Litigating the Declaratory Judgment Action

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Declaratory judgment actions are an important tool for insurers seeking to resolve insurance coverage issues. Does that exclusion preclude the insurer from having a duty to defend or indemnify the policyholder with respect to a loss? How much coverage is available under the policy? Is another insurer responsible for first layer of coverage? Did the insured engage in conduct that would allow avoidance of the policy altogether? The insurer can engage in a thorough and prompt investigation and analysis of the underlying facts, policy language, and applicable law to answer these questions. But, the insurer's position alone does not have the force of law and cannot protect it from "bad faith" claims from policyholders and, in some jurisdictions, third parties seeking to extra-contractual damages from the insurer, and the only way to settle the question of coverage is to obtain a ruling from a court.

At some point in handling the file, the adjuster, inside counsel, or outside counsel must make a decision: to file, or not to file? Should the insurer take a proactive position and initiate the declaration of rights action to establish its rights and responsibilities before suit is filed on the underlying claim? Or, should the insurer wait to see if the policyholder files suit first and seek a declaratory judgment in response?

Good trial attorneys use litigation to develop and tell his or her client's story to the jury. In reality, though, the story begins well before outside counsel is involved or any papers are filed in a court system, and declaration of rights actions should involve continuous analysis from the very beginning. Coverage cases start when a claim file is opened. Remember: every diary entry, letter, and activity that is taken—and how each activity is documented—can potentially be used as exhibits before a jury. What has not been done will be scrutinized. Whether the diary shows that the insurer openly and objectively considered competing underlying facts or possibilities will be important on ECL claims. Even though many cases settle, settlement negotiations are made in light of what a jury is likely to do should the case go to trial.

This article is not intended to alter any existing company's programs, procedures, or protocols. It is not intended to alter scorecards or other indicia of policy violations or exclusions. The discussion below is aimed to hit the highlights of common issues that arise in declaratory judgment actions and attempts to point out some pitfalls that can help the insurer's representatives (including outside counsel) analyze and assess the risk sooner and develop a successful claim resolution strategy. The first section discusses considerations involved in an

insurer's decision to file its own declaratory judgment action. The second section provides an overview of issues that can arise during the litigation itself.

The "Ws" of Filing a Declaratory Judgment Action

Insurers should conduct a comprehensive risk analysis in determining whether and how to seek a judicial determination regarding coverage issues. This should include identifying the persons for whom coverage defenses exist and what the policy defenses are. The insurer should consider when and whether to file in federal or state court or to file a separate action or intervene in an existing action. Moreover, the analysis should include an evaluation of waiver and estoppel issues and whether the coverage issues have been explained to the insured in writing.

Who and What: The Pre-suit Investigation and Analysis Should Support the Insurer's Coverage Position

Before seeking a declaration of rights regarding coverage issues, the insurer should fairly analyze whether its position is supported by the information uncovered during its investigation. The evaluation should identify each person or entity for which coverage defenses exist. The insurer's assessment should take into account the availability and strength of defenses available with respect to each putative insured, as the bases for the action will depend the underlying facts and the relationship between the parties. This analysis should include determining whether additional information is needed to clarify or confirm coverage issues.

The insurer must consider the strength of its coverage investigation. A prompt investigation of the incident should take place early in the claim, including site visits, documentation of the loss, and thorough witness interviews. Depending on the nature and extent of the loss, the investigation could encompass the following: 1) videos and still photographs of an early site visit and subsequent examinations of evidence; 2) experts to investigate whether the loss was caused by a condition that is excluded from coverage (i.e., defective construction, arson); 3) thorough interviews of the policy-holder, witnesses, and investigating agencies, if applicable; 4) an analysis of the policy-holder's proof of loss and documentation, which can be a fertile area for misrepresentation or exaggeration; 5) property value or other damage or repair estimates; 6) financial records, receipts, proof of purchase/ownership of damaged property and consideration of whether a forensic accountant review is warranted; 7) a review of information from the policy-holder's agent, particularly the application information and the personal information about the insured; and 8) consideration of any communications with the state department of insurance regarding the policy language upon which the coverage determination is based.

One of the key investigatory tools is the examination under oath (EUO) of the policyholder, which is taken under oath and recorded by video and/or stenographic means. Typically, the insurer has a right to obtain an EUO as part of the policyholder's duty of cooperation under the insurance policy. Although it can be difficult to schedule, it is preferable for the claim adjuster or attorney to attend the EUO to conduct a first-hand assessment of the insured as a persuasive or elusive witness.

