"Splitting the File" in Washington State

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There are no published Washington court cases or claim handling regulations that expressly require an insurer to "split the file" when an insurer is providing a defense under a reservation of rights. Nonetheless, if a claim results in bad faith litigation, the insurer can be sure that the insured will allege that the insurer improperly obtained and relied upon information in the claim file to support its coverage defenses. One way to combat this allegation is to "split the file." But, before doing so, the insurer should consider the nature of the information that is likely to be shared between the two files.

In this writing, I'll use "splitting the file" to mean when an insurer keeps distinct files: one containing communications concerning the merits of the insured's defense and one containing communications concerning coverage, with different claims personnel assigned to each file.[1] The legal basis for splitting a file and the practical issues raised in handling split files are discussed below.

1. <u>The legal basis for splitting the file</u>

No Washington statute or regulation requires file splitting. *See generally* Wash. Rev. Code § 48.30.010, et seq.; Wash. Admin. Code §§ 284-30-300, et seq. In Washington, the concept of "splitting the file" appears to have come from a Washington Supreme Court case entitled *Safeco Ins. Co. of Am. v. Butler*, 118 Wn.2d 383, 395, 823 P.2d 499 (1992). *Butler* was a declaratory judgment action brought by the insurer, in which the insureds counterclaimed for bad faith. To support the bad faith counterclaim, the insureds alleged that the insurer engaged in bad faith in eight distinct ways, among them that 1) the insurer "attempted to use the Butlers' attorney to obtain statements for use in the coverage action" and 2) the insurer "commingled information from the tort defense and coverage action files." *Butler,* 118 Wn.2d at 395. The insurer moved for summary judgment on the bad faith claim, which was denied.

On appeal, the Washington Supreme Court first noted:

> We do not prejudge the issue of bad faith or prejudice. Counsel for Safeco has advanced explanations for each alleged act of bad faith. Nonetheless, as noted by the trial court, there are material facts in dispute whether Safeco acted in bad faith and whether those acts harmed the Butlers.

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[1] A file may also be split when claims are made against two or more insureds, who have conflicting interests in the litigation, e.g., a named insured subcontractor and an additional insured general contractor. This paper doesn't address that circumstance, although some claim handling procedures may overlap.

The court affirmed the denial of the insurer's motion, finding that ***questions of fact*** existed as to whether the insurer acted in bad faith. *Id*. at 400.[2] The court did not indicate which of the bases claimed by the insured posed the fact question. Nonetheless, later legal authorities point to *Butler* to argue that "an insurer must avoid any commingling of information between its tort defense and coverage files."[3]

For example, in *Miller v. Kenny*, 158 Wn. App. 1049 (2010) (unpublished), the Washington Court of Appeals interpreted *Butler* as follows: "Our Supreme Court first imposed a rebuttable presumption of harm in *Butler*. There, Butler had established bad faith by showing that Safeco had delayed investigation, comingled defense and coverage files, and delayed over two months in notifying the insured of its reservation of rights." *Id.* at *4.

The Washington Supreme Court also referred to "file splitting" in *Cedell v. Farmers Ins. Co. of Wash*., 176 Wn.2d 686, 295 P.3d 239 (2011), but that was in a different context. There, the court addressed the application of the attorney-client privilege to communications between Farmers and its coverage counsel, during the handling of a first-party claim. In that context, the *Cedell* court noted: "Where an attorney is acting in more than one role, insurers may wish to set up and maintain separate files so as not to co-mingle different functions." *Id.*, 176 Wn.2d at 699, n. 5. The court was referring to an attorney who both "engaged in the quasi-fiduciary tasks of investigating and evaluating or processing the claim" and "provid[ed] the insurer with counsel as to its own potential liability; for example, whether or not coverage exists under the law." *Id.*, 176 Wn.2d at 699.

Published Washington federal courts cases have not said that file splitting is a requirement for handling a claim in good faith. In fact, one federal trial court has ruled that not assigning a single adjuster to defense and coverage functions does not constitute to bad faith. *Am. Capital Homes, Inc. v. Greenwich Ins. Co.*, 2010 WL 3430495, at *5–6 (W.D.Wash. 2010). Other federal district courts have looked more closely at the substance of the information that was shared between the defense and coverage files.

