

FALL 2006

Volume 42, Number 1

# Tort Trial & Insurance Practice Law Journal

The (Often Insurmountable) Hurdles Facing Foreign  
Claimants Prosecuting Class Actions in American  
Courts ..... CHARLES F. RYSAVY AND PRANITA A. RAGHAVAN

Bad Faith Coverage Litigation: The Insurer's  
Covenant of Good Faith and Fair  
Dealing ..... BRENT W. HUBER AND ANGELA P. KRAHULIK

Recurring Issues in Rescission  
Cases ..... SUSAN KOEHLER SULLIVAN AND DAVID A. RING

Epidemiology as More Than Statistics: A Revised Tool for Products  
Liability ..... ROBERT J. BERLIN

Contingent Fees in Mass Tort Litigation.....  
TASK FORCE ON CONTINGENT FEES OF THE AMERICAN BAR  
ASSOCIATION'S TORT TRIAL & INSURANCE PRACTICE SECTION

On the *Level 3*: Reviewing the (Un)insurability of Restitutionary  
Payments ..... RICHARD F. HANS

Fraud in the Inducement as a Defense to Fidelity and Surety  
Claims ..... BOGDA M.B. CLARKE, JAMES D. FERRUCCI,  
AND ARMEN SHAHINIAN

Index to Volume 41

TORT TRIAL & INSURANCE PRACTICE SECTION  
■ AMERICAN BAR ASSOCIATION ■

## BAD FAITH COVERAGE LITIGATION: THE INSURER'S COVENANT OF GOOD FAITH AND FAIR DEALING

*Brent W. Huber and Angela P. Krabulik*

### I. INTRODUCTION

The policyholder that is the target of a liability claim must account for two cases: the liability case and the coverage case. The policyholder is both a defendant and a plaintiff in such situations. On the one hand, the policyholder faces an underlying liability claim, which may give rise to one lawsuit. On the other hand, the policyholder needs to pursue liability coverage from its insurers, which often gives rise to another lawsuit. Although there may be procedural tools that could provide some protection for the policyholder in these situations, in many jurisdictions the policyholder has no realistic choice but to litigate both the liability case and the coverage case at the same time.

This article analyzes several ways in which the liability insurers of such a policyholder may violate their duties of good faith and fair dealing. Although an insurer has the right to defend itself in a coverage lawsuit, this right is not without limits, especially when that insurer's policyholder simultaneously faces claims from the plaintiff in the underlying liability case. In these situations, the insurer's abuse of the legal process is not necessarily the issue. The issue is the extent to which the insurer's conduct during the course of the coverage lawsuit can form the basis for an independent claim of bad faith by the policyholder.

---

---

*Brent W. Huber (brent.huber@icemiller.com) is a partner at Ice Miller in Indianapolis and the founding member of the firm's Insurance Recovery Practice Group. His primary areas of practice are risk management and insurance coverage dispute resolution. Angela P. Krabulik is an associate with Ice Miller, focusing on insurance coverage and regulation, business litigation, and environmental law. This article does not necessarily represent the views of Ice Miller LLP or its clients and is not intended to constitute legal advice.*

---

---

This article argues that liability insurers must act reasonably in the course of coverage litigation because of the special relationship that is created by the insurance contract, especially when their insureds are targets of underlying liability claims. The article identifies and discusses some of the specific ways in which insurers can commit insurance bad faith during the course of coverage litigation. It is not intended to be exhaustive. Rather, it describes some of the common situations in which insurers can breach their duties of good faith and fair dealing in their conduct and dealings with their insureds after coverage litigation ensues, including (1) hiring defense counsel to jointly represent two insureds with conflicting interests; (2) suing the insured and the underlying claimant in the same action or attempting to intervene in the underlying action; (3) demanding the production of materials that could result in the waiver of the insured's litigation privileges; (4) failing to establish a conflict screen to account for the insurer's conflict of interest and using confidential and sensitive information, obtained from the insured under the guise of defending the underlying claim, to develop coverage defenses; and (5) asserting multiple, unsubstantiated defenses in coverage litigation with the insured.

## II. THE SPECIAL RELATIONSHIP CREATED BY THE INSURANCE CONTRACT

Many courts characterize the relationship between an insurer and its insured as fiduciary in nature.<sup>1</sup> Other courts, although refraining from describing the relationship as fiduciary per se, have recognized the nature of the insurer-insured relationship as "characterized by unique bargaining power in which the insured must depend on the good faith and performance of the insurer,"<sup>2</sup> leading the courts to impose on insurers "special and heightened duties" or "duties of good faith" and "fair dealing."<sup>3</sup> One court characterized the relationship as "quasi-fiduciary," stating that the insurance company owes its insured an "enhanced fiduciary obligation" and that the "insurer must deal fairly with an insured, giving equal consideration in all matters to the insured's interests as well as its

1. See *Grewell v. State Farm Mut. Auto. Ins. Co.*, 162 S.W.3d 503, 508-09 (Mo. Ct. App. 2005); *Gilderman v. State Farm Ins. Co.*, 649 A.2d 941, 943 (Pa. Super. Ct. 1994), *appeal denied*, 661 A.2d 874 (Pa. 1995); *Powers v. United Servs. Auto. Ass'n*, 962 P.2d 596, 603 (Nev. 1998); *Gossett v. Farmers Ins. Co. of Wash.*, 948 P.2d 1264, 1277 (Wash. 1997).

2. *Tran v. Farmers Group, Inc.*, 128 Cal. Rptr. 2d 728, 735 (Ct. App. 2002) (quoting *Vu v. Prudential Prop. & Cas. Ins. Co.*, 33 P.2d 487, 492 (Cal. 2001) (internal citations omitted)).

3. *Van Noy v. State Farm Mut. Auto. Ins. Co.*, 16 P.3d 574, 582-83 (Wash. 2001); see also *Scott Wetzel Servs., Inc. v. Johnson*, 821 P.2d 804, 808 (Colo. 1991) (referring to the insurer-insured relationship as "quasi-fiduciary" in nature); *Erie Ins. Co. v. Hickman*, 622 N.E.2d 515, 518 (Ind. 1993).

own."<sup>4</sup> That court went on to state that "an insurance company has an elevated good faith obligation that rises to a level higher than that of mere honesty and lawfulness of purpose."<sup>5</sup>

An insurer's breach of the above-described duties to its policyholder constitutes bad faith.<sup>6</sup> The vast majority of states recognize such a cause of action, either by judicial decision or statute.<sup>7</sup> Depending on the particular situation, insurers may engage in actionable bad faith in a variety of ways. Some commonly recognized situations that may give rise to claims of bad faith include an insurer's unfounded refusal or delay in paying policy proceeds, an insurer's failure to properly investigate claims before denial, deceiving or misinforming the insured, or exercising an unfair advantage over the insured.<sup>8</sup>

### III. INSURERS' DUTIES OF GOOD FAITH AND FAIR DEALING TOWARD THEIR INSURED DO NOT CEASE AFTER COVERAGE LITIGATION ENSUES

This article suggests that an insurer should not be immunized from the consequences of bad faith conduct simply because it is litigating coverage issues with the policyholder. The insurer's duty of good faith to its policyholder continues even after one of the parties to the insurance contract commences coverage litigation.<sup>9</sup> Courts in several jurisdictions have

4. *Van Noy*, 16 P.3d at 578.

