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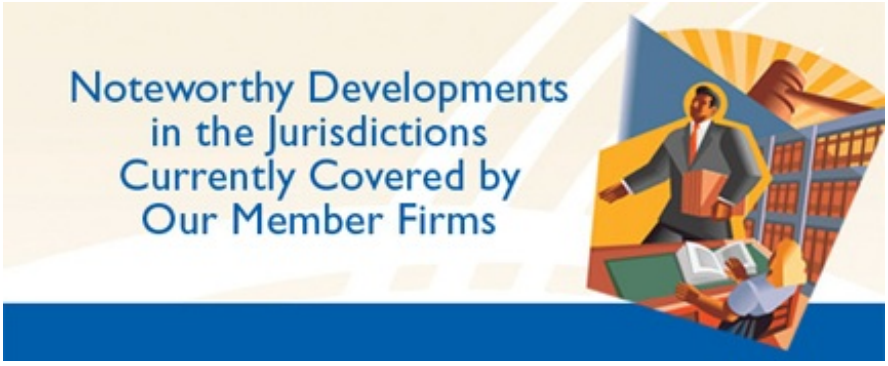
Insurance and Corporate Liability Defense Reporter

Issue #3 Spring 2013

Reservation of Rights Issue

In This Issue



Greetings!

Your House Counsel® and its Member Firms are very pleased to provide you with this ***Reservation of Rights Issue*** of the Your House Counsel® Insurance and Corporate Liability Defense Reporter.

The I&CLDR presents a snapshot of notable Insurance and Corporate Liability Defense issues and cases from across the country in our Member Firms' jurisdictions.

We look forward to presenting you with future I&CLDR issues on a regular basis; and because the Your House Counsel® membership is continually growing, so shall the number of jurisdictions and cases provided to you by the I&CLDR.

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Alabama

Notice

An insurer that intends to defend an insured pursuant to a reservation of rights must (1) "provide notice to its insured of that fact" and (2) "keep its insured informed of the status of the case." *Shelby Steel Fabricators, Inc. v. U.S. Fid. & Guar. Ins. Co.*, 569 So. 2d 309, 313 (Ala. 1990).

In *Shelby Steel Fabricators*,the court held that where a non-waiver form was mailed to the insured, the insured received at least "constructive notice" that the insurer was defending the claim against it pursuant to a reservation of rights. A letter was also mailed to the insured's attorney, which indicated that because of extensive investigation involved, it would be necessary for the insurer to handle the matter under a non-waiver agreement. The fact that the insured never signed the non-waiver form, nor mailed it back to insurer, was deemed immaterial by the court for purposes of notice. Nevertheless, the court found that by failing to keep the insured informed of the status of the case, as required under the second prong of notice, the insurer failed to satisfy its enhanced obligation of good faith (discussed below) and could not later deny coverage pursuant to a reservation of rights. 569 So. 2d 309.

Grounds/Defenses

A disclaimer of coverage should describe all grounds for denial and defenses to coverage; any ground or defenses not included are deemed waived. *First Ala. Bank of Montgomery, N.A. v. First State Ins. Co.*, 899 F.2d 1045, 1063 (Ala. 1990). However, "coverage under an insurance policy cannot be created or enlarged by waiver or estoppel." *Home Indem. Co. v. Reed Equip. Co.*, 381 So. 2d 45, 50-51 (Ala. 1980).

Waiver/Estoppel

The insurer must make its position clear to the insured or else it might be held to have waived its right to withdraw. *Tapscott v. Allstate Ins. Co.*, 526 So. 2d 570 (Ala. 1988). An insurer that undertakes the defense without reserving rights and with knowledge of coverage defenses waives its rights to rely on those coverage defenses. An insurer may avoid operation of that rule by giving notice that its assumption of the defense is not a waiver of the right to deny coverage. The notice need only be given timely to avoid waiver. *Campbell Piping Contractors, Inc. v. Hess Pipeline Co.*, 342 So. 2d 766 (Ala. 1977).

Answering questions certified by the Eleventh Circuit Federal Court of Appeals, the Alabama Supreme Court held that an insurer that undertakes to defend without reserving its rights waives its coverage defenses. The Court specifically declined to decide whether there was a waiver in the case before it. *Burnham*

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YHC News

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Your House Counsel® is pleased to announce that we have become a *Preferred Service Organization* for the National Association of Mutual Insurance Companies, known as NAMIC. We are grateful to the NAMIC Member who sponsored us, and look forward to further developments with this fine organization.

ACE 2013

On June 19 and 20 of this year, many of our Member Firms will be attending America's Claims Event 2013 in Austin, Texas. Please come to our Workshop on *Reservation of Rights*, or our Panel Session on *Cyber Liability and Data Loss Claims*, and be sure to say hello to us at Booth 311.

NAMIC 2013

On Sept. 22 to 25, several of our Member Firms will be

attending the National Association of Mutual Insurance Companies 118th Annual Convention in Seattle, Washington. Please come see us at Booth 205.

Forward to a Friend

Shoes Inc. v. West Am. Ins. Co., 504 So. 2d 238 (Ala. 1987).

Enhanced Obligation of Good Faith

In the seminal case in this area, *L&S Roofing Supply Co. v. St. Paul Fire & Marine Ins. Co.*,521 So. 2d 1298 (Ala. 1998), the Supreme Court of Alabama held that when an insurance company undertakes a defense pursuant to a reservation of rights, it does so under an "enhanced obligation of good faith." This "enhanced obligation" requires that the defense be undertaken in compliance with the following stated criteria:

> The company must thoroughly investigate the cause of the insured's accident and the nature and severity of the plaintiff's injuries;
> The insurer must retain competent defense counsel for the insured, and both retained defense counsel and the insurer must understand that only the insured is the client; and
> The carrier is responsible for fully informing the insured not only of the reservation-of-rights defense itself, but of all developments relevant to the policy coverage and the progress of the lawsuit. Information regarding progress of the lawsuit includes disclosure of all settlement offers made by the company.

