Insurance Strategies

A reservation of rights letter can pit insurer vs. insured when coverage is uncertain.

Why a Reservation of Rights Letter Is a Reservation for Trouble

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It all starts with a simple contract. Insurance Company sells a policy promising to defend Policyholder against, and pay damages for, certain claims filed against Policyholder. Plaintiff then files claims against Policyholder. Policyholder notifies Insurance Company of the claim. Insurance Company then defends the claim and pays damages settled upon or awarded by a court. That's the deal; that's the contract. But as risk managers and insurance specialists know, that simple contract gives rise to the most complex problems, and among those problems is the insurer's reservation of rights letter.

What Is a Reservation of Rights Letter?

The reservation of rights letter (ROR) is, in some ways, a natural outgrowth of the insurance contract. Under the contract, Insurance Company agrees to defend Policyholder against *certain* claims and to pay *certain* damages. But what happens when Plaintiff raises *other* claims against Policyholder? Or when Plaintiff seeks *other* damages against Policyholder? Or when the claim falls into a gray area? Must Insurance Company defend against *those* claims, too? Or pay *those* damages, too? In short, because the contract is based on *conditions*, legitimate questions can arise over

those conditions. An ROR warns Policyholder that, because of certain conditions, Insurance Company may not have to defend or pay for those *other* claims.

Potential ROR Issues

But just that simple warning can create a host of problems for both Insurance Company and Policyholder. Is the warning *clear* enough? Is the warning *timely*? Is the warning *specific* enough? In view of that warning, can Policyholder trust that Insurance Company's investigation of the claim will be *fair*? Should Policyholder now provide Insurance Company with *privileged* information as part of that investigation? What happens if Policyholder fails to *cooperate* with Insurance Company? Can Policyholder trust Insurance Company's appointment of *defense counsel*? Will defense counsel necessarily *protect* Policyholder's interests under the policy?

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To be sure, each of these questions amounts to a legal question, and many have found their way to court. An ROR is unenforceable if it is unclear or unintelligible,[1] if it is sent unreasonably late,[2] or if it fails to adequately specify what coverage defenses are inadequate.[3] These and other issues have forced insurance companies to take due care in sending RORs to policyholders, lest they forfeit their rights to disclaim coverage, legitimately, under their policies. At the same time, an ROR can put a policyholder at risk of forfeiting *its* rights under a policy, too, and therefore, a policyholder must take due care when it receives an ROR.

Why Does an Insurer Send an ROR?

The first thing a policyholder must understand about an ROR is *why* the insurance company has sent it. As noted, an ROR arises out of the nature of the contractual relationship between the parties. Once the insurance company receives notice of the claim against the policyholder, the insurance company has three options: (1) accept defense and appoint counsel to defend the policyholder; (2) reject coverage and abandon the policyholder; or (3) accept defense *tentatively and conditionally*. (It has another option, too — file a declaratory action against the policyholder to obtain judicial approval over the intended choice — but this option is not typically pursued upon first notice of the claim.)

These options present a dilemma to the insurance company. If the insurer accepts the defense and later finds the claim is not covered, the policyholder may prevent it from abandoning the defense.[4] A court might legitimately wonder why the insurance company abandoned the defense after it had initially thought a defense existed. Was it purely (or mainly) for financial reasons? If so, that would amount to something the law calls "bad faith."[5]

The second option is perilous, because the law greatly disfavors an insurance company found to have abandoned a policyholder improperly. An insurance company had better be sure of its coverage position if it chooses this option.

By default, the third option is safest. It gives an insurance company options as the case develops: "We'll take your case for now, but if such-and-such happens, we may later withdraw." This allows it to later say, "We told you so!" In insurance company parlance, the concluding language of an ROR often looks like this:

> Nothing herein, nor any action taken by us, including but not limited to, investigation, defense, settlement, or adjustment, shall be construed as a waiver of any right to deny coverage, and is subject to a full reservation of rights.

Common examples of when an insurance company will issue an ROR include lawsuits alleging both negligence and intentional torts (because intentional torts are generally excluded from coverage by law, even if the insurance company is otherwise bound by law to defend them), claims in excess of policy limits (because the company has no duty to pay for damages beyond limits), claims alleging both "occurrences" and "expected events" (because the former are covered, while the latter are usually excluded), claims alleging that an accident was both

within and outside the scope of work (because the latter are excluded), claims against a contractor and subcontractor (because the contractor's policy covers the contractor's damage, not that of the subcontractor), or claims triggering liability under multiple policies (because liability might be shifted to other insurance companies).

An ROR Protects Insurers, Poses Threat to Policyholders

At the same time as the ROR offers protection to the insurance company, it poses a threat to the policyholder. As long as an insurance company has reserved its right to abandon the defense, while remaining in full control of that defense, the company (and its appointed counsel) is in position — wittingly or unwittingly — to take actions that could cause the policyholder to lose coverage for the claim. The policyholder will lose coverage if, to use some of the above examples, conduct is shown to be "intentional" or "expected" or "outside the scope of work."