5. *Id.*

6. See generally *id.* Similarly, in *Erie Ins. Co.*, the court explained thus:

Clearly, a relationship exists between an insurer and its insured because they are in privity of contract. However, the existence of a contract, standing alone, does not give rise to the required "special relationship" to support imposition of a tort duty. Rather, it is the unique character of the insurance contract which supports the conclusion that there is a "special relationship." This contractual relationship is at times a traditional arms-length dealing between two parties, as in the initial purchase of a policy, but is also at times one of a fiduciary nature, and, at other times, an adversarial one, as here in the context of a first-party claim. Easily foreseeable is the harm that proximately results to an insured, who has a valid claim and is in need of insurance proceeds after a loss, if good faith is not exercised in determining whether to honor that claim. Given the *sui generis* nature of insurance contracts, then, we conclude that it is in society's interest that there be fair play between insurer and insured. These factors, coupled with our return to the rule of no punitive damages in contract cases, leads us to conclude that recognition of a cause of action for the tortious breach of an insurer's duty to deal with its insured in good faith is appropriate.

*Erie Ins. Co.*, 622 N.E.2d at 518-19 (internal citations omitted).

7. PETER J. KALIS ET AL., POLICYHOLDER'S GUIDE TO THE LAW OF INSURANCE COVERAGE §24.06(B)(2); *Erie Ins. Co.*, 622 N.E.2d at 519, n.1.

8. See generally *Erie Ins. Co.*, 622 N.E.2d at 519; KALIS, *supra* note 7, §24.06(B)(2).

9. See, e.g., *Sosbee v. State Farm Mut. Auto. Ins. Co.*, 164 F.3d 1215, 1217 (9th Cir. 1999); *Graham v. Gallant Ins. Group*, 60 F. Supp. 2d 632, 635 (W.D. Ky. 1999); *Gooch v. State Farm Mut. Auto. Ins. Co.*, 712 N.E.2d 38, 41-42 (Ind. Ct. App. 1999).

explicitly recognized that evidence to support a claim for bad faith may include postlitigation conduct.<sup>10</sup>

For example, in *T.D.S., Inc. v. Shelby Mutual Insurance Co.*,<sup>11</sup> the U.S. Court of Appeals for the Eleventh Circuit found that an insurer's litigation conduct was relevant to show its dishonesty and deliberate deceit in its dealings with its insured. In that case, the insured sought insurance coverage for damage resulting from a fire that destroyed its restaurant business. On appeal after a jury verdict for the insured, the insurer asserted that the jury's assessment of punitive damages was based not on any evidence of an independent tort, but rather on the insurer's decision to raise an arson defense. Thus, the insurer argued its litigation conduct was irrelevant to the independent tort claim. The court referred to this argument by the insurance company as "a straw man" that was "easily dismantled."<sup>12</sup> The court explained thus:

Certainly the litigation conduct of [insurer] was relevant to the claim that [insurer] or those acting on its behalf dealt dishonestly with [insured]. Although this conduct occurred after the denial of [insured's] claim, it did corroborate [insured's] contention that [insurer] deliberately deceived it while [insurer] was investigating the fire. Additionally, much of the evidence concerning the recklessness of the investigation and the poor quality of the investigative reports [insurer] stated it relied upon to deny [insured's] claim is relevant to the issue of whether in fact the fire was the result of arson and, if so, the identity of the arsonist. Surely these are matters of consequence in an insurance suit where arson is raised as a defense.<sup>13</sup>

In *Graham v. Gallant Insurance Group*,<sup>14</sup> an insured brought suit seeking uninsured motorist and property damage coverage, as well as alleging bad faith against the insurer. During the course of discovery, the insured

10. See, e.g., *Home Ins. Co. v. Owens*, 573 So. 2d 343, 344 (Fla. Dist. Ct. App. 1990) (stating that "[i]n pursuing a bad faith claim, it appears to us that [post-litigation] evidence . . . is relevant"); *Palmer v. Farmers Ins. Exch.*, 861 P.2d 895, 913 (Mont. 1993) ("Courts have held, and we agree, that an insurer's duty to deal fairly and not to withhold payment of valid claims does not end when an insured files a complaint against the insurer."). But see *Timberlake Constr. Co. v. U.S. Fid. & Guar. Co.*, 71 F.3d 335, 340-41 (10th Cir. 1995) (stating that the insurer's litigation conduct should "rarely, if ever, be allowed to serve as proof of bad faith"); *Sinclair Oil Corp. v. Republic Ins. Co.*, 967 F. Supp. 462, 468 (D. Wyo. 1997) (litigation conduct is not a basis for bad faith because other avenues of redress exist); *Rose v. St. Paul Fire & Marine Ins. Co.*, 599 S.E.2d 673, 680 (W. Va. 2004) (holding that claimant could establish a violation of the West Virginia Unfair Trade Practices Act "by showing that an insurance company, through its own actions, breached its duties under the Act by knowingly encouraging, directing, participating in, relying upon, or ratifying wrongful litigation conduct of a defense attorney hired by the insurance company to represent an insured");

11. 760 F.2d 1520 (11th Cir. 1985).

12. *Id.* at 1527.

13. *Id.*

14. 60 F. Supp. 2d 632 (W.D. Ky. 1999).

sought information regarding the insurer's postcomplaint conduct. In ordering the insurer to produce all documents that concerned defense of the uninsured motorist and property damage claims, the court stated that "there is no question that the duty of good faith by an insurance company is a continuing duty, which continues past the filing of a complaint against the insurer. Because of this continuing duty, there may be evidence of post-filing conduct that is relevant to the bad faith claim."<sup>15</sup>

Similarly, in *Gooch v. State Farm Mutual Automobile Insurance Co.*, the Indiana Supreme Court found that an insurer's postlitigation conduct could be used as evidence of bad faith because it was "relevant to whether [insurer] failed to take certain actions in order that they could maintain a legal position that would involve substantial cost and delay."<sup>16</sup> The court also concluded that a genuine issue of material fact existed as to whether the insurer's behavior in "intentionally refusing to further investigate a matter brought to its attention in order to give its counsel the factual predicate upon which to rest its Motion to Dismiss" was intended in bad faith to coerce the insured to settle its claim, stating: "[W]e are unwilling to allow [the insurer] to escape liability because its bad faith attempt to enforce a provision of [the] insurance policy was a 'litigation position.'"<sup>17</sup> According to these and other case authorities, an insurer's conduct toward its insured thus can support a claim for bad faith even after coverage litigation is commenced.

#### IV. PROBLEMATIC SITUATIONS FOR INSURERS

##### A. *Hiring Defense Counsel to Represent Two Insureds with Conflicting Interests*

When there is a coverage dispute, one of the threshold questions facing the primary liability carrier is whether there is a duty to defend under the policy. The insurer may breach its duty of good faith and fair dealing during the course of its defense of its insured in the underlying action. Such breaches may occur while the insurer is litigating coverage issues with its policyholder. Although the insurer may be involved in coverage litigation, it must nevertheless account for potential conflicts of interest between other parties it is representing and its insured, as well as conflicts it may have with the insured.

A serious conflict of interest exists where the insurer-appointed defense counsel acts against the interest of the insured for the benefit of another

15. *Id.* at 635.

16. 712 N.E.2d 38, 42 (Ind. Ct. App. 1999).