Conversely, polygraph examinations are generally disfavored as they are typically not admissible as evidence of whether or not an insured was involved in wrongdoing and cannot be requested by insurers. *See, e.g.*, 50 Ill. Adm. Code 919.60(d); 806 Ky. Admin. Reg. 12:095. Some jurisdictions, however, have allowed polygraph test results to be considered under certain limited circumstances, such as in evaluating the insurer's state of mind in considering dispositive motions on bad faith claims. *See Moss v. Nationwide Mut. Ins. Co.*, 24 Ohio App. 3d 145, 147 (Ohio App. Franklin County 1985); *Conti v. Republic Underwriters Ins. Co.*, 782 P.2d 1357, 1363 (Okla. 1989). These will not be of much value unless, for example, the policyholder asks to take a polygraph test and then fails.

Finally, ensure that key evidence was properly preserved in the course of the investigation. Generally, any evidence testing should be thoroughly documented and, in certain cases, videotaped. If the evidence was subject to destructive testing, the review should take into account whether the insurer could be subject to a spoliation of evidence instruction at trial.

In determining whether and upon what bases to file a declaratory judgment action, consider the potential effect of a retaliatory "bad faith" claim asserted by the policyholder or third party plaintiff. This should include 1) what the diary notes and correspondence reflect about the coverage investigation, 2) the substantive investigation, 3) inventory and proof of loss forms, 4) financial information, 5) specialist investigations to which you have access, 6) the strength and effectiveness of the policyholder and witnesses, and 7) the agent's file and information. The documentation should reflect and support a fair debate regarding the underlying facts or law. It is also helpful if the file indicates that the insurer tried to get additional information and the

policyholder or his attorney was non-responsive or delayed or blocked efforts to obtain information. Additionally, paying separate claims for distinct causes of loss under the policy can also evidence good faith on the part of the insurer in denying coverage for other matters of loss and mitigate a potential pain and suffering claim by the insured.

When to File: Proactive vs. Reactive

The timing of the declaratory judgment action will depend on whether the insurer takes a proactive or reactive approach, which will depend on the particular facts of the case and the parties and attorneys involved in the claim. In any event, suit should not be filed until the investigation into the coverage defenses is complete, and the insurer is confident that its evaluation was fair, reasonable, and took into account all pertinent information.

Proactively initiating suit has the advantage of allowing the insurer to choose the forum but can appear overbearing or as though the insurer is attempting to strong-arm the insured, particularly if it is an unsophisticated individual. Additionally, filing early could result in a waiver of a contractual time limit under the policy if suit is filed before the expiration of the timeframe in the provision.

Conversely, if a declaratory judgment is sought as a reaction to suit from the insured, the insurer may retain the benefit of a limitation of action provision that otherwise might have been waived. But, the insurer may be subject to the insured's preference in forum; the insured is likely to file in state court and may include a local adjuster or agent to defeat diversity and prevent removal to federal court.

Where to File: Federal vs. State; Intervention vs. Separate Action

Another important decision is whether to file in federal or state court and, if applicable, whether to intervene in an existing suit against the insured or to file a separate suit to determine the coverage issues.

The first consideration is whether the insurer wants to be heard in federal court or state court. While substantive contract law and extra-contractual issues will be determined by state law, federal court can provide advantages in the form of a better summary judgment standard, more favorable precedent regarding the scope of discovery, and a more efficient progression of cases. Additionally, the available jury pool is obtained from several counties, rather than the home county of the policyholder or third-party plaintiff. Depending on the particular state and venue, the insurer may prefer to have the case assigned a federal district court judge instead of the potential state court judges, and vice versa. Local counsel can provide valuable information and insight regarding these issues.

This consideration is related to whether the insurer takes a proactive approach to litigation. If the policyholder initiates the declaration of rights action in state court, removal will typically only be available if there is complete diversity between the parties and the amount in controversy exceeds $75,000. Policyholders can preclude removal by joining a non-diverse agent or adjuster as a defendant. A proactive declaration of rights action eliminates this concern.

Initiating an action in or removing an action to federal court, however, does not mean that the case will stay in federal court. Federal courts have discretion to exercise jurisdiction over declaratory judgment actions under the federal Declaratory Judgment Act, 28 U.S.C. § 2201 but

are not required to accept jurisdiction. This issue can be raised by the parties or by the court itself.