Finally, an insurance company must refrain from engaging in any action which would demonstrate a greater concern for its own monetary interest than for the insured's financial risk. *Twin City Fire Ins. Co. v. Colonial Life Ins. & Accident Ins. Co.*,839 So. 2d 614, 616 (Ala. 2002) (quoting *Tank v. State Farm Fire & Cas. Co.*,105 Wash. 2d 381,715 P.2d 1133, 1137 (1986).

The Supreme Court of Alabama has since clarified in *Aetna Cas. & Sur. Co. v. Mitchell Bros. Inc.*,814 So. 2d 191 (Ala. 2001) that the enhanced obligation only applies in cases where the insurer exercises control over the defense of the lawsuit pursuant to a reservation of rights. It would therefore not apply in a case where, although the insurer appointed defense counsel and defended under a reservation of rights, the insured nonetheless maintained complete control over the manner in which the case was handled.

An insured's failure to fulfill its enhanced obligation of good faith constitutes a breach of contract, not a tortious act. *Twin City Fire*,839 So. 2d 614.

Conflicts of Interest and Independent Counsel

Alabama has no legislation mandating the use of independent defense counsel when an insurer tenders a reservation of rights, but case law explicitly outlines the duties of both the insurer and insured in such cases. The insurer may select counsel and is not required to pay for separate independent counsel for the insured simply because a potential conflict of interest exists. *Twin City Fire Ins. Co. v. Colonial Life Ins. & Accident Ins. Co.*,839 So. 2d 614 (Ala. 2002).

To address the potential conflict of interest, case law subjects the insurer to an enhanced obligation of good faith, as described above. *Twin City Fire*, 839 So. 2d at 1303. When the enhanced obligation of good faith is triggered, the insured acquires the right to retain its choice of defense counsel, to be paid by the

insurer. *L & S Roofing Supply*, 521 So. 2d at 1304.

The handling of coverage matters must be clearly separated from the defense of the lawsuit against the insured. Any assistance given by defense counsel to the insurer may result in a waiver of the insurer's coverage defenses; defense counsel also risks exposure to a malpractice claim by the insured.

Time for Providing Insured with Coverage Position/Reservation of Rights

- Within 30 days of receipt of the proof of loss (or the number of days specified in the policy), an insurer must advise the insured of the status of acceptance or denial of the claim by the insurer. Ala. Admin. Code r. 482-1-125.07.
- If the insurer needs more time to determine whether to accept or deny a claim, it shall notify the insured within 30 days, or the time specified in the policy, after receipt of proof of loss that it needs more time. Ala. Admin. Code r. 482-1-125.07.
- If the investigation remains incomplete, the insurer shall notify the insured 45 days from the initial notification, and every 45 days thereafter, of the reasons that additional time is needed. Ala. Admin. Code r. 482-1-125.07.

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California

Notice

An insurer must "adequately" reserve its right to deny coverage. An insurer can "adequately" and unilaterally reserve its right to assert non-coverage by merely giving notice to the insured. By accepting the insurer's defense under these circumstances, the insured is deemed to have accepted this condition. *Val's Painting & Drywall Inc., v. Allstate Ins. Co.*, 53 Cal. App. 3d 576, 126 Cal. Rptr. 267 (1975).

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A reservation of rights letter should state the basis for the reservation under the policy, as well as the facts on which a potential denial of coverage would be based. *Blue Ridge Ins. Co. v. Jacobsen*, 25 Cal. 4th 489, 22 P. 3d 313 (2001).

Waiver/Estoppel

An insurer does not waive a potential defense to coverage by not including it in a reservation of rights letter. *Waller, Jr. v. Truck Ins. Exch., Inc.*, 11 Cal. 4th 1, 900 P. 2d 619 (1995). When issuing a disclaimer, an insurer must include all grounds for disclaiming coverage; any defense to coverage not stated in a disclaimer

letter will be deemed waived. *Communale v. Traders & Gen. Ins. Co.*, 253 P.2d 495, 498 (Cal. Ct. App. 1953). However, a defense that the insurer had no knowledge of at the time of the disclaimer is not waived. *William Body Enters. v. Fireman's Fund Ins. Co.*, 7 Cal. App. 4th 1567, 1579-1580 (1991).

Reimbursement of Settlement Payment

An insurer has the ability to enter an agreement with the insured reserving its right to assert a defense of non-coverage even if it accepts a settlement offer on behalf of the insured. If, having reserved such rights and having accepted a reasonable offer, the insurer subsequently establishes the non-coverage of its policy, it would be free to seek reimbursement of the settlement payment from its insured. *Johansen v. Cal. State Auto. Assoc. Inter-Ins. Bureau*, 15 Cal. 3d 9, 123 Cal .Rptr. 288, 538 (1975); *Forum Ins. Co. v. County of Nye*, *Nev.*, 26 F.3d 130 (9th Cir. (Nev.) 1994).

Reimbursement of Defense Costs

The insurer has a duty to defend the insured as to the claims that are at least potentially covered by the insurance policy. With regard to defense costs for these claims, the insurer has been paid premiums by the insured. It bargained to bear these costs. To attempt to shift them would upset the arrangement. *Val's Painting & Drywall, Inc. v. Allstate Ins. Co.*, 53 Cal. App. 3d 576, 582-585, 126 Cal. Rptr. 267 (1975). This would not be the case if the policy itself provided for reimbursement: such a policy would qualify itself. It would also not be the case if there were a separate contract supported by separate consideration. Such a contract would supersede the policy *pro tanto*. Apart from these exceptions, the insurer may not seek reimbursement. *Buss v. Superior Court*, 16 Cal. 4th 35, 939 P.2d 766 (1997).

