Mean Streets and Icy Potholes:

Pitfalls in Adjusting and Defending the Litigious First-Party Claim

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I. Introduction

In a perfect world, first-party property claims would be submitted timely, and insurers would be given plenty of time to investigate the claim, evaluate it, and relay a coverage decision to the insured. In this hypothetical perfect world, first-party property insureds would be cooperative with their insurer, would provide information promptly when requested, and would refrain from adversarial posturing. Guess what? We don't live that world.

In our real world, first-party property insureds are just as likely to file a claim, and then file a lawsuit very shortly thereafter, even before the claim decision has been reached. The filing of the lawsuit in this situation creates a minefield of potential problems for the insurance company. Whereas the filing of a lawsuit typically means "the gloves have come off," and everything proceeds from there on an adversarial basis, in the world of first-party property coverage, there are duties of good faith and compliance with claim handling guidelines which still need to be considered. This paper and the accompanying presentation are intended to discuss some of the issues created in such a scenario.

II. Overview of Typical Problem Scenarios

In a typical problem scenario, an insured files a first-party claim, and begins immediately to pepper the insurer with correspondence urging the claim be accepted and paid right away. Sometimes the insured does not understand that significant property claims often involve complicated issues that require consultants (*i.e.*, construction consultants, accountants, etc). Or perhaps the insured *does* understand that such claims take time, but they are simply unwilling to wait because they have convinced themselves that the insurance company is going to deny the claim. Or perhaps the insured is being spurred toward litigation by a public adjuster or attorney. Whatever the motivation, it is not uncommon to see a lawsuit filed very shortly thereafter, either with or without bad faith claims.

Another scenario, though less common, is the first-notice lawsuit where the insured simply skips the claim notification and files the lawsuit, contending that the lawsuit is the notification. This is arguably a breach of the policy and, in most cases, could be a basis to have the lawsuit dismissed (without prejudice) or at least "stayed" while the insurer is given an opportunity to investigate the claim.

Whichever scenario, the filing of the lawsuit before the insurer has made a decision on the insurance claim significantly changes the relationship between the insured and insurer:

Rules of Civil Procedure kick in to address discovery in the lawsuit, but do those rules supplant the statutory claim-handling requirements?

What implications does the lawsuit filing have on discovery of the claim file?

Does the filing of the lawsuit impact the retention of a "consultant" or "expert" for resolution of remaining factual issues?

Can the remaining investigation on the claim be completed simultaneously with the insurer's efforts to defend itself in the lawsuit?

And where is the dividing line between activities best performed by the adjuster (on an objective basis in order to resolve the claim) and the attorney (zealously advocating for his/her client against the lawsuit)?

III. Some Thoughts on the Legal Context

Most states recognize an implied covenant of good faith between an insured and insurer. In most states, a breach of this covenant of good faith is actionable as a tort, with damages recoverable beyond the scope of the insurance contract. Courts generally agree that the duty to act in good faith continues – in some fashion – even after the insured files suit. See generally Allan D. Windt, Insurance Claims and Disputes, ¶ 9.28 (3d ed. 1995). However, there is obvious tension between an insurer's ability to defend itself, and its duty of good faith toward the insured.

From a policyholder's perspective, if a lawsuit terminates the insurer's duty of good faith, it would simply encourage insurers to engage in conduct that will precipitate a lawsuit, thus freeing the insurer from the constraints of acting in good faith. On the flip side, insurers contend that if the quasi-fiduciary relationship between an insurer and first-party insured continues unabated after a lawsuit is filed, policyholders (and their lawyers) would be encouraged to file premature lawsuits, thus depriving insurers of their ability to investigate and adjust losses, and significantly handicap an insurer's rights as a litigant.

This general topic is commonly phrased as one of "continuing good faith." There is a growing body of case law shaping some general rules as to when post-filing conduct by an insurer can be admissible within the lawsuit, and whether those post-filing actions are simply evidence to support a claim which accrued pre-filing, or whether they can constitute a separate theory of liability.

One of the most frequently cited cases addressing the continuing duty of good faith is *White v. Western Title Ins. Co.*, 710 P.2d 309 (Cal. 1985), in which the California Supreme Court looked at the issue as a case of first impression. In *White*, the insured was allowed to introduce into evidence post-filing settlement negotiations between the insurance company and the policyholder, which the insured-plaintiff argued were evidence of bad faith. Normally, settlement discussions are inadmissible under the rules of evidence. The *White* court found that the quasi-fiduciary relationship between the insured and insurer continues even after the lawsuit is filed. The court allowed the settlement offers into evidence because they were being offered to show something other than contractual liability; in this case, the settlement offers were being used as evidence of bad faith rather than breach of contract.

