ETHICAL ISSUES IN THE CONTEXT OF INVESTIGATION AND PURSUIT OF PROPERTY DAMAGE SUBROGATION CLAIMS

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I. LOSS SITE INVESTIGATIONS/ SPOLIATION AND PRESERVATION OF EVIDENCE

What are the implications of the insured being advised that the insurer is undertaking a subrogation investigation? Does this undertaking necessarily include protection of the insured's interests with respect to its uninsured losses? If the insured affirmatively requests the insurer to share information arising from the subrogation investigation, is the insurer required to accommodate this request? Is it in the best interests of the insurer to share information concerning the subrogation investigation with the insured, irrespective of any legal obligations to do so?

If the investigation entails the preservation of physical evidence, who is responsible for ensuring that the evidence is properly identified, collected and preserved: the insurer, the insured, forensic experts, the adjuster, counsel, or other interested parties? If the evidentiary artifacts are owned by a third party, what, if any, obligations are there on the part of the insurer or the insured to preserve such evidence? If the insurer undertakes to preserve evidence and fails to do so properly, thereby impairing the insurer's subrogation claim as well as the insured's claim for recovery of its uninsured losses, what, if any, is the resulting liability exposure to the insurer? Under such circumstances, what recourse, if any, does the insurer have with respect to proceeding against independent adjusters, forensic experts, and/or legal counsel, to the extent any of them breached any obligations to preserve pertinent physical evidence. Who, among the various interested parties, has the ultimate responsibility to preserve such evidence?

Should expert reports be obtained in writing to document the investigation? What are the consequences of obtaining written expert reports with respect to disclosure to the insured and/or to potentially responsible third parties? How are instructions properly communicated to forensic consultants? Is there any requirement for the scope of the work and the corresponding budget to be set forth in writing?

GUIDELINES:

Spoliation is the destruction, loss or material alteration of evidence or potential evidence by an act or omission of a party in pending or future litigation. Various sanctions are available – dismissal, preclusion and/or adverse inference instruction.

> "The threshold question is whether (the insurer) owed a duty to preserve evidence to (the insured), since absent a duty of care, there can be no breach and no liability. (The insured) alleges that once obtaining the defective water heater and knowing full well that the loss had extended to the tenant below who is likely to make a claim for its damages, (the insurer) had a duty to preserve and keep the water heater so that it would be available in its defense of the action by the other tenant.
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> As (the insurer) took possession of the water heater during the course of its investigation, it is not unreasonable to hold it responsible for its destruction or loss and to subject it to third-party liability for indemnification to (the insured) which has nothing to defend itself against plaintiff's cause of action against it"

FADA Industries, Inc. v. Falchi Building Co. 730 N.Y.S. 2d 827 (2001).

If an insurer undertakes to conduct a subrogation investigation, such an undertaking may implicate duties which otherwise do not arise:

> "Although there is no general duty to preserve evidence, Alabama clearly recognizes the doctrine that one who volunteers to act, though under no duty to do so, is thereafter charged with the duty of acting with due care and is liable for negligence in connection therewith."

Smith v. Atkinson, 771 So. 2d 429 (Ala. 2000).

California has been at the forefront of creating affirmative liability for spoliation of evidence.

> "A duty in a third-party negligence spoliation case can be created by the spoliator voluntarily undertaking to preserve the evidence and a plaintiff reasonably and detrimentally relying thereon; by an agreement to preserve between the spoliator and the plaintiff; or by a specific request to the spoliator to preserve a particular item.

Johnson v. United Services Automobile Association, 79 Cal. Rptr. 2d 234 (1998).

If expert forensic consultants undertake or are charged with the responsibility for preserving evidence and fail to do so, traditional notions of witness immunity may fail to protect them from legal liability:

> "This case presents an issue of first impression in Missouri: Whether a cause of action for negligence may be stated against a professional who agrees to provide litigation – related services for compensation. We hold that witness immunity does not bar suit if the professional is negligent in providing the agreed services."

Murphy v. Mathews, 841 S.W. 2d 671 (Mo.1992).

Indeed, potential liability exposure on the part of forensic consultants may extend to a cause of action for failing to sustain obligations to supply agreed upon litigation support services.

Honeywell v. American Standards Testing Bureau, Inc. 851 F. 2d 652 (3rd Cir. 1988).

If an insurer, through its representatives, advises the insured that the findings of the investigating expert will be made available, and then fails to provide its findings, the insurer may find itself subject to exposure for compensatory as well as punitive damages. Rawlings v. Apodaca, 726 P. 2d 565 (Az. 1986).

> The breach of contractual covenants ordinarily sounds in contract. However, because of the special relationship between an insurer and its insured, the insured may maintain an action to recover tort damages if the insurer, by an intentional act, also breaches the implied covenant by failing to deal fairly and honestly with its insured's claim or by failing to give equal and fair consideration to the insured's interests…If in addition the insured demonstrates that the insurer acted with the evil mind described above, then plaintiff may recover punitive damages.