As to the claims that are not even potentially covered, however, the insurer may indeed seek reimbursement for defense costs. Under the policy, the insurer does not have a duty to defend the insured as to the claims that are not even potentially covered. With regard to defense costs for these claims, the insurer has not been paid premiums by the insured. It did not bargain to bear these costs. To attempt to shift them would not upset the arrangement. *Ins. Co. N. Am. v. Forty-Eight Insulations*, 633 F.2d 1212, 1224-1225 (6th Cir. 1980) (applying Illinois and New Jersey law, but speaking generally). The insurer therefore has a right of reimbursement that is implied in law as quasi-contractual, whether or not it has one that is implied in fact in the policy as contractual. *Buss v. Superior Court*, 16 Cal. 4th 35, 939 P.2d 766 (1997).

In a "mixed" action, where some claims are covered and others are not, the insurer may recover defense costs that can be allocated solely to the claims that are not even potentially covered by the policy. Generally, a party desiring relief must carry the burden of proof thereon. Courts have found no exception for an insurer seeking reimbursement for defense costs, therefore the burden of proof is on the insurer. Thus, in order to obtain reimbursement from the insured for costs incurred defending such claims, the insurer must prove, "by a preponderance of the evidence," that the claims were not even potentially covered. *Buss v. Superior Court*, 16 Cal. 4th 35, 939 P.2d 766 (1997).

Conflicts of Interest and Independent Counsel

The landmark case on independent counsel came from California in 1984. In *San Diego Navy Federal Credit Union v. Cumis Insurance Society, Inc.*, the insurance company undertook the defense of its insured, retained a firm, and notified the attorneys of that firm and the insureds themselves that the insurance company was reserving its rights to disclaim coverage with respect to possible punitive awards. The insureds then retained independent counsel. The court held that when an insurer reserves its right to assert non-coverage at a later date, a conflict of interest is created between the insurer and the insured. In this situation, "the insured has a *right* to independent counsel paid for by the insurer" and a right to control his defense, if he so chose. 162 Cal. App. 3d 358, 361, 208 Cal. Rptr. 494 (1984) (emphasis added). If representation by insurer-selected counsel begins and a conflict of interest is subsequently discovered, the insurer's counsel must cease to represent the insured unless the insured gives informed consent to the continued representation. *Id.*at 375.

In 1987, the *Cumis* decision was codified by California Civil Code § 2860, which provides, in sum and substance:

> (a) When an insurer has a duty to defend under a policy, and conflict of interest arises such that the insured requires independent counsel to represent its interests, the insurer must provide such counsel unless the insured "expressly waives [the right to independent counsel] in writing."
>
> (b) Outright denial of coverage does not create a conflict of interest; "however, when an insurer reserves its rights on a given issue, [the outcome of which] can be controlled by counsel first retained by the insurer for the defense of the claim, a conflict of interest *may* exist." (emphasis added) Allegations of punitive damages or suits in excess of policy coverage do not, alone, constitute a conflict of interest.
>
> (c) The insurer has the right to require that the insurer-selected independent counsel meet certain qualifications of competency and experience. The fees to be paid may be limited to the fees that the insurer usually pays similar counsel for similar litigation in the same location.
>
> (d) The insured and its independent counsel have a duty of timely disclosure to the insurer.
>
> (e) The insured may waive its right to independent representation in writing.
>
> (f) Insurer-selected counsel and insured-selected independent counsel shall work together on overlapping parts of the litigation, subject to limits of ethical obligations to their clients. The insured still has a duty to cooperate with the insurer as described in the policy contract.

As Section 2860(b) implies, not every reservation of rights creates a conflict of interest. As California courts have explained, "[i]t is only when the basis for the reservation of rights is such as to cause assertion of factual or legal theories which undermine or are contrary to the positions to be asserted in the liability case that a conflict of interest sufficient to require independent counsel, to be

chosen by the insured, will arise." *Park Townsend, LLC v. Clarendon Am. Ins. Co.*, 12-CV-04412-LHK, 2013 WL 66246 (N.D. Cal. Jan. 2, 2013) (citing *Gafcon, Inc. v. Ponsor & Assocs.*, 98 Cal. App. 4th 1388, 1404, 120 Cal. Rptr. 2d 392, 403 (2002)).

The conflict of interest must be "significant, not merely theoretical, and actual, not merely potential." *Dynamic Concepts, Inc. v. Truck Ins. Exch.*, 1007, 71 Cal. Rptr. 2d 882, 887 (Cal. Ct. App. 4th 1998). It appears that California courts will look to the facts of each situation in an attempt to reconcile the differing interests of insurer and insured.

Time for Providing Insured with Reservation of Rights

- "Failing to promptly provide a reasonable explanation of the basis in the insurance policy in relation to facts or applicable law for denial of a claim or for the compromise of a settlement" constitutes an unfair claim settlement practice. Cal. Ins. Code § 790.03(h)(13) (2006).
- An insurer must accept or deny a claim within 40 days of receiving proof of a claim. Cal. Code Regs. tit. 10, § 2695.7(b).
- If more time is needed to investigate a claim, the insurer must notify the insured of that fact within 40 days of its receipt of a proof of loss, setting forth the reasons that additional time for investigation is required and every 30 days thereafter until the determination is made or legal action is served. Cal. Code Regs. tit. 10, § 2695.7(c)(1).