17. *Id.* at 43.

insured and/or the insurer. Ethical rules require a lawyer to exercise independent professional judgment on behalf of the client.<sup>18</sup> Courts have consistently held that an attorney retained by an insurer to defend the insurer's policyholder represents the policyholder.<sup>19</sup> As one court aptly explained,

When counsel, although paid by the casualty company, undertakes to represent the policyholder and files his notice of appearance, he owes to his client, the assured, an undeviating and single allegiance. His duty to the assured is paramount. The canons of professional ethics make it pellucid that they are not two standards, one applying to counsel privately retained by a client, and the other to counsel paid by an insurance carrier. If the interest of the carrier and the assured are, or are likely to become diverse, he cannot represent both. Divided obligations and trust relations are obnoxious to the law, and in none more so than in that of attorney and client.<sup>20</sup>

Such a conflict of interest can arise when an insurer is obligated to defend two or more insureds. Although the insureds may share similar interests in defeating third-party claims against them, their interests may diverge regarding issues that could affect ultimate responsibility for the third party's alleged damages. It is for this reason that the majority of courts addressing this issue have found that an insurer's duty to defend each insured includes a duty to provide independent counsel to each.<sup>21</sup>

These types of potential conflicts of interest must be recognized by insurers at the outset of accepting an insured's defense; and separate and independent counsel for each insured must be provided, or full disclosure must be made and consent obtained, to avoid any such conflicts of interest. If the insurer fails to properly account for these conflicts, it exposes itself to the bad faith claim that it is taking unfair advantage of the insured's vulnerable position and need for a defense.

For example, in *Bituminous Insurance Cos. v. Pennsylvania Manufacturers' Ass'n Insurance Co.*,<sup>22</sup> the court found that an insurer's obligation to defend

18. See MODEL CODE OF PROF'L RESPONSIBILITY DR5-105(A)-(B) (1980); MODEL RULES OF PROF'L CONDUCT R. 1.7 (2002).

19. See *In re* Petition of Youngblood, 895 S.W.2d 322, 328 (Tenn. 1995) (stating obligation to defend insured under a contract of insurance obviously contemplates representation by counsel who can exercise professional judgment and devote complete loyalty to the insured regardless of the circumstances); see also *Smith v. Anderson-Tulley Co.*, 608 F. Supp. 1143, 1147 (S.C. Miss. 1985), *aff'd*, 846 F.2d 751 (5th Cir. 1988); *Pine Island Farmers Co-Op v. Erstad & Riemer*, 649 N.W.2d 444, 449 (Minn. 2002); *In re Allstate Ins. Co.*, 722 S.W.2d 947, 954 (Mo. 1987); *Feliberty v. Damon*, 527 N.E.2d 261, 265 (N.Y. 1988); 14 LEE R. RUSS, COUCH ON INSURANCE §202:18 (3d ed. 2005).

20. *Am. Home Assurance Co. v. Sand*, 253 F. Supp. 942, 948 (D. Ariz. 1966) (internal citations omitted).

21. See *Bituminous Ins. Co. v. Pa. Mfr.'s Ass'n Ins. Co.*, 427 F. Supp. 539, 555 (E.D. Pa. 1976); *Ill. Masonic Med. Ctr. v. Turegum Ins. Co.*, 522 N.E.2d 611, 619 (Ill. App. Ct. 1988); *Nisson v. Am. Home Assurance Co.*, 917 P.2d 488, 490 (Okla. Ct. App. 1996).

22. 427 F. Supp. 539 (E.D. Pa. 1976).

both the general contractor and a subcontractor in a lawsuit alleging faulty construction involved a conflict of interest requiring separate counsel for each. In so finding, the court discussed the difficulty counsel could face if it represented both parties:

Assuming that he is engaged by [insurer], there is a possibility that counsel might attempt to establish that the damage at the construction site was caused solely by [general contractor]'s independent acts of negligence, thereby relieving [subcontractor] of the obligation to indemnify. [General contractor]'s interests, on the other hand, require that the case be defended to establish, first, that neither [subcontractor] nor [general contractor] was at fault for the damage, but second, if it should be determined that at least one was at fault, to attempt to lay blame on [subcontractor] to preserve [general contractor]'s right of indemnity. Clearly the interests of [subcontractor] and [general contractor] do not coincide, and they must be represented by separate counsel which [insurer] must provide under its duty to defend.<sup>23</sup>

Similarly, in *Williams v. American Country Insurance Co.*,<sup>24</sup> the Illinois Appellate Court found the conduct of an insurer in failing to fully disclose a conflict of interest and pay for costs of independently selected counsel for its insured was prejudicial to the insured and that the insured was entitled to an attorney fees award. In that case, a pedestrian was struck by a taxicab owned by Yellow Cab Company and driven by Thomas Williams. Williams was subsequently convicted of misdemeanor battery as a result. The pedestrian filed a tort action against Williams and Yellow Cab. American Country undertook the defense of the tort action. While the underlying case was pending, Williams filed suit seeking a declaration that American Country was obligated to provide him with independent counsel because of a conflict of interest. The underlying plaintiff was granted leave to intervene. American Country filed a counterclaim seeking a declaration that it had no duty to defend Williams.<sup>25</sup>

The court found that American Country had a conflict of interest when it assumed Williams's defense in the underlying case and that Williams was prejudiced as a result of the conflict.<sup>26</sup> The court stated that "the test of whether a conflict exists is if, in comparing the allegations of the complaint to the terms of the policy, the insurer's interest would be furthered by providing a less than vigorous defense to the allegations."<sup>27</sup> A conflict existed

23. *Id.* at 555; see also *First Ins. Co. of Haw. v. Minami*, 665 P.2d 648, 654 (Haw. 1983) (holding that insurer was "required to provide separate counsel" to represent the interests of each insured because although the insureds shared a "common interest . . . to prevent plaintiffs from securing any recovery, a potential conflict between the interests of the [insureds] is apparent").

24. 833 N.E.2d 971 (Ill. App. Ct. 2005).

25. *Id.* at 974-76.

26. *Id.* at 979.

27. *Id.*

here because it was in the insurer's best interest, in order to shift liability, to establish that Williams was not an agent of Yellow Cab. As the court put it,

American Country was charged with providing a full and vigorous defense to both Williams and Yellow Cab, whose interests in how the underlying suit was defended were in opposition to each other. . . . [I]t would be in Williams' best interest to present a defense that he was an agent of Yellow Cab, while it would be in Yellow Cab's best interest to establish the exact opposite.<sup>28</sup>

In fact, the counsel appointed by American Country to represent Williams denied Williams was an agent of Yellow Cab and denied there was any applicable insurance. The court went on to say that such a conflict can be resolved by full disclosure and consent from the parties.<sup>29</sup>

The *Williams* court's ruling was based in large part on a previous Illinois Supreme Court case, *Murphy v. Urso*.<sup>30</sup> In *Murphy*, a bus driver took a school-owned bus after hours for his personal use in helping a friend move. The driver and his friend, who was riding in the van as a passenger, were involved in an accident, and the friend was injured. The passenger sued both the driver and the school that employed him on theories of negligence.<sup>31</sup>

The court found that the school's insurer had conflicts of interest that precluded it from defending under a reservation of rights where the insurance company controlled both the defenses for the school and for the driver:

An analysis of the possibilities reveals the dilemma in which [the insurer] found itself. It controlled both defenses. To best defend the preschool, it would try to show that [the driver] did not have permission to use the bus at the time of the accident. . . . But to best serve [the driver], [the insurer] had to try to show that he did have permission to use the bus. . . . The interests of [the school] and [the driver] in how the suit was to be defended were diametrically opposed, creating an ethical conflict for [the insurer], which was charged with providing a full and vigorous defense to each. . . . In order to defend either the school or [the driver], [the insurer] had to resolve the conflict and pick a strategy of defense. How could it do so for one without harming the other?<sup>32</sup>

The *Murphy* court went on to point out that the fundamental conflict existed not only between the interests of the driver and the school but also between the driver and the insurer. It was in the driver's interest to side with the underlying plaintiff and shift liability to the school so the insurance would pay any judgment, whereas the insurer's interest lay in separating the driver from the school so the driver would bear the entire liability.<sup>33</sup>

28. *Id.* at 980.