II. PURSUIT OF CLAIMS AGAINST COMMON DEFENDANTS: SHARING RECOVERIES AND EXPENSES/ SPLITTING CAUSES OF ACTION

The most frequently encountered situation which may raise potential conflicts of interest is found in the typical claims scenario in which the insured has suffered a deductible or other significant uninsured loss. What is the recommended approach for determining how the insurer's subrogation claim should go forward in conjunction with a claim by the insured for its uninsured loss? Is either the insurer or the insured entitled to first monies? Is the answer necessarily dependent upon specific state law? Is it the insurer's obligation to inform the insured of entitlement to first monies by either party? If the insured is entitled to first monies, is it acceptable to advise the insured of this and then to propose a pro rata agreement for the sharing of any recovery on the basis of proportionate losses? If so, does there have to be legal consideration for execution of a pro rata agreement? Can that consideration take the form of the insurer advancing costs on behalf of the insured, to be repaid, in part, in the event of a recovery? Does a pro rata agreement have to be in writing? Does the insured have to be informed of the advisability of retaining legal counsel before signing a pro rata agreement?

What are the subjects that need to be addressed in a pro rata agreement? Should it specify which of the parties has the ultimate authority to settle and/or discontinue the case? Can subrogation counsel represent both the insurer as well as the insured pursuant to a validly executed pro rata agreement?

GUIDELINES:

The issue of apportionment of recovery between an insurer and an insured in a property damage context varies from state to state. In some states, a subrogating insurer is permitted to be paid first before an insurer is made whole. Peterson v. Ohio Farmer's Insurance Company, 191, N.E. 2d 157 (Ohio 1963); but see Porter vs. Tabern, 1999 WL 812357 (Ohio Ct. App. 1999), showing recent trend to disallow priority to insurer when doing so results in partial recovery for insured. In others, an insured must be fully compensated for its losses before an insurer can be reimbursed. Garrity v. Rural Mutual Insurance Company, 253 N.W. 2d 512 (Wis. 1977). Most states allow a "proration" approach if agreed to among the parties. See, e.g., Aetna Life Insurance Company v. Martinez, 454 N. E. 2d 1338 (Ohio Ct. App. 1982).

There are many jurisdictions that do not have a definitive rule regarding whether the insurer or insured are entitled to be made whole first from proceeds obtained from a third-party tortfeasor.

Litigation agreements must be fair and reasonable under all circumstances. They should address cooperation between the parties, control the litigation and apportionment of cost and any recovery by way of settlement or verdict.

Some states look to whether the insured has been fully compensated for its damages before allowing any subrogation recovery to go to the insurer, notwithstanding the existence of a written pro rata agreement. Other states will enforce a pro rata agreement if it is fair and reasonable in scope, and supported by legal consideration.

When an insured has a large self-insured retention or deductible, an issue may arise regarding whether the insurer can settle its claim against the tortfeasor, leaving the insured to proceed against the tortfeasor for any uninsured losses. If the settlement has not been addressed in a litigation agreement and the parties have agreed to prosecute the claim jointly, the issue may be critical once offers are made that may be unacceptable to one party or the other, but not to both. This issue is especially important in jurisdictions adhering to the rule against splitting a cause of action, where settlement by one party may impair the claim by the non-settling party. See Winkelman v. Excelsior Insurance Company, 50 N.E. 2d 841 (N.Y. App. Div. 1995). (allowing the insurer to resolve its claims against the tortfeasor independently of the insured's claim for its uninsured loss, based upon New York cases allowing splitting a cause of action).

Conflicts also may arise from the relationships among primary and excess insurers. Conventional wisdom is that the excess insurer typically is entitled to recover first monies. However, priority of rights of recovery ultimately will be determined by the policy provisions.

III. HOW TO ADDRESS A FACTUALLY GROUNDLESS, EXCESSIVE AND/OR FRAUDULENT CLAIM

After a claim has been made against a potentially responsible party, what obligations are there on the part of the insurer if it has learned that the property subrogation claim is factually unfounded and/ or contains elements of fraud? Is the insurer required to withdraw the claim? Is there an obligation to report the claim to governmental authorities? If the insured does not commit fraud, but there is a change in recollection or new and different information or documents are uncovered, is the insurer obligated to provide such information to potentially responsible third parties?

If there is evidence of an overpayment of loss, as a result of a non-fraudulent error, is the subrogating insurer affirmatively required to bring this the attention of the liability insurer for the tortfeasor? What, if any, duties are owing from the insurer to the insured to refrain from taking action which may impair the insured's recovery of its claimed uninsured losses?

What evidence is required to support the institution of arbitration proceedings or legal proceedings for a subrogation claim? Is it appropriate for the insurer to pursue a claim against a liability insurer which the subrogating insured knows is unsupportable? What if any

consequences result from doing so? Is it appropriate to omit pertinent information or evidence which is known to be relevant but harmful to the position of the subrogating insurer?

GUIDELINES:

Rule 3.1: Meritorious Claims and Contentions

A lawyer shall not bring or defend a proceeding, or assert or controvert an issue therein, unless there is the basis in law and fact for doing so that is not frivolous which includes a good faith argument for an extension, modification or reversal of existing law.