In deciding whether to exercise jurisdiction, the court will consider a number of factors, including but not limited to: 1) whether the declaratory judgment action would settle the controversy, rather than constitutes piecemeal litigation, 2) the availability of another remedy or pendency of another action, like an underlying action in state court, 3) the inconvenience and burden to litigants, 4) whether it would serve a useful purpose in clarifying the legal relations at issue, 5) whether it is being used for procedural fencing or to provide an arena for *res judicata*, 6) whether it would increase friction between federal and state courts or encroach upon state court jurisdiction, for example, by ruling on an issue that has not yet been considered by state courts. *Scottsdale Ins. Co. v. Flowers*, 513 F.3d 546, 554 (6th Cir. 2008); *Dow Jones & Co. v. Harrods Ltd.*, 346 F.3d 357, 360 (2d Cir. 2003); Wright & Miller, § 2759 Discretion of Court, 10B Fed. Prac. & Proc. Civ. § 2759 (3D ED.). If the underlying case is pending in state court when the coverage issues are raised in federal court, the federal court may decide to decline jurisdiction because of overlapping factual issues in the underlying and coverage actions. When a federal court declines to exercise jurisdiction, it will either dismiss the matter so that the insurer can re-file in state court or remand it to state court.

There is an additional limitation on federal court jurisdiction that may apply to insurer versus insurer actions. In some circuits, courts do not have Declaratory Judgment Act jurisdiction over disputes between insurers regarding which insurer has to pay for a certain loss, unless and until there is actually a judgment against the insured. *See, e.g., Nationwide Mut. Ins.*

Co. v. Fid. & Cas. Co. of N. Y., 286 F.2d 91, 92 (3d Cir. 1961); *Century Indem. Co. v. McGillacuty's, Inc.*, 820 F.2d 269, 270 (8th Cir. 1987); *c.f. United Servs. Auto. Ass'n v. Royal-Globe Ins. Co.*, 511 F.2d 1094, 1096 (10th Cir. 1975). Accordingly, an insurer should check the status of the law in the applicable circuit before it initiates an early suit asking a federal court to decide which insurer must pay for a particular loss.

In deciding whether to intervene in an existing action involving the underlying case or to file a separate coverage action, the insurer should consider the judge who will be handling the state court action and the likelihood that a separate action will be transferred and consolidated with the underlying action. Separate actions reduce the opportunities for conflicts to arise for counsel retained to defend the policyholder under a reservation of rights, but, in most cases, the coverage claims will likely be consolidated with the underlying claims, at least for discovery purposes, to further judicial economy.

Why: Have the Coverage Issues Been Explained to the Policyholder in Writing?

To avoid potential estoppel and waiver issues, the insurer must confirm that it has communicated the "why" of its coverage defenses to the insured. All coverage defenses should be preserved through a prompt reservation of rights letter or non-waiver agreement. Non-waiver agreements are bilateral written agreements by which the insurer and the policyholder agree that that the insurer does not waive coverage defenses by continuing to handle, investigate, and—if applicable—defend the claim. Conversely, reservation of rights letters are unilateral communications to the policyholder from the insurer. In most jurisdictions, non-waiver

agreements and reservation of rights letters provide the same level of protection, but reservation of rights letters are far more common because they are not negotiated with the insured.

The key elements of a reservation of rights letter could be the topic of an entire article. Generally, the letter should include an unequivocal statement of the grounds for the coverage defenses and cite to all pertinent policy provisions. The letter should be clear and unequivocal, but also broad enough to preserve other possible policy violations or reasons for denying coverage that are not yet known, including fraud, misrepresentation in the presentation of claim, or a concealment of material facts. Additionally, the letter should notify the policyholder of any limitation of actions provisions in the policy, explicitly state that the insurer is not waiving any exclusions or defenses to coverage by taking any action and advise the insured of its right to retain separate personal counsel to provide advice regarding any questions raised by the letter. It should also give the policyholder an opportunity to provide additional information and clarify anything incorrectly stated in the letter.

Supplemental reservation of rights letters should be issued after new information that is relevant to coverage defenses is obtained, including the allegations of any underlying suit filed against the insured. After suit is filed, it can be simpler and more effective to quote the allegations of the claims asserted against the insured, instead of re-reciting the results of the investigation. Any post-suit reservation of rights letter should clearly explain that a defense will be provided under a reservation of rights and reserve the insurer’s ability to continue the investigation and subsequently deny coverage.

Finally, the coverage issues may be so clear that a denial of coverage—rather than a defense under a reservation of rights—is appropriate. The decision to issue a denial without first obtaining a judgment regarding coverage can subject the insurer to a significant risk of extra-contractual liability to the insurer. For example, in some jurisdictions, an insurer who denies coverage can be held liable for the insured's entire loss—regardless of policy limits and including attorney fees and costs of defense—if a court subsequently determines that the denial of coverage was incorrect. Accordingly, the risk of extra-contractual liability should be taken into account before a denial is issued.