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Colorado

If an insurer believes that the complaint against its insured includes claims which it is under no obligation to defend, the insured should still undertake the defense of those claims, subject to a "reservation of its rights to seek reimbursement should the facts at trial prove that the incident resulting in liability was not covered by the policy, or to file a declaratory judgment action after the underlying case has been adjudicated." *Hecla Min. Co. v. N.H. Ins. Co.*, 811 P.2d 1083, 1089 (Colo. 1991). The reservation of rights allows the insurer to investigate, employ counsel, and defend the underlying suit without waiving any of the rights to which it is entitled under the policy. *See, e.g., Union Ins. Co. v. Hottenstein*, 83 P.3d 1196 (Colo. App. 2003). In certain circumstances, a declaratory judgment action may be brought simultaneously with the insurer's defense of the insured under a reservation of rights. *Constitution Assocs. v. N.H. Ins. Co.*, 930 P.2d 556, 562-64 (Colo. 1996). However, for the declaratory judgment action to proceed, the issues in that action must be independent and separable from the issues to be decided in the underlying lawsuit. *Progressive Cas. Ins. Co. v. Herring*, 22 P.3d 66, 67 (Colo. 2001).

Notice

Notice of a disclaimer of coverage must be timely, and must include the grounds on which coverage may be denied. *See Lextron, Inc. v. Travelers Cas. & Sur. Co. of Am.*, 267 F. Supp. 2d 1041, 1048 (D. Colo. 2003). A reservation of rights letter should, generally, be sent prior to the commencement of the defense. *Church Mutual Ins. Co. v. Klein*, 940 P.2d 1001 (Colo. App. 1996), *cert. denied* (1997).

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The language of the reservation must be sufficiently specific to put an insured on notice of a future disclaimer of coverage.

Waiver/Estoppel

The purpose of the reservation of rights is to protect the insurer's ability to dispute policy coverage while fulfilling its contractual duty to defend. Therefore, generally, if an insurer enters a reservation of rights to deny coverage, it does not waive those rights by subsequently litigating and/or settling a claim. *Nikolai v. Farmers Alliance Mut. Ins. Co.*, 830 P.2d 1070, 1073 (Colo. App. 1991) (citing *Hartford Ins. Grp. v. District Court*, 625 P.2d 1013 (Colo.1981)).

An insurer *may* be estopped from denying coverage if "(1) the insurer had sufficient knowledge of the facts or circumstances indicating noncoverage; (2) in spite of this knowledge, the insurer assumed the defense of the insured without obtaining an effective reservation of rights; and (3) the insured suffered harm as a result of the insurer's assumption of the insured's defense." *Management Specialists, Inc. v. Northfield Ins. Co.*, 117 P.3d 32, 38 (Colo. App. 2004). Thus, if an insurer assumes and conducts a defense of an action brought against an insured without disclaiming liability and giving notice of its reservation of rights, and if the insurer's conduct prejudiced the insured, then the insurer may thereafter be precluded from denying coverage. *Id.* Note, however, that the rule is somewhat different in actions concerning construction professionals, where an insurer may not withdraw a defense, regardless of the existence of prejudice, unless the right to do so is reserved in writing when the insurer accepted or assumed the defense obligation. Colo. Rev. Stat. § 13-20-808(7)(b)(III).

Generally, "mere delay in making a disclaimer is not enough" for an insured to claim that the insurer waived its rights. "[W]here the insurer makes a timely notice of its disclaimer and the grounds therefore, there is no presumption of prejudice and the insured must carry its burden of showing reliance to its detriment before estoppel can bar a defense of non-coverage.... Waiver or estoppel do[es] not necessarily result from the entry of an appearance for the insured by the insurer nor from investigation of the case by the insurer for a reasonable period of time." *Lextron, Inc.*, 267 F. Supp. 2d at 1048. Waiver or estoppel "cannot...create[] liability where none existed under the policy." *Empire Cas. Co. v. St. Paul Fire & Marine Ins. Co.*, 764 P.2d 1191, 1198 (Colo. 1988).

Once an insurer identifies the policy conditions or exclusions upon which it asserts the bases for a denial of coverage, it may be estopped, at a later time,

from asserting different defenses to the same claim, at least to the extent doing so would prejudice the insured. *Sanchez v. Conn. Gen. Life Ins. Co.*, 681 P.2d 974, 977 (Colo. App.), *cert. denied* (1984).

A recent case considered collateral estoppel in the reservation of rights context. In *Vaughn*, the plaintiff in the underlying action claimed the insured had acted negligently. The insurer entered a reservation of rights letter, because its interest was in the insured being found to have acted intentionally. The trial court found that the insured had acted negligently. When the insurer contested coverage, the appellate court held that the insurer was not precluded from litigating the issue of whether the insured acted intentionally, despite the trial court's judgment, because the negligence or intentionality of the insured had not been actually litigated in the underlying action. *Shelter Mut. Ins. Co. v. Vaughn*, No. 12CA0654, 2013 WL 789204 (Colo. App. Feb. 28, 2013).

"An insurer that reconsiders its decision to provide a defense under a reservation of rights is not barred from later contesting coverage and its duty to defend." *EMC Ins. Cos. v. Mid-Continent Cas. Co.*, 884 F. Supp. 2d 1147, 1173 (D. Colo. 2012).

Reimbursement of Litigation Expenses

If an insurer breaches its duty to defend, it may be required to reimburse the insured for attorney's fees and litigation costs incurred as a result of that breach, unless the insurer can show that the expenses were unreasonable. *Gustafson v. Am. Family Mut. Ins. Co.*, No. 11-CV-01303-PAB-MEH, 2012 WL 5904301 (D. Colo. Nov. 26, 2012) (interpreting Colorado law).

Where an insured never disclosed the underlying suit to its insurer and unilaterally retained defense counsel, insured was not entitled to reimbursement by the insurer after the insurer later undertook the defense. *Van Winkle v. Transamerica Title Ins. Co.*, 697 P.2d 784, 786 (Colo. App. 1984).