Policyholders Must Protect Their Rights

For this reason, the policyholder must be vigilant in protection of its rights, both during the investigation of the claim and during the defense. Indeed, upon receiving an ROR, the policyholder should respond, declare disagreement, and pledge subsequent follow-up. The policyholder should avoid saying nothing, as silence might be used against it, especially if this language is buried in the ROR: "Unless we hear otherwise, we assume you agree with our approach." The policyholder must create an active record of opposition.

Sometimes, an insurance company will aim to investigate a claim before deciding whether coverage exists and, therefore, before having issued an ROR. In that case, the policyholder often has little choice but to comply with the request to cooperate. Implied in every policy (and often expressly included, too) is the requirement that a policyholder must cooperate reasonably with the insurance company in its investigation and defense of a claim. But the policyholder cannot ignore the very real possibility that the insurance company may conduct an investigation to defeat coverage. To protect against that risk, the policyholder should first ask the insurance company to commit to coverage before initiating the investigation.

Coverage Counsel Likely Will Be Needed

If that request fails, the policyholder must proceed with caution. It goes without saying that if the claim is large enough, coverage counsel should be retained immediately. As a practical matter, the insurance company will have every incentive to avoid paying the claim and coverage counsel will be needed to monitor the company and correspond on the policyholder's behalf. Indeed, cooperation with the insurance company's investigation is a dicey matter.

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Claim Investigation Issues

On the one hand, the policyholder's conduct will be under critical examination because of the policyholder's duty to cooperate. To maintain that duty, the policyholder should permit claims investigators to interview key employees and obtain documents. But coverage counsel should participate in this process to insure the investigators obtain all key information in favor of coverage. Sometimes, policyholders omit communicating critical coverage information, as they assume the insurance company will develop it for them. Experience has shown this to be manifestly not the case. No one will advance and defend the interests of the policyholder as much as the policyholder. Indeed, not only should the policyholder provide all favorable information to the claims investigator, but it should remind the investigator of that information, sometimes repeatedly.

On the other hand, the policyholder should not turn over confidential attorney-client information to the insurance company. Courts tend to recognize that the policyholder may legitimately withhold documents from the insurance company on grounds of attorney-client privilege, in spite of a policy's cooperation clause.[6] This is especially true when the insurance company and the policyholder are in an adversarial relationship.[7] Arguably, an insurance company's insistence on seeing privileged documents creates an adversarial relationship. Why would an

insurance company have such vital interests in seeing documents that not even a third-party adversary may see unless it had designs on denying coverage?

But giving an insurance company ammunition to deny coverage is not the only fear the policyholder should have. Disclosure of privileged documents arguably *waives* the privilege as to third parties, including the underlying claimant. Thus, instead of providing such information to the insurance company, the information should be given to appointed defense counsel instead. If the insurance company insists on seeing that information, then the policyholder should insist on a confidentiality agreement. But even then, the policyholder should be sure that the information requested is limited to the issues in defense of the claim. The insurance company has no right to see information that goes beyond defense of the claim.

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The investigation itself will be taxing. Insurance companies are practiced in wearing down opponents. Some employ the "Big Stall" — a seemingly endless delay in commitment or a replacement of one claims adjustor after another, each of whom needs to "get up to speed." The policyholder must be patient, must create a paper trail, and must avoid the politics of appeasement. A serious attitude will elicit a serious response. At the same time, the policyholder must never, out of frustration or otherwise, compromise the defense of the case in any way. The policyholder may not settle the claim without the insurance company's consent or assume contract duties or assignments. In that case, an ROR letter will quickly turn into a denial of coverage letter, and the policyholder will have to demonstrate that the insurance company's conduct left it no choice but to take the compromising actions it did.

Issues Around Payment of Counsel

Often, policyholders who are subject to particularly sensitive or large claims will retain their own counsel to monitor the defense of a case while the insurance company's appointed counsel defends the case. Special issues are then raised about whether the insurance company may be required to pay separate counsel also, and those issues go beyond the scope of this article. But one important rule is worth noting. Almost all states recognize the general rule that an insurance company may be compelled to pay for independent counsel — often referred to as *Cumis* counsel, after the landmark California Supreme Court case by that name[8] — when a policyholder can demonstrate that the insurance company defense counsel is capable of steering the defense of a case *away* from covered claims and *toward* noncovered claims. The policyholder need not show that defense counsel has, in fact, prejudiced the policyholder's rights, but simply that counsel *could* prejudice those rights through the presence of an actual conflict of interest between counsel and the policyholder. In that case, the insurance company's duty to pay for such counsel is not some gratuity, but an actual *right* in law that arises out of the interests that exist under the insurance policy and the ethical obligations of the attorney engaged to represent an insured under a policy.

If, apart from independent counsel, a policyholder wishes to retain separate counsel for its defense, the insurance company may ask the policyholder to waive its right to those costs as a condition of coverage. The policyholder should avoid so agreeing, as this condition was not part of the original insurance policy bargain. If the insurance company insists on this condition, the policyholder may have to capitulate, but only after declaring duress, so as not to waive future rights of recoupment. No capitulation should ever be made, however, when independent counsel is available as a matter of right.