29. *Id.*

30. 430 N.E.2d 1079 (Ill. 1982).

31. *Id.* at 1081.

32. *Id.* at 1083.

33. *Id.* at 1083-84.

A comparable conflict of interest existed in *Public Service Mutual Insurance Co. v. Goldfarb*.<sup>34</sup> In that case, the insurer sought a judicial declaration that the policy of professional liability insurance it issued to a dentist did not provide coverage for a civil claim of sexual abuse alleged to have occurred during the course of dental treatment. The court found that to the extent the underlying complaint could be construed as a claim for injuries unintentionally caused by the dentist, the dentist could seek indemnity from his insurer. However, the insurer could not be compelled to indemnify the dentist for damages flowing from any intentionally caused injury or punitive damages.<sup>35</sup>

Because claims within the stated coverage had been made, the court found that the insurer was required to defend the doctor. Recognizing the insurer's conflict of interest in this case, the court further held that the doctor was entitled to defense counsel of his own choosing, to be paid for by the insurer. The court explained that a conflict of interest necessitating separate counsel does not always arise where there are multiple claims:

Independent counsel is only necessary where the defense attorney's duty to the insured would require that he defeat liability on any ground and his duty to the insurer would require that he defeat liability only upon grounds which would render the insurer liable. When such a conflict is apparent, the insured must be free to choose his own counsel whose reasonable fee is to be paid by the insurer. On the other hand, where multiple claims present no conflict—for example, where the insurance contract provides liability coverage only for personal injuries and the claim against the insured seeks recovery for property damage as well as for personal injuries—no threat of divided loyalty is present and there is no need for the retention of separate counsel. This is so because in such a situation the question of insurance coverage is not intertwined with the question of the insured's liability.<sup>36</sup>

Thus, where questions of coverage and liability become intermingled such that a conflict is presented for the defending counsel, the insured must be provided with independent counsel. The failure to do so could constitute a breach of the insurer's duties of good faith and fair dealing.<sup>37</sup>

*B. Suing an Insured and the Underlying Claimant in the Same Action*

In most situations the underlying claim against the insured and the coverage litigation between the insured and insurer proceed as two separate actions.

34. 425 N.E.2d 810 (N.Y. 1981).

35. *Id.* at 814-15.

36. *Id.* at 815.

37. The failure to provide independent counsel in a conflict situation could also constitute a breach of the duty to defend and thus support a claim of waiver and estoppel against the insurer, a topic that is beyond the scope of this article.

This section address the potential prejudice to insureds when insurers attempt to combine the underlying suit with the coverage action or when insurers attempt to intervene in the underlying liability case. The harm to the insured in such a situation is twofold: the insured is prejudiced in defending itself against the underlying claim and is prejudiced in the coverage action because coverage issues are necessarily injected into the liability case and vice versa. Moreover, there is no workable means of protecting any insurer-insured privilege under such circumstances, thereby further prejudicing the insured.

When an insurer makes the underlying claimants parties to its declaratory judgment action against the insured, the insurer's discovery regarding indemnity issues can severely prejudice the policyholder's ability to defend the underlying liability claims. Resolution of issues relating to indemnity will necessarily involve the actions of the insured and discovery regarding the nature, scope, and extent of damage giving rise to the underlying claims. In addressing these issues, the insurer's interest will be directly adverse to the insured's, and as a result the insurer may attempt to interject facts and issues related to its coverage defenses that may interfere with the insured's defense of the underlying claims. Thus, in its eagerness to avoid any coverage obligations, the insurer may adversely impact the policyholder's position in the underlying liability case.

A similar problem arises when an insurance company provides a defense to its insured subject to a reservation of rights. This also often creates a conflict of interest between the insurer and insured. In most states, this conflict entitles the policyholder to independent, or *Cumis*, counsel in the underlying case.<sup>38</sup> The term *Cumis counsel* comes from the leading decision, *San Diego Navy Federal Credit Union v. Cumis Insurance Society, Inc.*,<sup>39</sup> in which the California Court of Appeal held that an insured was entitled to retain independent counsel at the expense of the adverse insurer, a right that has since been codified in California.<sup>40</sup> A right to independent counsel where there is a conflict of interest has been recognized in many other states as well.<sup>41</sup>

38. See, e.g., *Kan. Bankers Sur. Co. v. Lynass*, 920 F.2d 546, 548 (8th Cir. 1990); *Armstrong Cleaners, Inc. v. Erie Ins. Exch.*, 364 F. Supp. 2d 797, 805-11 (S.D. Ind. 2005); Todd R. Smyth, Annotation, *Duty of Insurer to Pay for Independent Counsel When Conflict of Interest Exists Between Insured and Insurer*, 50 A.L.R. 4TH 932 (1986).

39. 208 Cal. Rptr. 494 (Ct. App. 1984), *superseded by statute as stated in* *Dynamic Concepts, Inc. v. Truck Ins. Exch.*, 71 Cal. Rptr. 2d 882 (Ct. App. 1998).

40. CAL. CIV. CODE §2860 (West 1993).

41. See, e.g., ALASKA STAT. §21.89.100 (Michie 1995); *Golotrade Shipping & Chartering, Inc. v. Travelers Indem. Co.*, 706 F. Supp. 214, 219 (S.D.N.Y. 1989); *Pepper Constr. Co. v. Cas. Ins. Co.*, 495 N.E.2d 1183, 1185 (Ill. 1986); *Mut. Serv. Cas. Co. v. Luetmer*, 474 N.W.2d 365, 368-69 (Minn. App. 1991). *But see* *Am. Motorists Ins. Co. v. Trane Co.*, 544 F. Supp. 669, 686, *aff'd*, 718 F.2d 842 (7th Cir. 1983); *Fed. Ins. Co. v. X-rite, Inc.*, 748 F. Supp. 1223, 1229 (W.D. Mich. 1990).

As one court aptly put it, the risks in these situations are such that "if there are several theories of recovery, at least one of which is not covered under the policy, the insurer might conduct the defense in such a manner as to make the likelihood of a plaintiff's verdict greater under the uninsured theory."<sup>42</sup> Allowing an insurer to proceed with a declaratory judgment action in which the underlying claimant has been named as a party, before the underlying litigation is resolved, infringes on the policyholder's right to defend itself. Naturally, the insurer will have an interest in directing the coverage litigation toward issues that favor a finding of no coverage. The plaintiffs in the underlying litigation, as parties, will be full participants and privy to all discovery in the coverage action, leaving the policyholder in an impossible situation.