Conversely, when an insurer reserves the right to seek recovery from the insured for attorney fees and other litigation expenses the insurer incurs in defending a claim that is ultimately determined not to have warranted a defense, the insurer can seek reimbursement of defense costs from the insured. *Valley Forge Ins. Co. v. Health Care Mgmt. Partners, Ltd.*, 616 F.3d 1086 (10th Cir. 2010); *Cotter Corp. v. American Empire Surplus Lines Ins.*, 90 P.3d 814, 828 (Colo. 2004).

Conflicts of Interest and Independent Counsel

No statute controls the use of independent counsel when the insurer enters a reservation of rights.

An attorney retained by the insurer to represent the insured in litigation has a duty only to the insured. *Shelter Mut. Ins. Co. v. Vaughn*, No. 12CA0654, 2013 WL 789204 (Colo. App. Feb. 28, 2013); Colorado Bar Ass'n, Formal Ethics Op. 91, *Ethical Duties of Attorney Selected by Insurer to Represent Its Insured* (1993).

In light of this duty, no Colorado court has asserted or implied that there is any situation in which an insurer must separately pay for independent counsel after asserting a reservation of rights. However, no case has yet directly addressed this issue.

Time for Providing Insured with Coverage Position/Reservation of Rights

- "Failing to affirm or deny coverage of claims within a reasonable time after proof of loss statements have been completed" constitutes an unfair claims practice. Colo. Rev. Stat. Ann. § 10-3-1104(h)(V) (West).

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Connecticut

Notice/Basis

An insurer that wishes to defend under a reservation of rights should inform its insured that its investigation and defense of the claim is done "without prejudice to its right to deny coverage" and should specify the facts and policy language on which a potential denial is based. The notice must "clearly [inform] the insured that the appearance of its attorneys on the insured's behalf is under a reservation of rights." *West Haven v. Hartford Ins. Co.*, 221 Conn. 149, 165, 602 A.2d 988 (1992) (citing *Basta v. United States F & G Co.*, 107 Conn. 446, 450, 140 A. 816 (1928)).

Estoppel/Waiver

"[T]he insurer may avoid a waiver of the reservation of rights if it clearly informs the insured that the appearance of its attorneys on the insured's behalf is under a reservation of rights, and the insurer performs no acts inconsistent with such reservation." *West Haven v. Hartford Ins. Co.*, 221 Conn. at 165, citing *Basta v. United States F & G Co.*, 107 Conn. at 450.

An insurer that properly conducts a defense under a reservation of rights will not be estopped from asserting any policy defenses that may be available to it; however, the failure to disclaim coverage based on a policy condition, when the insurer has knowledge of facts that would support the disclaimer, constitutes waiver of a policy defense based on the condition. *Nat'l Cas. Ins. Co. v. Stella*, 601 A.2d 557 (1992).

In *National Casualty Insurance Co. v. Stella*, the plaintiff/insurer knew of the circumstances surrounding the claim against the defendant/its insured that likely would allow it to deny coverage, yet the insurer acknowledged coverage and

sought compensation in the form of a deductible from its insured. These acts constituted an implied waiver of its right to disclaim; therefore, the plaintiff's subsequent letter, which sought to disclaim liability, did not terminate its earlier waiver of its right to disclaim coverage. *Id*.

In *Jenkins v. Indemnity Insurance Co.*, 205 A.2d 780 (1964), the court found a waiver of an insurance company's right to disclaim coverage where the company originally acknowledged that the policy covered the claim and also investigated the claim. The insurance company was aware that a New York law would possibly allow it to disclaim coverage. Approximately two months after it acknowledged coverage, the company sought to disclaim coverage on the basis of the New York statute. The court found that the insurance company had sufficient knowledge to conclude that the New York statute would apply to the accident and thereby waived its right to invoke the protection of the New York statute when it acknowledged coverage of the claim.

Waiver can be either express or may consist of acts or conduct "'from which waiver may be implied.'" *Andover v. Hartford Accident & Indem. Co.*, 217 A.2d 60 (1966) (quoting *MacKay v. Aetna Life Ins. Co.*, 118 Conn. 538, 547 (1934)); *Nat'l Cas. Ins. Co. v. Stella*, 26 Conn. App. 462, 464 (1992).

Conflicts of Interest and Independent Counsel

Connecticut legislature and judiciary have yet to address the right to independent counsel in a reservation of rights context. The Connecticut Supreme Court has mentioned that when an insurer retains counsel on to defend the insured, the counsel's only client is the insured, regardless of the fact that the insurer is liable for counsel's fees. *Metro. Life Ins. Co. v. Aetna Cas. & Sur. Co.*, 730 A.2d 51, 65 (Conn. 1999).

Time for Providing Insured with Coverage Position/Reservation of Rights

- "[F]ailing to affirm or deny coverage of claims within a reasonable time after having completed its investigation related to a claim" may constitute an unfair claim settlement practice by an insurer. Conn. Gen. Stat. § 38a-816(6)(E).
- Connecticut's statutory and case law do not define specifically what length of time constitutes a "reasonable time."

Thus, a good practice is to provide the insured with a coverage explanation within 30 days after the insurer's acknowledgement of the claim.

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Florida

Notice

An insurer cannot deny coverage based on a particular coverage defense unless the insurer provides notice of its reservation of rights to assert a coverage defense within 30 days after the insurer knew or should have known of the coverage defense. Fla. Stat. § 627.426.

However, failure to comply with this statute "will not bar an insurer from disclaiming liability where a policy or endorsement has expired or where the coverage sought is expressly excluded or otherwise unavailable under the policy or under existing law." *AIU Ins. Co. v. Block Marina Inv., Inc.*, 544 So. 2d 998, 1000 (Fla. 1989).

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A reservation of rights letter should state that the insurer is reserving its right to limit or deny coverage and specify the basis of a potential denial of coverage. *Aguero v. First Am. Ins. Co.*, 927 So. 2d 894, 896 (Fla. Dist. Ct. App. 3d 2005).