In *Berkshire Hathaway Homestate Ins. Co. v. SQI, Inc.*, 132 F. Supp. 3d 1275, 1294 (W.D. Wash. 2015), *appeal dismissed* (June 24, 2016), for example, the federal trial court ruled that

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[2] The discussion of whether the trial court was correct in denying Safeco's motion for summary judgment focused exclusively on whether the Butlers suffered harm for any of Safeco's actions, not on the claim handling. Safeco argued that because the Butlers had entered into an agreement with the claimants whereby the claimants agreed not to execute their judgment on the Butlers' assets, the Butlers were not harmed by any of Safeco's actions. The court disagreed, finding that the insureds could still have suffered harm, even if they ultimately did not have to pay the judgment, and their assignment of their bad faith claim did not relieve Safeco from liability.

[3] Thomas V. Harris, Washington Insurance Law § 19.05 (3d Ed.2010), citing: "*Safeco Ins. Co. of Am. v. Butler*, 118 Wn.2d 383, 395, 823 P.2d 499 (1992). When their interests are adverse, an insurer has an enhanced obligation to act fairly with respect to confidential information involving its insured."

commingling coverage and defense communications in one file, handled by one adjuster, is not *per se* bad faith:

> With respect to their commingling claim, Defendants point to only the following evidence: Cornhusker claims examiner Rebecca Messineo signed the reservation-of-rights letter, Ms. Messineo stated in a 2010 email that she was assisting with coverage issues on SQI's claim, and Cornhusker identified Ms. Messineo in discovery in this matter as "Cornhusker's claims handler for SQI's defense." . . . Defendants provide no analysis or authority to show how this evidence indicates bad faith, and the court finds Defendants' evidence insufficient to support the conclusion that Cornhusker acted in bad faith. *See Scott,* 550 U.S. at 380, 127 S.Ct. 1769. Furthermore, in the only case to which Defendants cite on this issue, the court ruled that assigning a single adjuster to defense and coverage functions does not constitute to bad faith. *Am. Capital Homes, Inc. v. Greenwich Ins. Co.*, No. C09–622–JCC, 2010 WL 3430495, at *5–6 (W.D.Wash. Aug. 30, 2010). Accordingly, the court grants summary judgment against Defendants' claims that Cornhusker's discovery abuses and commingling amount to bad faith.

Similarly, in *Milgard Mfg., Inc. v. Liberty Mut. Ins. Co.*, 107 F. Supp. 3d 1171, 1181–82 (W.D. Wash. 2015), order amended on reconsideration, 2015 WL 4898902 (W.D. Wash. 2015), the court first held that the insured failed to show the existence of coverage under the Liberty policy. Then the trial court addressed the insured's bad faith claim:

> Milgard asserts that it was prejudiced by Liberty's actions. Dkt. 170 at 22. For example, Milgard claims that Liberty inserted itself into active ligation over Milgard's objections, failed to split Milgard's file between claims adjusting and coverage counsel, and had inappropriate contact with the parties in the underlying claims. Dkt. 208 at 21. Milgard, however, does not point to specific evidence of harm resulting from Liberty's actions. "[B]ecause harm is an essential element, summary judgment in favor of the insure[r] is appropriate if a reasonable person could only conclude that the insured suffered no harm." *Werlinger*, 129 Wash.App. at 808, 120 P.3d 593. Accordingly, the Court denies Milgard's motion for summary judgment with respect to its bad faith and CPA claims.

In *Haley v. Allstate Ins. Co.*, 2010 WL 4052935, at *4 (W.D. Wash. Oct. 13, 2010), as amended on reconsideration, 2010 WL 5224132 (W.D. Wash. Dec. 14, 2010), the federal district court reached a similar conclusion, but in a slightly different context. There, the insured objected to the insurer's use of "the IMEs, which were conducted to determine the extent of her MedPay benefits, in defending against Plaintiff's UM claim." The court rejected this claim for "comingling" of the insured's MedPay and UM files:

> Moreover, comingling the UM and MedPay files likely would not have given rise to a claim for bad faith. *See Kim v. Allstate Ins. Co.,* 153 Wash.App. 339, 223 P.3d 1180 (Wash.App. Div. 2 2009) (holding, in dicta, that Allstate did not act in bad faith when it simultaneously investigated the insured's MedPay and UM claims). In defending against a UM claim, the insurer "stands in the shoes" of the third-party tortfeasor. *Ellwein v. Hartford Acc. and Indem. Co.,* 142 Wash.2d 766, 779–780, 15 P.3d 640 (Wash.2001), *overruled on other grounds by Smith v. Safeco Ins. Co.,* 150 Wash.2d 478, 78 P.3d 1274 (Wash.2003). In Washington state court, a third-party tortfeasor would have been able to compel an IME of the Plaintiff and/or compel the discovery of the IME(s) conducted by Allstate in the settlement of Plaintiff's MedPay claim. *See generally* Sup.Ct. CR 35. In addition, Plaintiff expressly authorized Allstate to obtain medical information from "all persons with knowledge of my medical history." (Dkt. # 13, Ex. 1,, p. 00715). Therefore, a claim for bad faith arising out of the comingling of Plaintiff's MedPay and UM files would have failed as a matter of law.

In sum, Washington state and federal district case law does not support a *per se* requirement that files be split simply because a case is being handled under a reservation of rights. Rather, the courts can and should consider the substance of the information being shared between the two files in determining whether the insurer acted in bad faith in failing to split the files. For example, the sharing and use of confidential, coverage-sensitive information to support the insurer's coverage defenses is more likely to result in a finding of bad faith.

2. Practical aspects of splitting the file

If the insurer elects to split the file, the main goal should be kept in mind: To prevent confidential, coverage-sensitive information from being shared, without the insured's permission, with anyone making coverage decisions on the file. To further this goal, communications as to the merits of the claim against the insured are strictly segregated from communications regarding coverage issues. Two adjusters should be assigned—one to handle the liability or merits file and one to handle the coverage file. The liability adjuster communicates with defense counsel and the insured to fully investigate the merits of the claim against the insured so the insurer has a complete picture of the insured's potential liability, including what damages may be awarded.

Because some information relevant to the insured's liability may also be relevant to the coverage issues raised by the claim, the insured may be reluctant to share such information with the insurer unless it knows the liability adjuster will not share any such confidential, coverage-sensitive information with the insurance personnel making coverage determinations. Splitting the file gives the insured confidence that its confidential communications will not be shared – to the insured's disadvantage – with the coverage adjuster.[4]

[4] To this end, it is vital that the insured is timely informed of any coverage issues that may affect the extent of the insurance coverage available to it.

Of course, information that is not ***confidential*** should not raise the same concerns. Thus, information exchanged by the parties in discovery in the lawsuit against the insured may be shared with the coverage side of the file, although it is good practice for the coverage adjuster to request such information from the insured's personal counsel, rather than getting it directly from the liability adjuster or appointed defense counsel, without the insured's knowledge. However since it should not be subject to any privilege, its disclosure to the insurer should not be seen as an act of bad faith.

Similarly, nothing prohibits the sharing of confidential information that is not ***coverage-sensitive*** with the coverage adjuster. For example, even if the liability adjuster's evaluation of the settlement value of the case takes confidential coverage-sensitive information into account (which should not be shared with the coverage adjuster), the result of the evaluation (e.g., appropriate settlement range) – although confidential – is not coverage-sensitive. Accordingly, these results do not have to be protected from disclosure to the coverage adjuster.

Once a file is split, the liability adjuster may still communicate with the coverage adjuster and vice versa, as long as the goals of the file splitting are kept in mind, although it is best that coverage information generally not be shared with the liability adjuster so as to protect against any allegation that coverage issues influenced the defense of the insured or the evaluation of the merits of the claim against the insured.

Of course, in preparing for settlement negotiations, the insurer has to take into account both the liability evaluation (how much will the insured ultimately become liable for) and the coverage evaluation (how much of those damages are covered). While there is no precise formula, a practice that allows the liability adjuster to fully and fairly evaluate the insured's potential liability for damages – with no regard to the coverage issues – and that allows the coverage adjuster to make an independent evaluation of the coverage for each element of damages should provide a defense to any claim that the insurer gave greater weight to its own interest, at the expense of the insured.

As of September 2017

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