indication that they apply to more senior supervisors of both adjusters, including those who would have to approve payment of the attorney fees and any settlement. In addition, the adjuster handling the defense issues has a copy of the reservation of rights letter and must be presumed to understand the coverage issues."

The court found a sufficient conflict and ordered the insurer to pay for independent counsel.

Expert and industry commentary on dividing the claims file include:

- *Splitting Claims Files: Managing for Conflicts of Interest Through Use of Insurance Company Conflict Screen*, 22 No. 2 Cal. Ins. L. & Reg. Rep. 1 (March 2010)
- *Splitting the File in Liability Insurance*, 79 Def. Counsel J. 399 (October 2012)
- 1 Practical Tools for Handling Insurance Cases § 7:19 (June 2018 update)

B. Practical/Ethical Considerations Regarding a Divided Claims File

Insurers need to be aware of when it is prudent to divide a claims file. In certain circumstances that needs to be done as soon as there is a conflict, with one adjuster handling more than one aspect of the claim, such as:

- Rights have been reserved on significant coverage or indemnity issues
- Insurer is considering or has filed a declaratory relief action
- Rights have been reserved to rescind the insurance policy
- A rescission action has been filed
- Possibly when the insured has demanded independent counsel, but the insurer has declined that request (unless it is settled the insured is not entitled to independent counsel)

Dividing the claims file is one way to fulfill the insurer's obligations to the insured. Dividing the claims file should also help insulate the insurer from potential "bad faith" liability based, in part, on any alleged failure to divide the file.

From existing cases the trend seems to be that if the insured is defended by independent counsel, there will be no "duty" to divide the insurer's claim file. If independent counsel is appointed that appears to work as an exception to any "duty" on the part of the insurer to divide the claim file.

In light of the *Armstrong Cleaners* case out of the Indiana federal court, there is existing case law support that the "duty" to divide the claim is not limited to the front-line claims adjuster but would extend to supervisors and perhaps even senior management who are approving claims decisions.

II. Impact on the Reinsurer and Obligations Owing to the Reinsurer with a Divided or Undivided Claims File of the Insurer

A. Reporting to the reinsurer – when that must be done, what should be disclosed and who is doing the communicating with the reinsurer

In general, the ceding insurer will have obligations owing to the reinsurer under the terms of the reinsurance treaty or as a mater of law. In situations where coverage issues exist, reinsurers can face a challenge to obtain complete information from the insurers on issues of both coverage and liability so that the reinsurer can adequately determine its own exposure.

Front line claims adjusters may not know what information to share with the reinsurer and how best to share that information. Large insurers may have ceding reinsurance departments which handle communications with the reinsurer. Smaller or regional insurers may not. If third party administrators are handling claims, they may or may not know what information is being shared with the reinsurer.

The existence of reinsurance should not affect how the insurer handles a claim. The claim should be handled based on the facts of the claim and information developed by the insurer in the handling of the claim to determine the insured's liability and damages.

For example, in California and New York, the following obligations are owed by an insurer to the reinsurer:

> California Insurance Code § 622 -- "Where an insurer obtains reinsurance, he must communicate all the representations of the original insured, and also all the knowledge and information he possesses, whether previously or subsequently acquired, which are material to the risk."
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> *Sumitomo Marine & Fire Ins. Co. v. Cologne Reinsurance Co. of America*, 75 N.Y.2d 295, 552 N.Ed2d 139, 552 N.Y.S.2d 891 (1990) – "A reinsured is obliged to disclose to potential reinsurers all 'material facts' concerning the original risk, and failure to do so generally entitles the reinsurer to rescission of its contract."

B. How the Reinsurer is Impacted by the Insurer's Divided or Undivided Claims File

1. Communications with Insured, Defense Counsel and/or Independent Counsel and What Duties, If Any, are Owed to the Reinsurer

Presently, reinsurers are sometimes faced with an insurer not providing the reinsurer with complete information from the insurer's claim file(s) as they are concerned about waiving privilege. The reinsurer needs documents from both the coverage and defense claim files to evaluate coverage under the terms of the reinsurance agreement and exposure, even when the claim file has been divided. The reinsurer is seeking to determine its own exposure, in light of the strength of the coverage position taken by the insurer.

2. Concerns about Information Disclosed to the Reinsurer – What, If Anything, Cannot or Should Not be Disclosed to the Reinsurer When the Claims File is Divided

a. Discoverability of Reinsurance Information

There are also concerns about policyholders seeking information from the reinsurance claim file to try to get around issues of privilege that have been asserted by the insurer. Ceding insurers are becoming increasingly concerned about what information is shared with the reinsurer. This raises a potential ethical issue about what an insurer can or should disclose to the reinsurer, as efforts are made to gain additional information from the reinsurer which the insured is not able to obtain from the insurer due to claimed attorney-client and work product privileges and protections.