Consent

An insured may, but need not, accept the defense under a reservation of rights. If the insured objects to the defense, the insurer has not wrongfully failed to defend. *Taylor v. Safeco Ins. Co.*, 361 So. 2d 743 (Fla. Dist. Ct. App. 1st 1978).

If the insured objects to the defense under a reservation of rights, the insured has the right in this situation to enter into settlement with the plaintiff, notwithstanding the provisions of the policy. The insurance company's reservation of its assertion of non-liability, although privileged, relinquishes to the insured, at his election, control of the litigation and settlement. To recover such a settlement, however, the insured must prove the settlement was entered into without bad faith, fraud, collusiveness, or any effort to avoid liability. Further, since the insurance company did not violate any duty to defend, its maximum liability is limited to the amount of a reasonable settlement up to a maximum of the policy limits. *Taylor v. Safeco Ins. Co.,* 361 So. 2d 743 (Fla. Dist. Ct. App. 1st 1978).

Prejudice/Estoppel

An insurer may provide a defense to its insured while reserving the right to challenge coverage if timely notice of such reservation is given to the insured. However, a delay in informing the insured of a dispute as to coverage may, but need not, result in estoppel of the insurer. Estoppel exists only if the insured can show he has been prejudiced. *Centennial Ins. Co. v. Tom Gustafson Indus., Inc.*, 401 So. 2d 1143 (Fla. Dist. Ct. App. 4th 1981).

Reimbursement for Defense Costs

The reservation of rights letter may provide the insurer with the right to seek reimbursement for defense costs it pays if it later establishes that those costs were incurred in defending non-covered claims. The reason for allowing an insurer to seek reimbursement of the cost associated with defending non-covered claims

is that the insurer is required to defend both covered and non-covered claims but does not receive a premium for defense of the non-covered claims.

In *Colony Insurance Company,* the court held that the insurer was entitled to reimbursement of attorney fees and costs spent to defend the insured under a reservation of rights because the insured accepted a mutually agreeable counsel on the condition that it would repay the insurer upon a finding that the insurer had no duty to defend. The court noted that the insured would have been in the same position if it had retained and paid for the attorney itself. *Colony Ins. Co. v. G & E Tires & Serv., Inc.*, 777 So. 2d 1034 (Fla. Dist. Ct. App. 1st 2000)

Conflict of Interests and Independent Counsel

Florida does not require that the insurer provide independent counsel as recognized by California in *Cumis*. However, Florida addresses the conflict issue in Florida Statute § 627.426 ("Claims Administration"), which provides that mutually agreeable counsel must be provided under certain circumstances.

The statute provides that a liability insurer shall not be permitted to deny coverage based on a particular coverage defense unless:

> (a) within 30 days after the liability insurer knew or should have known of the coverage defense, written notice of reservation of rights to assert a coverage is given to the named insured by registered or certified mail sent to the last known address of the insured or by hand delivery; AND
>
> (b) within 60 days of compliance with paragraph (a) or receipt of a summons and complaint naming the insured as a defendant, whichever is later, but in no case later than 30 days before trial, the insurer:
>
> (1) gives written notice to the named insured by registered or certified mail of its refusal to defend the insured;
>
> (2) obtains from the insured a nonwaiver agreement following full disclosure of the specific facts and policy provisions upon which the coverage defense is asserted and the duties, obligations, and liabilities of the insurer during and following the pendency of the subject litigation; OR
>
> (3) retains independent counsel which is mutually agreeable to the parties. Reasonable fees for the counsel may be agreed upon between the parties or, if no agreement is reached, shall be set by the court.

In other words, Florida law provides that when an insurer asserts a coverage defense and the insured rejects the reservation of rights defense or declines to enter into a nonwaiver agreement, the insurer is required to provide "mutually agreeable" counsel to defend the insured. This "mutually agreeable" requirement allows for the insurer and the insured to share equal rights in the selection of defense counsel.

The statute is implicated only when the insurer raises a "coverage defense," defined by the Florida Supreme Court as defense to coverage that otherwise

exists. *AIU Ins. Co. v. Block Marina Inv., Inc.*, 544 So. 2d 998, 1000 (Fla. 1989). Accordingly the statute cannot create or extend coverage where none existed to begin with (such as where the loss does not fall within the terms coverage or because of a limitation or exclusion.) Rather the statute will estop a coverage defense (such as a breach of notice provision or duty to cooperate) where there would otherwise have been coverage for the loss.

Time for Providing Insured with Coverage Position/Reservation of Rights

- An insurer does not waive its rights to coverage defenses if a reservation of rights letter is sent to the insured, via hand-delivery or certified mail, within 30 days of when the insurer knew, or should have known, of the loss. Fla. Stat. § 627.426(2)(a).

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Illinois

Notice

An insurer that wishes to assert its nonliability under the policy must notify the insured "without delay." A notification is "without delay" if it is communicated with reasonable promptness. A delay is reasonable if it is not so long as to prevent the insured from taking such action as would save the insured from loss and damages. *Apex Mut. Ins. Co. v. Christner*, 99 Ill. App. 2d 153, 170, 240 N.E.2d 742, 753 (1st Dist. 1968) (two months was "without delay").