While *White* has been distinguished by courts both inside and outside of California, it is still valid law, and evidence of post-filing conduct of insurance companies that would normally not be admissible has been allowed into evidence in many jurisdictions. For example, the Arizona Supreme Court has stated that evidence of an insurer's past claims practices may be admissible to show the company has engaged in similar bad acts. *Hawkins v. Allstate Co.*, 733 P.2d 1073 (Ariz. 1987). Similarly, the West Virginia Court of Appeals allowed discovery of similar bad faith claims against the insurer. *State Farm Mutual Ins. Co. v. Stephens*, 425 SE2d 577 (W.Va App. 1992). In addition to settlement offers and past claim practices, courts have allowed evidence of unreasonable defenses, filing in a particular forum, filing of responsive pleadings, filing of meritless appeals, discovery requests, and cross examinations of witnesses in order to show an insurer acted in bad faith. *Ingalls v. Paul Revere Life Ins. Group,* 561 NW2d 273, 280 (N.D. 1997).

IV. Specific Issues for Insurance Companies

Insurers must be extremely vigilant in investigating and handling claims where the insured has filed suit because post-filing conduct of insurance companies may be admissible in court, especially when the

insured attempts to introduce that conduct to show the "bad faith" of the company. "Continuing bad faith" theories may even allow the insured to introduce the conduct of the insurer's lawyers and claim managers directly involved in the litigation. A judge may allow this type of evidence to "complete the story" of the insurer's bad faith in dealing with the claim.

A. Litigation Conduct as "Bad Faith" Generally

Having recognized that a general obligation of good faith toward a first-party insured continues after the filing of a lawsuit, courts are struggling to find a bright line rule for expressing what litigation conduct can constitute evidence of "insurance bad faith," and what litigation conduct is "immunized" from such liability. In this context, "litigation conduct" means the conduct of a first-party insurer and its attorneys in litigation with an insured, regardless of who filed the lawsuit. An insurer, like any litigant, has certain litigation privileges. An insurer should not be deprived of those privileges simply because the insured has chosen to file suit on the claim. And yet, disparate results can be found among the reported cases.

The tension between a post-filing duty of good faith, and typical "litigation privilege" is discussed in *Slater v. Liberty Mutual Ins. Co.*, 1999 U.S. Dist. LEXIS 3753 (E.D. Pa. 1999)(applying Pennsylvania law), where an insured sought to amend its complaint to add an allegation of bad faith arising from the insurer's alleged abuse of discovery. The court recognized the state statute codifying the general tort of insurance bad faith, but concluded that it would be "quite another matter to permit a recovery under [the state's bad faith statute] for discovery abuses by an insurer in a bad-faith action in which it and the insured are legal adversaries." *Id.* at 2. The court concluded that an action for bad faith is directed at the conduct of an insurer in the context of the quasi-fiduciary relationship with its insured, "and does not encompass sanctionable litigation tactics of an insurer in defending itself in an action initiated by an insured." *Id.* at 5.

On the other hand, the Montana Supreme Court stated in *Federated Mutual Ins. Co. v. Anderson*, 991 P.2d 915 (Mont. 1999) that "the commencement of a lawsuit by the insured does not end an insurer's duties to the insured. Therefore, the continuing duty of good faith can be breached by an insurer's post-filing conduct." *Id.* at 921-22.

The majority of courts which have considered the question have determined that non-sanctionable litigation conduct by insurer's attorneys cannot be the basis for a bad faith claim against the insurer. See *Timberlake Constr. Co. v. U.S. Fid. & Guar. Co.*, 71 F.3d 335 (10th Cir. 1995); *Palmer v. Farmers Ins. Exchange*, 861 P. 2d 895 (Mont. 1993).

B. Claim File Documentation Issues

When a claim is investigated and analyzed through to a final claim decision, there is a clear line of demarcation between documents generated during investigation of the claim, and later documents generated "in anticipation of litigation" and therefore privileged in a subsequent law suit. That line of demarcation becomes "fuzzy" when a lawsuit is filed while the claim is still being investigated.

The claim adjuster in such a situation is still obligated to maintain a complete claim file which can demonstrate – without reference to materials outside the claim file – the general history of the claim and justification for whatever claim decision is made. It is not necessary or appropriate, however, for the claim file to include litigation issues. Determining between the two is the trick, and should be a discussion which occurs soon after the lawsuit is filed between the claim adjuster, his/her supervisor, and outside counsel.

The claim file should continue to reflect objectivity after the lawsuit is filed. Let the attorney worry about the adversarial issues.

C. Claim Handling Guidelines

The company's internal claim-handling guidelines, supplemented by the statutory claim-handling guidelines in the specific state of loss, are supplemented even further when the claim goes into litigation while the claim is still pending. The question becomes whether the duties and obligations of the adjuster are modified when the case is in litigation. How do the overlapping rules affect the timeliness and scope of the investigation?