In certain states reinsurance information is discoverable but may still be cloaked with an applicable privilege such as the attorney-client privilege. Insureds in a "bad faith" or coverage case will argue that any communication with the reinsurer has waived any attorney-client privilege between the insurer and counsel hired by the insurers. In a "bad faith" case, the policyholder may seek reinsurance information in discovery and contend reinsurance information is discoverable as evidence supporting the "bad faith" claim. Insurers can argue that reinsurance information is (1) not relevant to the issues in the lawsuit and (2) privileged or protected. Such concerns often lead to insurers redacting or withholding certain information from the reinsurers.

The insurer needs to be aware of the law applicable in the jurisdiction. The reinsurers are seeing privileged information redacted or withheld due to concerns by the insurer regarding discovery of the reinsurance claim file. Courts disagree on whether reinsurance information is discoverable. For example:

> *Lipton v. Superior Court*, 48 Cal.App.4th 1599 (1996). The California Court of Appel held that reinsurance documents may be relevant to the issues in the "bad faith" case. However, "where reinsurance documents include attorney-client or protected work product communications they would be entitled to the same privilege protection as would similar communications between

the ceding insurer and tis attorneys handling the insured's claim." Further, communications to a reinsurer which may contain advice from counsel for the ceding insurer relating to coverage, exposure and other liability issues "would, in all probability, be protected by the attorney-client privilege." The burden is on the requesting party to "demonstrate a basis to overcome such privilege."

Rhone-Poulenc Rorer Inc. v. Home Indem. Co., 139 F.R.D. 609 (E.D. Pas. 1991). The Pennsylvania federal district court held that reinsurance information may be discoverable if there is an ambiguity in the insurer's policies.

Leksi, Inc. v. Federal Ins. Co., 129 F.R.D. 99 (D.N.J. 1989). The New Jersey federal district court held that reinsurance information is relevant where there is a lost or missing policy issue "in order to attempt to reassemble the terms of the original contract which is now unavailable."

Discoverability of Communications Between Insurer and Reinsurer, 104 A.L.R. 6th 207.

Discoverable or Not: Whether Reinsurance Agreements and Communications are Discoverable in Federal Courts, 79 Def. Couns. J. 90 (Jan. 2012).

b. What Claims Adjusters and Claim Managers for the Insurer Need to Know

Claims adjusters, supervisor, managers and directors for the insured should be aware of these issues and concerns so that how the claim is initially handled will be done in an ethical way. Proper understanding of these issues will alleviate any potential "bad faith" exposure as the claim continues and should avoid disputes with the reinsurer.

Dividing the claims file when appropriate and doing so timely will fulfill ethical responsibilities the insurer owes to the insured and will fulfill all duties of the insured to properly and reasonably handle the claim.

C. The Best Practices for Insurers in Communicating with the Reinsurer in a Divided Claims File Scenario

The reinsurer will want as much information as possible. The insurer may be guarded in what is provided to the reinsurer. The insurer must be aware of the duties and obligations owed to the reinsurer under the reinsurance treaty, as well as the law applicable in the jurisdiction at issue regarding discoverability and privilege waiver as discussed above.

D. The Best Practices for the Reinsurer to Deal with a Divided Claims File

Coverage and defense files should be divided unless the insured is being represented through independent counsel. If the insurer agrees to defend the insured through the insured's independent counsel, there is case law support for one adjuster handling both the coverage and defense files.

If rescission of the policy is sought by the insurer, divide the claim files so there is an ethical wall in place so information obtained in the defense is not used in the rescission action against the insured.

III. Recommendations from the Insurer and Reinsurer Perspectives

Insurers face ethical dilemmas on whether and when to divide the claim file. While existing case law does not support any "duty" to divide the claim file, there are instances in which the insurer should divide the claim file. Doing so will fulfill the ethical and contractual obligations owed to the insured and will be evidence of "good faith" claims handling. If the situation calls for the claims file to be divided, the insurer or its third party administrator handling the claim should divide the claims file and do so timely. Do not wait for the insured's counsel to press the insurer to divide the claims file.

A further ethical dilemma is how far up the chain of command the claims file should be divided by the insurer. Doing so only at the front-line claims adjuster level may not be enough to fulfill the insurer's ethical obligations to the insured. Doing so may not fully insulate the insurer from alleged "bad faith" due to improper handling of the claim in a situation which calls for the claims file to be divided.

A further ethical dilemma exists between the insurer and reinsurer on what information can and should be communicated to the reinsurer from the divided claim files. Is it enough to provide the reinsurer with information from the defense file? The reinsurer will argue "no" because the reinsurer will also want to see the information in the coverage file, including any coverage opinion obtained from counsel.