Pre-Trial Strategy and Procedure in Declaratory Judgment Actions

The initial steps following a declaratory judgment—either by the insurer or a policyholder or third party plaintiff—depend on whether the contractual claims are joined with extra-contractual claims. If extra-contractual claims are involved, the insurer must determine whether there are any practical or real conflicts that would preclude the same attorney from representing the insurer on both the coverage and extra-contractual issues. This decision should be made on the basis of the particular case, but typically separate counsel, are maintained to preserve privileges applicable to the bad faith case.

Another early issue is whether and how to separate the extra-contractual claims from the contractual claims through severance or bifurcation. Severance involves dividing the lawsuit into at least two independent causes, and any judgment disposing of a particular cause is final and appealable; conversely, bifurcation means that the matters stay in the same litigation but are

divided for the purposes of trial and that an order dealing with one cause is not necessarily final and appealable. *See, e.g., Hall v. Austin*, 450 S.W.2d 836 (Tex. 1970). While insurers typically seek severance or bifurcation and abatement of discovery on the extra-contractual claims pending resolution of the contractual issues, it may be advantageous to keep the claims in a single action in certain cases. Keeping the claims united for purposes of trial may allow for the admission of evidence obtained during the insurer's investigation that would be inadmissible as incompetent hearsay for the contractual claims but go to the insurer's state of mind with respect to the bad faith claims.

A motion to bifurcate the claims at trial is often coupled with a motion to abate discovery on the extra-contractual claims pending resolution of the contractual claims. Abatement of discovery on the extra-contractual claims prevents the disclosure of material that would be irrelevant to the contract claims and/or privileged and helps the parties avoid expensive discovery battles. Additionally, discovery on the extra-contractual claims may be unnecessary if the insurer attains a successful result on the contract claims. In evaluating this issue, keep in mind whether the policyholder's attorney is familiar with extra-contractual discovery or has an aggressive or passive case-handling style and is likely to push institutional discovery.

Finally, depending on the jurisdiction, the court may not automatically abate discovery and will engage in an evaluation of the efficiency of proceeding with discovery on all claims. *Wolf v. Geico Ins. Co.*, 682 F. Supp. 2d 197 (D.R.I. 2010). The necessary discovery may overlap if the contractual and extra-contractual claims share many factual issues. Additionally, simultaneous discovery may decrease the number of discovery disputes over attorney client

privilege and work product privilege during the litigation and the length of time of any emotional damages claim asserted by the policyholder.

A thorough pre-suit investigation by the insurer allows it to move forward with aggressive discovery on the production of documents, information regarding damage, and expert witness opinions. To simplify the presentation of proof at trial, the insurer can use requests for admission to establish the authenticity and admissibility of photographs, videos or financial records and data.

Discovery depositions of the experts should thoroughly explore the experts' opinions, bases, and possible bias. If there is a concern that a key witness or investigating agency will not be available at trial, it may be necessary to conduct evidentiary depositions to preserve the testimony, but there is a risk in presenting your case too soon. Motions in limine should include possible *Daubert* challenges to experts' qualifications, methodology and opinions.

Pre-trial motions should also address the admissibility of evidence that a jury could improperly use to decide the case. For example, a motion in limine should address whether the lack of criminal indictment, dismissal, or acquittal of charges is admissible in an arson case, because a jury could potentially believe that if one is not charged criminally, there can be no finding of arson that would preclude coverage under the policy. Or, the insurer may make a motion to address the potentially prejudicial use of family photographs at trial to gain juror sympathy under the guise of proving a property loss. To the extent these evidentiary motions are overruled, trial counsel should expressly address confusing issues to the jury during voir dire and throughout the trial.

Finally, consideration should be given to dispositive motions. A motion to dismiss could be warranted for failure to supply the necessary financial documents or information or to otherwise cooperate under the terms of the policy. A motion for summary judgment may be appropriate to address the case entirely, narrow the issues to be submitted to the jury at trial, and preserve arguments for appeal. The standards that apply to these motions will vary, depending on the jurisdiction.

Preparing for Trial

While most coverage issues present questions of law, factual issues will typically be subject to a jury trial. Additionally, trial of the contractual issues may be joined with extra-contractual claims, depending on the jurisdiction and the facts of the case.