Under ABA Formal Opinion 93-376, the "duty of candor toward the tribunal" is not confined to statements made or evidence offered in open court, but includes deposition testimony and discovery responses and essentially any other misrepresentation that could "taint" the adjudicative process.

Duty of candor toward the tribunal trumps the duty to maintain client confidentiality. If an attorney knows that a client has offered or intends to offer testimony or evidence that is false, counsel is required to advise against undertaking such conduct, and counsel must insist that any previous misrepresentation be corrected. If the client refuses to follow this advice, counsel must take appropriate remedial measures to prevent ongoing fraud upon the tribunal, which may include disclosure of the false testimonial or evidence.

IV. THE ANTI-SUBROGATION DOCTRINE: IS A SUBROGATED INSURER ENTITLED TO PURSUE A CLAIM AGAINST A TORTFEASOR WHO IS A LIABILITY INSURER UNDER THE SAME OR A DIFFERENT POLICY

The anti-subrogation rule references case law in different states which bars a subrogation action against an individual or company who is a liability insured under the same policy or under a separate policy than that giving rise to the subrogation claim. There is a split of authority among the states that have addressed this issue.

If there is an appropriate factual and legal basis, what are the criteria for a subrogated insurer to address in order to evaluate whether to proceed with a claim against its liability insured, or not? If state law does not permit such a claim to be brought, is it advisable, or even required, on the part of the subrogated insurer to pursue a claim internally in order to ensure that responsibility for the loss ultimately is imposed upon the responsible tortfeasor? What interests are implicated, other than those of the property/liability insurer, by the decision of whether or not to pursue such a claim? Is it an important distinction if there are other claimants and/or tortfeasors who are not insured by the subject property/liability insurer?

GUIDELINES:

Approximately six states which have addressed this issue allow subrogation under the foregoing circumstances, and approximately eight states prohibit it. There is at least one state which has contradictory authority.

Consideration should be given to the fundamental principal of our system of justice that the party ultimately responsible for causing the loss should be held liable. Pursuit of the subrogation claim also bears directly upon loss ratios both of the subrogor, as well as the tortfeasor. Interests of other entities, such as reinsurers, excess insurers, brokers and risk managers also must be taken into consideration. Where the interests of other claimants and/or tortfeasors are involved, there is a substantial basis for arguing against the application of the anti-subrogation rule.

V. UNDERTAKING A SUBROGATION INVESTIGATION: OBLIGATIONS ON THE PART OF THE INSURER AND THE INSURED

Most property policies provide that the insurer is subrogated to the rights of its insured upon making payment under the policy. Most policies further provide that the insured must cooperate with the insurer in conducting the subrogation investigation. Very few, if any, policies specify what is entailed in the cooperation clause, or perhaps more significantly, what constitutes non-cooperation.

In undertaking the subrogation investigation and advising the property insured of this, what obligations are triggered owing from the insurer to the insured? How are these obligations affected by the fiduciary relationship between an insurer and its insured? What constitutes reasonable cooperation by the insured with respect to the ongoing investigation into the cause of the loss, and the subsequent pursuit of a subrogation/recovery claim?

As a practical matter, is it advisable for the insurer to inform the insured of the status of the investigation, so as to encourage the insured to cooperate fully and provide all pertinent information? Should this "team" approach extend to provide the insured with forensic expert reports? If the insurer agrees to keep the insured informed regarding the status of the investigation, what are the potential liability implications if the insurer fails to do so?

How is the insured's duty of cooperation and the insurer's undertaking of a subrogation investigation affected if the subrogating insurer determines that the liability insured is covered under a separate policy issued by that insurer? What effect, if any, will a Litigation Agreement have with respect to the pursuit of the claim and control of any ensuing legal action?

GUIDELINES:

The potential exposure of an insurer which allows its own internal concerns to override the interests of its insured is illustrated by the Arizona Supreme Court decision in Rawlings v. Apodaca, 726 P. 2nd 565 (1986). The insured-farm owner suffered a fire loss which preliminary investigation indicated may have been the responsibility of a neighboring farmer. The property insurer retained a private investigative consultant and informed its insured (who affirmatively advised that he would have uninsured losses) that it was investigating potential third-party liability and would share the results of its investigation with him. Upon further request, the property insurer reversed itself and refused to provide its property insured with the investigation report. It ultimately was disclosed that the property insurer determined that the prospective defendant (the neighboring farmer) was its own liability insured.

The property insurer brought suit against both the tortfeasor as well as his property insurer, and the trial court awarded both compensatory as well as punitive damages against the property insurer. The Supreme Court upheld the judgment on all issues except that of punitive damages, with respect to which the matter was remanded for further proceedings. In support of its opinion, the Supreme Court stated:

> "[B]ecause of the special relationship between an insurer and its insured, the insured may maintain an action to recover tort damages if the insurer, by an intentional act, also breaches the implied covenant by failing to deal fairly and honestly with its insured's claim or by failing to give equal and fair consideration to the insured's interest."

Id. at 579.

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