This particular issue has not generated a significant amount of reported decisional law. There is, however, some thoughtful discussion of the issue in *Stegall v. Hartford Underwriters Ins. Co.*, 2009 WL 54237 (W.D. Wa, 2009)(applying Washington law). In that case, the insured filed suit while the investigation was still underway. Shortly after filing suit, the policyholder's attorney wrote to the insurance company's attorney and asked several questions seeking "clarification of [the insurance company's] position with respect to its investigation of the Stegall's claim." For various reasons, the company's attorney did not respond, and the policyholder attorney argued that the absence of a response from defense counsel was a violation of the state statutory claim-handling statute requiring prompt responses to communications from an insured. Defense counsel argued that the claim-handling guidelines were supplanted by litigation discovery rules when the insured filed suit. The district court judge agreed with defense counsel, but stopped short of concluding that post-filing violations of the statutory claim-handling code could never be admissible.

> This Court cannot accept Plaintiffs' formulation of a claim process separate from this litigation process. First, the litigation process in this Court is governed by the Federal Rules of Civil Procedure, which provide clear instructions on how opposing parties are to exchange information relevant to the legal dispute. The substance of the … inquiry is an inextricable part of this litigation as it involves the contested insurance claim. Information relevant to the litigation must be delivered according to the applicable rules of discovery, and these are not supplanted by the [statutory claim handling rules].
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> When plaintiffs filed this action, they effectively halted any claims settlement process and subjected themselves to the rules governing litigation.

Id. at 4–5.

D. Retention and Use of Consultants/Experts

Another issue is the way in which the insurer should retain and use consultants in evaluating a claim already being litigated. There is a difference in the type of expert normally retained by an insurer to investigate a claim, and a lawyer trying to support a theory of the case in court. For an insurer, objectivity is key in choosing the proper consultant. A trial attorney may look for an expert who presents well for a jury, and may not rate objectivity as high as an insurer would for a claim consultant. Because of this, insurers must be careful in choosing experts when a claim has yet to be paid or denied and is in litigation.

Similarly, what duties does an insurer have when its defense counsel receives an opinion from a retained expert which would tend to support some aspect of the insured's case? In terms of litigation ethics, a party may choose not to list such an expert a "testifying" witness, and in that fashion protect the potentially harmful opinion of the retained expert. If the quasi-fiduciary relationship between an insurer and first-party insured remains in full force and effect after the filing of a lawsuit, does the insurer face potential bad faith exposure by "burying" an adverse opinion in such a fashion?

E. Interaction with Defense Counsel

One issue that can arise in this setting is the implication of the insurer's attorney into the "claim story." It can be quite easy for the company's attorneys (both in-house and outside) to become witnesses, and thereby compromised if post-litigation activity is allowed into evidence. The attorney may be necessary as a witness in order to defend against allegations of bad faith, and therefore could have to recuse herself under the ethics rules of the state bar.

The insurer and its defense counsel need to establish lines of communication when a lawsuit has been filed while there are claims functions still to be accomplished. The insured is still entitled to prompt and fair claim handling up to and including a claim decision, and yet the insurer has legitimate interests to be protected in the litigation.

V. Practice Tips

- It is important to have in-house procedures for investigating and/or adjusting a claim in which a lawsuit has been filed, and that investigation should continue at the same pace and with the same vigilance on behalf of the adjuster. The claim should be "investigated," rather than "litigated," as much as possible.
- It is helpful to have an early conference between the claim adjuster, supervisor, and outside counsel to agree upon the protocol for maintaining a separation between the remaining claim investigation, and the litigation. Although that separation is necessary, it cannot be a complete separation because both the adjuster and the attorney still need to know what the other is doing.
- Claim files should refer to technical consultants as "consultants," not as "experts," which is more of a legal designation.
- Because some courts have allowed post-filing attorney conduct to be used as evidence of bad faith, the attorney representing the insurer should not directly participate in the adjustment of the loss, or if so, in only a very limited role. By doing so, the attorney is less likely to become a potential witness for any bad faith claims.
- It is helpful for both the adjuster and the outside counsel to communicate on each email as to whether it is a "claim communication" which should be part of the claim file, or is something that is entirely related to the litigation. For instance, there may be a case in litigation where the claim decision is still pending, and information is required in order to respond to Interrogatories, and that information may need to be supplied by the adjuster. That type of communication is not part of the investigation or adjustment of the claim and should not be part of the claim file.
- The scope of discovery might expand if an insured claims the insurer is acting in "bad faith" during the litigation. Because of the continuing duty of good faith, any evidence of bad faith normally inadmissible may be discoverable nonetheless. Even though this evidence may ultimately not be admissible under the rules of evidence, the insured may still be able to get these items during discovery.
- In jurisdictions where *White v. Western Title* has continued vitality, first-party insurers will often request a "*White* waiver" before making a settlement offer in a first-party case in litigation. In such a *White* waiver, the insured is agreeing in advance not to attempt to use a subsequent settlement offer as evidence in the case.