In most states, combining the issues of liability and coverage is strictly forbidden, and for good reason, because the policy of the law is to keep the issue of insurance coverage (or lack thereof) out of the underlying liability case against the insured.<sup>43</sup> Rule 411 of the Federal Rules of Evidence likewise provides: "Evidence that a person was or was not insured against liability is not admissible upon the issue whether the person acted negligently or otherwise wrongfully."<sup>44</sup> A coverage action including the underlying claimants as parties ignores this long-standing body of law and the potential prejudice to the insured if coverage and underlying liability are not separated.<sup>45</sup>

42. *CHI of Alaska, Inc. v. Employers Reins. Corp.*, 844 P.2d 1113, 1116 (Alaska 1993).

43. See, e.g., *Cromer v. Sefton*, 471 N.E.2d 700, 704 (Ind. Ct. App. 1984); *Jenks v. Bertelsen*, 86 P.3d 24, 29 (Mont. 2004); *Smith v. Starnes*, 364 S.E.2d 442, 443 (N.C. Ct. App. 1988); *Grammer v. Kohlhaas Tank & Equip. Co.*, 604 P.2d 823, 829 (N.M. Ct. App. 1979); *Pointkowski v. Scott*, 582 N.E.2d 1002, 1003 (Ohio Ct. App. 1989); *Fidelity Nat'l Title Ins. Co. of N.Y. v. Suburban W. Abstractors*, 852 A.2d 318, 321 (Pa. Super. Ct. 2004); *Clarke v. Vandermeer*, 740 P.2d 921, 924 (Wyo. 1987).

44. FED. R. EVID. R. 411.

45. Admittedly, a few jurisdictions do allow the insurer to join third-party claimants as parties to coverage actions against policyholders. See, e.g., *Franklin Life Ins. Co. v. Johnson*, 157 F.2d 653, 658 (10th Cir. 1946); *State Farm Fire & Cas. Co. v. Reuter*, 657 P.2d 1231 (Or. 1983), *rev'd on other grounds*, 700 P.2d 2361 (Or. 1985); *Fire Ins. Exch. v. Basten*, 549 N.W.2d 690, 698 (Wis. 1996). However, the courts in most of these jurisdictions appear to have wisely recognized the potential prejudice inherent in these cases and impose certain requirements as a result. For example, in *Dial Corp. v. Marine Office of America*, the Illinois Appellate Court found that "a declaratory judgment action filed prior to a determination of liability in the underlying claim is only appropriate where the issues in the underlying suit are separable from those in the declaratory action." 743 N.E.2d 621, 626 (Ill. App. Ct. 2002). The *Dial Corp.* court went on to state that the deciding factor is whether collateral estoppel would operate. "If the issues are substantially the same so that collateral estoppel would apply to control the resolution of issues in the underlying suit, declaratory judgment would be premature." *Id.* (quoting *Ill. State Med. Ins. Serv., Inc. v. Cichon*, 629 N.E.2d 822 (Ill. App. Ct. 1994)). As the courts have explained, "[a] declaratory judgment action to determine an insurer's duty to indemnify its insured should not be decided prior to the adjudication of the underlying action where the issues to be decided in both actions are substantially similar; the rationale for this

An insurer's decision to join underlying claimants in a coverage action necessarily exposes the insured to the risk that issues of liability will find their way into the coverage action and coverage issues will find their way into the underlying liability case. There is no feasible way to separate liability issues from coverage issues if the underlying claimants in the liability case are parties to the coverage case. In the typical liability case, the concern is that evidence of insurance will influence the fact finder's determination as to whether there is liability. In a coverage action involving the underlying claimants, the prejudice to the insured is multiplied because the claimants who are parties to the coverage case will be looking for ways to subject the insured to liability, and the insurer will be looking for ways to avoid coverage for that same liability.

It is this type of prejudice to the insured that has persuaded a number of courts to hold that insurers are not permitted to intervene in an underlying liability action.<sup>46</sup> Allowing the insurer to proceed with a coverage case in which the underlying claimants are parties before the underlying litigation is resolved effectively allows the insurer to intervene in the liability dispute between its insured and the underlying claimants. This is prejudicial to the insured's ability to defend its interests in both lawsuits.

Furthermore, if the declaratory action goes forward before the underlying litigation is resolved, there is no practical, workable way to protect any insurer-insured privilege. In many states, certain communication between an insured and its liability insurer are privileged, not unlike the attorney-client or work product privilege, when the carrier agrees to defend without reservation.<sup>47</sup> The purpose of this privilege is to encourage full and frank exchanges of information that cannot be used against the insured by the claimants in the underlying case.<sup>48</sup> Because the insurer would participate in depositions and discovery alongside the underlying claimants—thus litigating coverage issues and liability at the same time—there could be no privilege between the insurer and its policyholder. The insured could not

---

rule is that an untimely determination in the declaratory judgment action could subsequently prejudice a party in the underlying action through application of collateral estoppel.<sup>39</sup> *Allianz Ins. Co. v. Guidant Corp.*, 839 N.E.2d 113, 120 (Ill. App. Ct. 2005). Similarly, the California Insurance Code requires that contracts of insurance contain a provision that an action may be brought directly against the insurer by a third party only after a judgment has been obtained against the insured. CAL. INS. CODE § 11580 (West 2005).

46. See, e.g., *Snodgrass v. Baize*, 405 N.E.2d 48, 53 (Ind. Ct. App. 1980); *Allstate Ins. Co. v. Atwood*, 572 A.2d 154, 159 (Md. 1990); *Berry v. St. Peter's Hosp. of City of N.Y.*, 678 N.Y.S.2d 674 (App. Div. 1998); *State Farm Mut. Auto. Ins. Co. v. Colley*, 871 P.2d 191, 195 (Wyo. 1994).

47. See *People v. Ryan*, 197 N.E.2d 15, 17-18 (Ill. 1964); *Richey v. Chappell*, 594 N.E.2d 443, 446 (Ind. 1992); *Asbury v. Beerbower*, 589 S.W.2d 216 (Ky. 1979); *State ex rel. Cain v. Barker*, 540 S.W.2d 50, 54 (Mo. 1976).

48. See *Richey*, 594 N.E.2d at 446.

divulge information frankly and candidly to the insurer regarding liability issues in the coverage action without also disclosing the same information to the underlying claimants.

Protective orders are often used to guard such information, but the purpose of a protective order in a coverage case is to prevent the underlying claimants from obtaining sensitive or privileged information. A protective order will not suffice when the underlying claimants are a party to the case, participating in the same depositions and discovery. The only way to allow for any privileged communication between the insured and the insurer in this scenario would be to bifurcate the coverage action. This would essentially create two separate actions, one that addresses coverage issues and one that addresses liability issues.

Although such a bifurcated action would impose more burden, expense, and inconvenience on all involved, including the court, and defeat the purpose of allowing a carrier to combine its coverage action with the liability case, there would appear to be no other way to allow for any sensitive or privileged defense communications with the defending insurer while avoiding prejudice to the insured in the underlying liability case. For these reasons, it would appear that insurers should not be permitted to sue their policyholders and the underlying claimants in the same suit absent specific statutory or case authority providing necessary protections and protocols for such suits.

*C. Taking Actions or Making Demands That Result in Waiver of Their Insured's Litigation Privileges*

During the course of coverage litigation, liability insurers often ask their insureds to produce information that may include privileged work product or attorney-client communication in the underlying liability case. Insurers sometimes justify these requests under their so-called cooperation clauses, insisting that the policyholder is contractually obligated to produce all responsive information, even if it is privileged in the underlying case. Of course, in cases in which the insurer has denied coverage or is not providing a defense, the carrier arguably has no interest in this sensitive liability information. The cooperation clause literally does not apply in most liability policies if no defense is being provided, and the carrier does not share any common interest in the defense if the carrier has denied coverage. However, where the insurer has agreed to provide a defense under a reservation of rights, such requests can be harmful to the insured because, although the insurer and insured arguably have a shared interest in defending against the underlying claim or suit, they may have conflicting interests concerning the reservation of rights on indemnity issues.