Witness and exhibit lists should be completed in compliance with pre-trial orders of the Court. Even though good statements or depositions of witnesses may have already been taken, the physical presence of key witnesses is important. Witnesses should be provided with copies of prior statements or depositions, although that would then make discoverable by adversary of any statement reviewed by witness to refresh recollection. Counsel should be cautious of the "separation of witnesses rule." Fed. R. Evid. 615. Some trial judges take the position that once the separation of witness rule is invoked then it is inappropriate for counsel to inform that witness the substance of testimony of other witnesses. If a witness or party testifies differently than what that witness or party has either privately told counsel or given in a sworn statement, including a deposition, then counsel may be in a position to disclose the previous testimony or

not to offer knowingly false testimony. *See, e.g.,* Model R. of Prof'l Conduct at R. 3.3. At times the lawyer may be called as a witness to impeach the testimony of a witness. It is always best to have either a recorded statement or a sworn statement from a witness or another person present who can testify as to the substance of the prior inconsistent statement of the witness. *Id.* at R 3.7.

With respect to exhibit disclosure and preparation, disclosures should be in full compliance with any applicable pretrial orders. The insurer should attempt to obtain admission or stipulation of an exhibit, which allows it to be used in voir dire and the opening statement, before the parties begin to put on their proof. Trial counsel and the adjuster should strategize regarding which exhibits and documents to prepare for demonstrative purposes to the jury and practice with available courtroom technology to avoid any hiccups at trial.

Voir dire is can be a matter of art, science, or luck. Generally, this is the first opportunity to establish a theme for the insurer's case; it should flow directly into the opening statement and, by the time closing argument is reached, everything discussed during the opening statement has been proven. This is also an opportunity to get ahead of negatives early and introduce jurors to potentially problematic concepts. This is an opportunity to educate the jury on the elements of the case, and trial counsel should not be afraid to discuss damages and should take the opportunity to discuss attitudes about insurance companies, and try to humanize the insurance company in terms of individuals doing their jobs based on the information they have been provided. Additionally, trial counsel may discuss the insurer's obligation to pay claims that it owes and to not pay claims that it does not owe.

The opening statement is a continuation of a theme established in voir dire and should lay out an organized blueprint for the jury. Besides the fact that 78.2 percent of all statistics are made up right on the spot, empirical data seems to suggest that 80 percent of jurors would reach the same verdict at the conclusion of a trial that they would reach after opening statements. Use a summary of exhibits and expected testimony in an organized presentation of elements of case; misrepresentation, concealment, over valuation of contents or other aspects of claim, and/or failure to respond to inquiries by insurer, adjuster, or counsel. Keep in mind the concept of recency versus primacy—generally, people will recall what they hear first and last best.

Similarly, consider placing the most persuasive witnesses first and last in the order of witnesses to be presented to the jury. Mix video depositions with live witnesses to have a better shot at maintaining juror attention. An insurance adjuster can be an effective witness, depending on his or her testifying experience and appearance as an objective person making a tough decision. Oftentimes, it can be very effective to use the adjuster as a closing witness to explain why the decision was made to deny, when the easiest route would have been to simply pay the claim, and why the decision was not made in a specious manner. The toughest decision is which witness to present last. The final witness should always be presented in-person, rather than by videotape.

Prior to the submission of the case to the jury, the parties will have the opportunity to move for a directed verdict. Possible grounds particular to coverage issues may include failure to cooperate or provide documentation or the commission of intentional or fraudulent acts.

Generally, the motion will be denied if the court determines that reasonable jurors could differ on tie issues.

The parties will also argue jury instructions. The forms and instructions will be different, depending on whether the matter goes to trial in state or federal court. Issues that may be submitted to the jury will depend on whether the matter has been bifurcated. Accordingly, the jury may only consider the contractual issues, instead of both the contractual and extra-contractual liability issues. The instructions on the contractual issues will likely be simple and follow the policy language.

Finally, the theme and argument will be presented to the jury again through the closing arguments. If the court has given the insurer the burden of proof with respect to exclusions and avoidance issues, the insurer will get the last closing argument and the advantage of recency. Ideally, the theme is consistent with voir dire, the opening statement, and the presentation of evidence. At this stage, the insurer should have proven what counsel said it would prove during opening statements; otherwise, there may be problems. The closing argument should be tailored to and accurately and persuasively discuss what the jury has heard from witnesses and seen in the exhibits.

Conclusion

The progression of a declaratory judgment action involves analysis of several factors. The insurer must decide whether to take a proactive approach to filing the action and confirm that the available information and file material reflects a fair and reasonable debate about the underlying

facts and the coverage defenses. Whether to settle or proceed with trial is part of a continuing analysis that occurs during every step of litigation. Insurers should be cognizant of extra-contractual liability exposure but should not be afraid of it without reason. The analysis should be a fair and objective view of what has occurred with respect to the claim thus far. Work as a team without outside counsel and—if the case is worth the effort—do not be afraid to spend money; an aggressive plaintiff or policyholder's attorney will.