There is no material difference between providing the insured with notice by serving a reservation of rights or filing a declaratory judgment action. *Apex*, 99 Ill. App. 2d at 164, 240 N.E.2d at 749. *See also*, *Grinnell Mut. Reinsurance Co. v. LaForge*, 369 Ill. App. 3d 688, 863 N.E.2d 1132, 1140 (4th Dist. 2006) (insurer's filing of declaratory judgment action 25 days after underlying complaint filed was not untimely); *Twin City Fire Ins. Co. v. Old World Trading Co.*, 266 Ill. App. 3d 1, 12, 639 N.E.2d 584, 591 (1st Dist. 1993) (four months was reasonable where the underlying suit was pending for 32 months before the insured notified the insurer and at least 41 depositions had already been taken); *Aetna Cas. & Sur. Co. v. O'Rourke Bros., Inc.*, 333 Ill. App. 3d 871, 880-881, 776 N.E.2d 588, 596-597 (3d Dist. 2002) (insurer's filing of declaratory judgment action 11 months after learning of complaint filed against insured was untimely). It is an improper claims practice for an insurance company to fail to affirm or deny coverage of a claim within a reasonable time after proof of loss statements have been completed, without just cause. 215 Ill. Comp. Stat. 5/154.6(i) (2013).

Content

A proper reservation of rights letter is one that adequately informs the insured of the insurer's coverage defenses and allows the insured to intelligently decide whether to hire independent counsel. *Mobil Oil Corp. v. Maryland Cas. Co.*, 288 Ill. App. 3d 743, 754-755, 681 N.E.2d 552, 560 (1st Dist. 1997).

A reservation of rights letter must contain three elements, each of which must be set forth with clarity. The reservation of rights letter should (1) explain the insurer's coverage defenses; (2) describe the conflict of interest created by the insurer's assertion of the particular coverage defense; and (3) advise the insured of its right to independent counsel.

(1) Explanation of the coverage defenses. "Bare notice of a reservation of rights is insufficient." *Royal Ins. Co. v. Process Design Assocs., Inc.*, 221 Ill. App. 3d 966, 973, 582 N.E.2d 1234, 1239 (1st Dist. 1991). The reservation of rights letter must adequately inform the insured of the rights that the insurer intends to reserve, including specific reference to the policy defenses which the insurer asserts. *Mobil Oil*, 288 Ill. App. 3d at 754-755, 681 N.E.2d at 560; *Royal Ins.*, 221 Ill. App. 3d at 973, 582 N.E.2d at 1239.

Ambiguities in a reservation of rights letter will inevitably be construed against the insurer. Therefore, quoting the policy language that forms the basis for the reservation of rights is the best practice; it is also the simplest way to express the reservation with clarity and completeness. Where the applicability of the policy's limiting language may not be obvious to an ordinary policyholder, an explanation of how the policy language applies to the particular allegations of the complaint may also be required. Inadvertent waiver of defenses may be avoided by adding a general caveat to the reservation of rights letter stating "there may be other reasons why coverage does not apply." *Universal Fire & Cas. Ins. Co. v. Jabin*, 16 F.3d 1465, 1471 (7th Cir. 1994) (applying Illinois law).

(2) Description of the conflict of interest. It is not adequate to simply state that a conflict of interest exists. The reservation of rights letter must explain why there is a conflict of interest. The foundational Illinois case on reservation of rights letters, *Maryland Casualty Co. v. Peppers*, illustrates how this should be done. In
Peppers, the court found that there was a conflict of interest because the complaint filed against the insured contained one count alleging negligence and one count alleging intentional conduct. The Illinois Supreme Court explained the conflict as follows: "In the personal injury action if [the insured] is held responsible, it would be to his interest to be found negligent, which, under the policy of insurance, would place the financial loss on [the insurer]. On the other hand it would be to [the insurer's] interest to have a determination that [the insured] intentionally injured [the claimant], which, by terms of the policy, would relieve [the insurer] of the obligation to pay the judgment." *Md. Cas. Co. v. Peppers*, 64 Ill. 2d 187, 197, 355 N.E.2d 24, 30 (1976).

Although this kind of explanation does not address all of the ramifications of the conflict, it is deemed sufficient to place the insured on notice that advice of independent counsel should be sought. A proper reservation of rights letter

should explain the nature of the conflict in terms of the specific coverage defenses at issue, not in generic terms. Further, in an instance where the insurer has an established close relationship with the assigned defense attorney, the insurer may also need to advise the insured of that relationship in the reservation of rights letter. *Allstate Ins. Co. v. Carioto*, 194 Ill. App. 3d 767, 777, 551 N.E.2d 382, 388 (1st Dist. 1990).

(3) Advising the insured of its right to independent counsel. Unless the insured accepts the representation of an attorney appointed by the insurance company following full disclosure of a conflict, an insurer with a conflict of interest is obligated to reimburse the insured for the reasonable cost of retaining a defense attorney of the insured's choosing. A proper reservation of rights letter is one that specifically advises the insured of that right. Failure to include this notification in a reservation of rights letter may invalidate the reservation. Simply stating that the insured has a right to retain its own counsel is not sufficient, absent an acknowledgement that the insurer will pay. *Ins. Co. of Ill. v. Fed. Kemper Ins. Co.*, 291 Ill. App. 3d 384, 388, 683 N.E.2d 947, 950 (1st Dist. 1997).

An effective reservation of rights letter is one that includes each of the three necessary elements with clarity and completeness. A reservation of rights letter that omits any one of those elements has the same practical value and effect as no reservation of rights at all.

Estoppel

An insurer which takes the position that a suit not covered under the policy is estopped from raising policy defenses to coverage unless it either (1) defends the suit under a reservation of rights or (2) seeks a declaratory judgment that there is no coverage. *Employers Ins. of Wausau v. Ehlco Liquidating Trust*, 186 Ill. 2d 127, 148-150, 708 N.E.2d 1122, 1134-1135 (1999). However, even if an insurer agrees to provide a defense under a reservation of rights, it may still face estoppel problems if its reservation of rights letter is improper or incomplete. Careful draftsmanship is crucial when preparing a reservation of rights letter.