When an insurer reserves its rights under a policy and provides a defense in the underlying action while contesting coverage, it necessarily creates

an adversarial relationship with its policyholder; the insurer wants to avoid coverage, and the insured wants to secure coverage. These same insurers nevertheless frequently invoke the policy's cooperation clause, or assert that they have a common interest in the defense of their insureds, in an attempt to force the insured to waive any litigation privileges it may hold in the underlying case. These insurers will sometimes also claim that by bringing a coverage action, the policyholder itself places privileged communications regarding the underlying claim in issue, making them discoverable as a matter of course.<sup>49</sup> Most courts have rejected these arguments, concluding that a policyholder's interest in protecting its privileges trumps the insurer's asserted interest in the requested information and that a policyholder in an adversarial relationship with its insurer has no obligation to waive its attorney-client or work product privilege by turning over confidential evaluations, expert information, or other privileged communications and data.<sup>50</sup>

*Waste Management, Inc. v. International Surplus Lines Insurance Co.*<sup>51</sup> is the leading case cited by insurers to support the argument that privileged communications must be disclosed in an adversarial situation. In that case, the insurers issued policies that indemnified for defense costs for any claim arising out of an environmental impairment brought against the insureds by third parties. The insureds in this case owned and operated hazardous waste disposal sites that were the subject of several lawsuits. The insureds subsequently sought indemnity from the insurers for settlement and defense costs. In response, the insurers denied coverage, resulting in a consolidated declaratory judgment action.<sup>52</sup>

During discovery, the insurers requested production of the defense counsel's files in the underlying lawsuits. The insureds withheld certain documents based on the attorney-client and work product privileges. Although

49. See, e.g., *Potomac Elec. Power Co. v. Cal. Union Ins. Co.*, 136 F.R.D. 1 (D.D.C. 1990); *Truck Ins. Exch. v. St. Paul Fire & Marine Ins. Co.*, 66 F.R.D. 129 (E.D. Pa. 1975); *Metro. Life Ins. Co. v. Aetna Cas. & Sur. Co.*, 730 A.2d 51 (Conn. 1999); *Waste Mgmt., Inc. v. Int'l Surplus Lines Ins. Co.*, 579 N.E.2d 322 (Ill. 1991).

50. See, e.g., *Rhone-Poulenc Rorer, Inc. v. Home Indem. Co.*, 32 F.3d 851, 864 (3rd Cir. 1994) (documents prepared by counsel in the underlying matter relating to insured's knowledge of potential exposure were privileged); *First Pac. Networks, Inc. v. Atl. Mut. Ins. Co.*, 163 F.R.D. 574, 579-80 (N.D. Cal. 1995) (insured and its counsel did not have to produce documents protected by insured's attorney-client privilege); *Remington Arms Co. v. Liberty Mut. Ins. Co.*, 142 F.R.D. 408, 412 (D. Del. 1992) (documents related to underlying claim for environmental damage were not subject to discovery by insurer in coverage action); *Rockwell Int'l v. Superior Ct.*, 32 Cal. Rptr. 2d 153, 159 (Ct. App. 1994) ("We refuse to read into the cooperation clause an unintended implied waiver of the attorney-client privilege."); *E. Airlines, Inc. v. U.S. Aviation Underwriters, Inc.*, 716 So. 2d 340, 343 (Fla. Dist. Ct. App. 1998) (because parties were adversaries, no fiduciary relationship existed and cooperation clause did not override the attorney-client privilege).

51. 579 N.E.2d 322 (Ill. 1991).

52. *Id.* at 325.

concluding that the insurers' in issue argument was not dispositive, the court stated, "Indeed, it is the very conduct of defense counsel in the underlying litigation which is the basis of insurers' declaratory judgment action and its defense to insureds' declaratory judgment action."<sup>53</sup> The court held that the defense counsel's litigation files in the underlying cases were relevant and in issue in the insurer's declaratory judgment action. The attorney-client privilege was held to be inapplicable based on the premise that the cooperation clause eliminates the element of confidentiality and "renders any expectation of attorney-client privilege, under these circumstances, unreasonable."<sup>54</sup> The court also accepted the insurers' argument that the common interest doctrine likewise made the attorney-client privilege unavailable to the insureds, stating, "[C]learly, here both the insurers and insureds had a common interest in either defeating or settling the claim against the insureds in the [underlying] litigation. We believe that the communication by insureds with defense counsel is of a kind reasonably calculated to protect or further those common interests."<sup>55</sup>

Many courts have since criticized and rejected the reasoning of *Waste Management*, finding the cooperation clause, in issue, and common interest arguments unpersuasive. For instance, in *Eastern Airlines, Inc. v. United States Aviation Underwriters, Inc.*,<sup>56</sup> a discovery dispute arose regarding the policyholder's assertion that the attorney-client privilege protected communications with counsel in the underlying matter. The insurers filed a motion to compel based on the cooperation clause, a motion the court rejected:

[T]he cooperation clause does not eviscerate the attorney-client privilege. Instead, the cooperation requirement arises to prevent fraud and collusion in proceedings to determine liability once notice has been given. The cooperation requirement applies in Florida only when the insured and the insurer are in a fiduciary relationship; the insurer has the duty to operate in good faith, and the insured has the reciprocal obligation to allow the insurer to control the defense and to cooperate with the insurer. Where that fiduciary relationship exists, a Florida court may compel production of documents as between the two parties in the relationship. Where it does not exist and the parties are in an adversarial position—as in an action by an insured against an insurer for bad faith—the attorney-client privilege is not waived.<sup>57</sup>

The court went on to hold that no fiduciary relationship existed between Eastern Air Lines and its insurers, and, therefore, the cooperation clause could not be used to override the attorney-client privilege held by Eastern Air

53. *Id.* at 327.

54. *Id.* at 328.

55. *Id.*

56. 716 So. 2d 340 (Fla. Dist. Ct. App. 1998).

57. *Id.* at 343 (internal quotations and citations omitted).

Lines.<sup>58</sup> The court also rejected the insurers' argument that Eastern Air Lines had placed the communications in issue by filing the coverage lawsuit, eschewing the reasoning of the Illinois Supreme Court in *Waste Management*.<sup>59</sup>

Similarly, in *Rockwell International Corp. v. Superior Court*,<sup>60</sup> the insured brought a declaratory judgment action against its liability insurers for failure to defend a number of environmental contamination lawsuits. During discovery, the trial court ordered the insured to disclose certain documents and consultant reports, which the insured claimed were subject to the attorney-client privilege. On review, the California Court of Appeal held in favor of the insureds.<sup>61</sup>

The appellate court specifically rejected *Waste Management*, finding "several problems" with the analysis in that case, including the plain language of the cooperation clause, which did not specifically mention the privilege or waiver thereof; the carriers' concession that the standard cooperation clause was drafted without consideration of or intent that it could operate as a waiver of privilege; and the fact that overriding the privilege ignored California's legislative declaration that where a conflict exists because an insurer has reserved its rights, the insured is entitled to independent counsel and to a relationship with that counsel free from the fear of disclosure of privileged communications.<sup>62</sup> The court also held that the insurers did not share a common interest with their insured; thus, they did not fall under the joint-client exception to the attorney-client privilege, nor were the insurers entitled to the documents because the insured had placed in issue its conduct giving rise to the underlying claims. The court went on to state that because the insured did not tender any privileged communication or any issue that could not be proved by other, more direct evidence, "the *in issue* exception does not apply to this case."<sup>63</sup>

In *Remington Arms Co. v. Liberty Mutual Insurance Co.*,<sup>64</sup> an insurer moved to compel its insured to produce documents related to underlying actions against the insured for environmental damage. Applying Connecticut law, the federal district court found that "no waiver [of privilege] can be implied merely because [the insured] instituted this action against [insurer]," thereby rejecting the insurer's "at issue" argument.<sup>65</sup>

The court rejected the *Waste Management* analysis, stating that "Connecticut courts . . . have explicitly rejected constructions of cooperation clauses that would compel the production of privileged documents in

---

58. *Id.*

59. *Id.* at 342-44.