Allocation of Expenses

Another thorny issue can arise under an ROR when the insurance company declares the right to allocate defense costs among covered and noncovered claims. What the company is saying is that it will defend the policyholder against the suit, but it will reserve the right to return at the end of the case and force the policyholder to pay all defense costs expended in defense of noncovered claims. In a complex case with lots of attorney involvement, that can be devastating to the policyholder.

Courts are split on whether an insurance company can allocate defense costs.[9] But, even if it can, it still is not relieved of its duty to defend against the

noncovered claims. What is more, good arguments can be made that an ROR invoking such provisions creates a conflict of interest justifying appointment of independent counsel, because the policyholder would be uniquely vulnerable to an unreasonable allocation of defense costs.

Summary

A good general rule in reacting to the ROR is to react early and often. It pays to evaluate risks early and to involve the insurance broker and underwriter. Face-to-face meetings with the adjustor may help, too. If the insurance company continues to refuse requests for coverage, the policyholder should continue to document its position and need. Coverage litigation may be inevitable, and if the policyholder can effectively expound the risks of that litigation to the insurance company, success may be in the offing. As good as they are at wearing down others, insurance companies can be worn down, too.

Endnotes

1. *See e.g., Knox-Tenn Rental Co. v. Home Ins. Co.*, 2 F.3d 678 (6th Cir. 1993); *Richards Mfg. v. Great American Ins. Co.*, 773 S.W.2d 916 (Tenn. Ct. App. 1988); *Western Cas. & Sur. Co. v. Newell Mfg. Co.*, 566 S.W.2d. 74 (Tex. Civ. App. — San Antonio, 1978).
2. *Collins v. Grange Mut. Cas. Co.*, 124 Ohio App.3d 574, 577 (1997); *Hiser v. Rajik*, 700 So.2d 1302 (La. App. 1st Cir. 1997).
3. *Weber v. Biddle*, 483 P.2d 155 (Wash. 1971); *Bogle v. Conway*, 433 P.2d 407 (Kan. 1967); *Meirthew v. Last*, 135 N.W.2d 353 (Mich. 1965).
4. *Cigarette Racing Team, Inc. v. Parliament Ins. Co.*, 395 So. 2d 1238 (Fla. 4th DCA 1981); *Farmers Texas County Mut. Ins. Co. v. Wilkinson*, 601 S.W.2d 520 (Tex.Civ.App.— Austin 1980, writ ref'd n.r.e.); *Miller v. Elite Ins. Co.*, 100 Cal. App.3d 739, 754 (1980); *Gibraltar Ins. Co. v. Varkalis*, 46 Ill.2d 481, 263 N.E.2d 823 (1970).
5. Black's Law Dictionary defines insurance "bad faith" as "any frivolous or unfounded refusal to pay proceeds of a policy ... for purposes of an action against an insurer for failure to pay a claim, such conduct imports a dishonest purpose in means of breach of a known duty through some motive of self-interest or ill will."
6. *See e.g., Rockwell International Corporation v. Superior Court*, 32 Cal. Rptr. 2d 153 (Cal. Ct. App.1994); *Remington Arms Co. v. Liberty Mutual Ins. Co.*, 142 F.R.D. 408 (D. Del. 1992).
7. *See e.g., Eastern Air Lines, Inc. v. United States Aviation Underwriters, Inc.*, 716 So. 2d 340 (Fla. Dist. Ct. App. 1998).
8. *San Diego Fed. Credit Union v. Cumis Ins. Society, Inc.*, 162 Cal.App.3d 358 (1984), codified at Cal. Civ. Code §2860.
9. Courts in California, Connecticut, Florida, Montana, New Jersey, and New York have recognized reimbursement claims by insurance companies, with varying degrees of conditions and encouragement. *See Buss v. Superior Court*, 16 Cal. 4th 35 (1997); *Security Ins. Co. of Hartford v. Lumbermens Mut. Cas. Co.*, 826 A.2d 107 (2003); *Wendy's of N.E. Florida, Inc. v. Vandergriff*, 865 So.2d 520 (Fla. Dist. Ct. App. 2003); *Travelers Cas. & Sur. Co. v. Ribi Immunochem Research*, 108 P.3d 469 (Mont. 2005); *SL Indus., Inc. v. American Motorist Co.*, 607 A.2d 1266 (N.J. 1992); *Federal Ins. Co. v. Kozlowski*, (18 A.D.3d 33 (N.Y. App. Div. 2005). Courts elsewhere have declined to authorize such claims. *See Perdue Farms, Inc. v. Travelers Cas. & Sur. Co. of America*, 448 F.3d 252 (4th Cir. 2006); *Shoshone First Bank v. Pacific Employers Ins. Co.*, 2 P.3d 510 (Wyo. 2000); *Terra Nova Ins. Co. v. 900 Bar Inc.*, 887 F.2d 1213 (3d Cir.1989).

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