60. 32 Cal. Rptr. 2d 153 (Ct. App. 1994).

61. *Id.* at 160.

62. *Id.* at 157-58.

63. *Id.* at 161(emphasis in original).

64. 142 F.R.D. 408 (D. Del. 1992)

65. *Id.* at 416.

insurance cases” and concluding that the policy’s cooperation clause did not necessarily impose a duty to produce privileged documents: “[The insurer] does not seek these documents in order to cooperate on underlying litigation, but to succeed in [insured’s] coverage dispute against [insurer]. Insurance law principles do not impose a duty to cooperate that applies regardless of coverage.”<sup>66</sup> The court went on to state that the so-called common interest exception to the attorney-client privilege did not apply because the attorney never represented the party seeking the allegedly privileged materials<sup>67</sup> and that no exception to the work product doctrine applied to compel the production.<sup>68</sup>

Likewise, in *Rhone-Poulenc Rorer, Inc. v. Home Indemnity Co.*,<sup>69</sup> the Third Circuit stated that “relevance is not the standard for determining whether or not evidence should be protected from disclosure as privileged, and that remains the case even if one might conclude the facts to be disclosed are vital, highly probative, directly relevant, or even go to the heart of an issue.”<sup>70</sup> The court held that Rhone-Poulenc did not waive the attorney-client privilege by bringing the coverage suit, regardless of the relevance of the communications to the issue. The court reasoned that holding otherwise would undermine the purpose of the attorney-client privilege:

As the attorney client privilege is intended to assure a client that he or she can consult with counsel in confidence, finding that confidentiality may be waived depending on the relevance of the communication completely undermines the interest to be served. Clients will face the greatest risk of disclosure for what may be the most important matters. Furthermore, what may be relevant and discoverable from those consultations may depend on the facts and circumstances of as yet unfiled litigation, the client will have no sense of whether the communication may be relevant to some future issue, and will have no sense of certainty or assurance that the communication will remain confidential.

....

A party does not lose the privilege to protect attorney client communications from disclosure in discovery when his or her state of mind is put in issue in the action. While the attorney’s advice may be relevant to the matters in issue, the privilege applies as the interests it is intended to protect are still served by confidentiality.<sup>71</sup>

66. *Id.* at 416–17.

67. *Id.* at 417–18. In so doing, the court referred to the common interest exception as a “strange theory, reasoning that the commonality of interests created an exception to the attorney-client privilege even though the parties become adverse,” which was somehow accepted by the *Waste Management* court. *Id.*

68. *Id.* at 420.

69. 32 F.3d 851 (3d Cir. 1994).

70. *Id.* at 864.

71. *Id.*

These case authorities suggest that the policyholder risks waiving privileges if it turns over attorney-client communications or work product information regarding the underlying claim to an insurer that has not agreed to defend without reservation or is actually or potentially adverse to the policyholder.<sup>72</sup> Insurers may assert that a protective order can alleviate the waiver problem. However, despite any agreement between the insurer and its policyholder, the privilege can still be waived as to third parties, including any underlying claimants, because they are not parties to, nor are they bound by, the protective order.<sup>73</sup> Thus, the underlying claimants may still argue that the privilege has been waived as a result of the production of the otherwise privileged materials. This places the insured in an impossible Catch-22 situation in which the insured cannot produce privileged information from the liability case to its insurer without risking the waiver of its privileges.

In view of these considerations, insurers would be well advised to think twice before demanding that their insureds provide them with privileged evaluations of the liability case or other information protected by the attorney-client or work product privilege. Producing privileged information places the applicable privileges at risk, opening the door to the discovery of this information by the claimants in the underlying cases, thereby placing the policyholder in a worse position than if it had no insurance at all. In jurisdictions that reject the *Waste Management* approach, insurers that demand this type of production while at the same time refusing to indemnify the insured against the consequences are exposing themselves to potential bad faith liability.

#### *D. Using Confidential and Sensitive Information to Develop Coverage Defenses*

When requesting information from its insured during a coverage dispute, an insurer may be seeking the information for the purpose of investigating liability and defending the underlying claim (thus acting for the policyholder's benefit), or it may be seeking the information to evaluate coverage (thus acting for the insurer's benefit and to the policyholder's detriment). An insurer should not deceive its insured and use confidential and sensitive information obtained from its insured under the guise of providing a defense in an underlying matter because this would give the insurer an unfair advantage over the insured in the coverage dispute. Doing so could be actionable as bad faith litigation conduct.

72. See *Fort James Corp. v. Solo Cup Co.*, 412 F.3d 1340, 1350 (Fed. Cir. 2005) (party's failure to protect its privilege can result in waiver of same); *Dellwood Farms, Inc. v. Cargill, Inc.*, 128 F.3d 1122, 1126 (7th Cir. 1997) (once a privilege is waived, it is "lost").

73. See *Hartford Fire Ins. Co. v. Guide Corp.*, 206 F.R.D. 249, 250 (S.D. Ind. 2001) ("[W]hile the parties might bind themselves by agreeing to limit waivers of privileges and protections, their agreement cannot bind third parties.").

Because of the insurer's distinct conflict of interest when providing a defense to its insured while simultaneously investigating coverage defenses, many insurers recognize that they must set up a conflict screen, creating one file for liability and defense and one file for coverage purposes. The conflict screen recognizes that an insurer in a conflict-of-interest situation may not be permitted to use sensitive defense information against its insured in a coverage action. The conflict screen should prohibit disclosure to the coverage adjuster of facts detrimental to the policyholder; this is accomplished by prohibiting a single claims handler from investigating coverage defenses while simultaneously handling the defense of the underlying claims. Failing to implement such a conflict screen, thereby allowing a single claims handler to investigate coverage defenses while simultaneously handling the insured's underlying claims despite the inherent conflict of interest, is a breach of the insurer's duties to its insured, industry custom and practice, and many states' Unfair Claims Settlement Practices Acts.<sup>74</sup>

One treatise described this type of bad faith as follows:

[A] single claims representative may not investigate any coverage defenses available to the insurance company while simultaneously handling the vested interest of the policy holder. The claims representative represents either the policy holder or the insurance company who pays his salary. For a single claims adjuster to handle both portions of an overall claims file would create an immediate conflict of interest. Such conflict would also breach the claims representative's professional ethics, as well as the implied-in-law covenant of good faith and fair dealings, and the unfair claims settlement practices statutes of most states. . . .

When there is a claims coverage question, it is usually the best practice to have the files split. Two separate claims supervisors and two separate claims representatives handle assignments in which one team (a claims supervisor and a claims representative) handles the factual investigation and the second claims supervisor and second claims representative handle the coverage portions of the claim. This usually involves policy defenses to deny any claims being made by the policy holder. . . .

74. See, e.g., GA. CODE ANN. §§ 33-6-30 to -37 (2000), IND. CODE §§ 27-4-1-1 to -19 (2003); TEX. INS. CODE § 541.001 (Vernon 2006 Electronic Pocket Part); W. VA. CODE § 33-11-4 (2003). Some courts look to the relevant state's Unfair Claims Settlement Practices Act as an indication of the types of conduct that may qualify as bad faith. See, e.g., Seymour Tubing, Inc. v. TIG Ins. Co., No. IP020509CBS, 2004 WL 2272160, at \*9 (S.D. Ind. Sept. 24, 2004) (unreported) ("Indiana courts have also looked to the Indiana Unfair Settlement Practices Act as an indication of the types of conduct by an insurer that may qualify as 'bad faith.'"); Coomer v. Phelps, 172 S.W.3d 389, 390 (Ky. 2005); Westwood v. Fronk, 177 F. Supp. 2d 536, 544 (N.D.W. Va. 2001); Michigan Mut. Ins. Co. v. Sports, Inc., 698 N.E.2d 834, 844-45 (Ind. Ct. App. 1998) (citing evidence of violations of the Indiana Unfair Settlement Practices Act and the potential civil fine that could have been imposed thereunder in upholding a jury's award of punitive damages against the insurer).

The major reason that insurance companies must avoid any alleged conflict of interest when dealing with their own policy holder is to avoid the threat of an insurance bad faith lawsuit. Again, the insurance company cannot afford to get caught having a single adjuster representing the interest of the insurance company while simultaneously representing the interest of the policy holder when the insurance adjuster has the power to control the facts, opinions and conclusions and to avoid any coverage that might otherwise flow to the policy holder.<sup>75</sup>

The conflict screen must actually and sufficiently protect the policyholder's interest and must not be established as a mere formality. In *Armstrong Cleaners, Inc. v. Erie Insurance Exchange*,<sup>76</sup> for example, the court found a conflict screen<sup>77</sup> inadequate when screening procedures were limited to the "frontline adjusters" and there was "no indication that they appl[ied] to more senior supervisors of both adjusters, including those who would have to approve payment of attorney fees and any settlement."<sup>78</sup> In addition, the adjuster handling the defense issues had a copy of the reservation of rights letter and was "presumed to understand the coverage issues."<sup>79</sup> The court granted the insureds' request that they be permitted to select independent counsel paid for by the insurer due to the "significant risk that an attorney selected by and under the control of [the insurer] would be materially limited in the representation of [the insured] as a result of the relationship with [the insurer] and its reservation of rights."<sup>80</sup>

If no conflict screen (or only an inadequate one) exists, the claims handler may embark upon a fact-gathering mission to obtain only evidence of facts that will allow the insurer to deny coverage.<sup>81</sup> Insurers that fail to establish an adequate conflict screen when their coverage position creates a conflict of interest or, worse yet, that fail to disclose the existence of the

75. CLINTON E. MILLER, *HOW INSURANCE COMPANIES SETTLE CASES* §§311-311.2 (13th rev. ed. 2001). It should be noted that this position is the subject of some debate. In a subsequent edition, these particular sections in the Miller treatise have been revised and largely omitted.

76. 364 F. Supp. 2d 797 (S.D. Ind. 2005); see also *Aetna Cas. & Sur. Co. v. Mitchell Bros., Inc.*, 814 So. 2d 191, 199 (Ala. 2001) (Moore, J., concurring in part and dissenting in part) (where insurer's internal rules called for erection of a conflict screen between personnel involved in a coverage dispute with its insured and personnel simultaneously involved in the defense of a claim against its insured, and evidence presented could reasonably have led trier of fact to conclude that insurer failed to follow internal rules regarding personnel moving between coverage and defense and that the breaches of the conflict screen were withheld from policyholder, evidence supported finding of insurer's wrongdoing).

77. This is sometimes referred to as a *Chinese Wall*, a term the authors choose not to use.

78. *Armstrong Cleaners*, 364 F. Supp. 2d at 817.

79. *Id.*

80. *Id.*

81. See also *CHI of Alaska, Inc. v. Employers Reins. Corp.*, 844 P.2d 1113, 1118 (Alaska 1993) (describing one of three types of possible conflicts of interest between insurer and insured as "the insurer may gain access to confidential or privileged information which it may later use to its advantage") (citing *Cont'l Ins. Co. v. Bayless & Roberts, Inc.*, 608 P.2d 281 (Alaska 1980)).

conflict and obtain the insured's consent, run the risk of subjecting themselves to significant bad faith liability.

E. *Asserting a Litany of Boilerplate, Unsupported Defenses*

An insurer may not deceive or misinform its policyholder or take any action to unreasonably delay payment to its insured. Thus, insurers that assert numerous rote defenses in coverage litigation without verifying that a good faith basis exists for each defense run the risk of being accused of litigating in bad faith.<sup>82</sup> At least one commentator warns insurers against including affirmative defenses based on policy language if the insurer did not communicate the specific defense to the insured before denying the claim because this conduct could lead to further evidence of bad faith: a "plaintiff's attorney may seize upon a recently concocted policy defense as further evidence of the insurer's malicious attitude toward the insured."<sup>83</sup> This, of course, excludes defenses that arise after the insurer denied the claim.

The U.S. District Court for the Eastern District of Pennsylvania has specifically addressed the use of frivolous affirmative defenses, concluding that the use of boilerplate affirmative defenses, in and of itself, does not constitute bad faith.<sup>84</sup> However, the court went on to imply that if the insurer does not withdraw the affirmative defense once it is determined that there is no factual basis for it, then the continued assertion of the defense could be cited as evidence of the insurer's bad faith litigation conduct.<sup>85</sup> Thus, the assertion of multiple unsubstantiated policy defenses may be cited by insureds as another basis for showing bad faith litigation by an insurer.

V. CONCLUSION

Insurers' duties of good faith and fair dealing to their insureds necessarily continue and must be observed even after one of the parties to the insurance contract institutes a coverage action. Many jurisdictions have recognized that insurers can act in bad faith during the course of coverage litigation, and case law on these issues continues to evolve. Thus, counsel for both insurers and policyholders must be aware and remain mindful of these issues as they litigate their differences.

82. See *Erie Ins. Co. v. Hickman*, 622 N.E.2d 515, 520 (Ind. 1993) ("[A]n insurer which denies liability knowing that there is no rational, principled basis for doing so has breached its duty.")

83. See STEPHEN S. ASHLEY, *BAD FAITH ACTIONS LIABILITY & DAMAGES* §10:43 (2d ed. 1997).

84. See *Chowdhury v. LMI Ins. Co.*, No. CIV.A.94-6223, 1996 WL 53804, at \*8 (E.D. Pa. Feb. 8, 1996), *rev'd on other grounds*, 107 F.3d 6 (3d Cir. 1997).

85. "[T]he mere use of boilerplate affirmative defenses in an initial answer to a complaint does not rise to the level of bad faith conduct as long as those defenses are not pursued later in the litigation, even if, as here, those defenses are later found to lack any factual basis." *Id.*