Reimbursement for Defense Costs

Sometimes an insurer will include a provision in its reservation of rights letter giving the insurer the right to seek reimbursement for defense costs it pays if it later establishes that those costs were incurred in defending non-covered claims. However, Illinois courts have refused to permit an insurer to recover defense costs pursuant to a reservation of rights absent an express provision to that effect in the insurance contract between the parties. *Gen. Agents Ins. Co. of Am., Inc. v. Midwest Sporting Goods Co.*, 215 Ill. 2d 146, 164, 828 N.E.2d 1092, 1103 (2005).

The Illinois Supreme Court held that the insurer could not unilaterally modify its contract, through a reservation of rights, to allow for reimbursement of defense costs. *Id.*

Conflicts of Interest and Independent Counsel

As described above ("Content"), when an insurer reserves its rights, the reservation often creates a conflict between the interests of the insurer and the interests of the insured. A conflict of interest exists if the interests of the insurer would be furthered by providing a less than vigorous defense to certain allegations against the insured, *Mobil Oil Corp. v. Md. Cas. Co.*, 288 Ill. App. 3d 743, 756, 681 N.E.2d 552, 561 (1st Dist. 1997), or if "proof of certain facts would move liability from the insurer to the insured." *Pekin Ins. Co. v. Home Ins. Co.*, 134 Ill. App. 3d 31, 34, 479 N.E.2d 1078, 1082 (1st 1985).

If a conflict of interest exists, a defense attorney chosen by the insurance company cannot properly represent the insured, unless and until the insured has been fully informed of the conflict and knowingly consents to representation by the attorney. *Mobil Oil*,288 Ill. App. 3d at 756,681 N.E.2d at 561. This requires "full and frank disclosure" on the part of the insurer. *Preferred Am. Ins. v. Dulceak*, 302 Ill. App. 3d 990, 996, 706 N.E.2d 529, 533 (2d Dist. 1999). When a conflict of interest arises, the insured is entitled to retain independent counsel to be paid for by the insurer. *Md. Cas. Co. v. Peppers*, 64 Ill. 2d 187, 199, 355 N.E.2d 24, 31 (1976).

A related situation occurs where two insureds have conflicting defense positions, such as principal and agent, where vicarious liability is alleged against the principal. In that circumstance, it would be in the best interests of both insureds for the agent to be found not liable. However, if the agent were found liable, it would be in the agent's interest for the principal to also be found liable, so as to spread the potential loss. In that case, the insurer will be required to pay for defense counsel selected by at least one of the insureds, if not both.

Time for Providing Insured with Coverage Position/Reservation of Rights

- Failing to "adopt and implement reasonable standards for the prompt investigations and settlements of claims" and failing to "affirm or deny coverage of claims within a reasonable time after proof of loss statements have been completed" constitute improper claims practices. 215 Ill. Comp. Stat. 5/154.6(c) and (i) (2013).
- An insurer is required to affirm or deny liability on claims within a reasonable time and shall pay covered claims or provide a written explanation to the insured for a denial within 30 days of affirmation or determination of liability. Ill. Admin. Code tit. 50, § 919.50(a) (2011).·
- For third-party claims, the insurer must also provide the third party with a reasonable written explanation of the basis of a denial within 30 days after the initial determination of liability. Ill. Admin. Code tit. 50, § 919.50(a) (2011).
- The speed with which an insurer responds or provides its coverage position to the insured is a "factor" to be considered when evaluating the insurer's conduct, and a lengthy delay in responding is normally not enough to constitute an estoppel or waiver of a coverage defense. *Twin City Fire Ins. Co. v. Old World Trading Co.*, 266 Ill. App. 3d 1, 639 N.E.2d 584 (1st Dist.), *appeal denied*, 158 Ill. 2d 566, 645 N.E.2d 1369 (1994) (holding that assertion of defense within four months of receiving notice of claim was reasonable).
- Illinois permits an insured to seek extra contractual damages and

attorneys' fees for an insurer's vexatious and unreasonable delays in claims handling. 215 Ill. Comp. Stat. 5/155(1) (2013).

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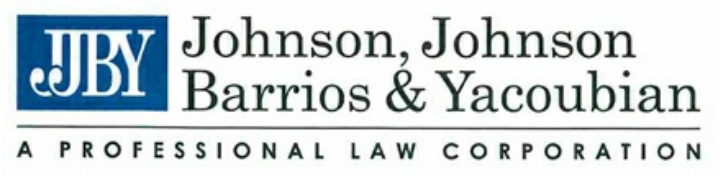

Louisiana

Notice

When an insurer intends to defend under a reservation of rights, it must do so "promptly." *Arceneaux v. Amstar Corp.*, 969 So. 2d 755 (La. Ct. App. 4th 2007).

In *Hiser v. Rajki*, an insurer, with knowledge of facts indicating non-coverage under the insurance policy, assumed and continued the insured's defense, waiting until 21 days before trial to assert an agreement reserving its rights. The court held that the agreement was untimely and the insurer had waived any such policy defense(s*). Hiser v. Rajki*, 700 So. 2d 1302 (La. Ct. App. 1st 1997).

In *Cassey v. Stew*art, a reservation of rights letter to the insured was timely when sent by the insurer one year and eight months after a lawsuit was filed against the insurer. *Cassey v. Stewart*, 727 So. 2d 655 (La. Ct. App. 2d 1999).

In *Peters v. State Farm*, the court held the insurer, who learned of the claim in January 1992 and issued reservation of rights letters in February, concluded its investigation and timely disclaimed coverage based on the policy exclusion on April 9, 1992. *Peters v. State Farm Fire & Cas. Ins. Co.*, No. 09-645, 2009 WL 1941240 (E.D. La. July 2, 2009).

Content

A non-waiver agreement or reservation of rights letter should state that "the insurer retains its rights to defend itself based on the alleged insured's lack of coverage under [the] policy." Notice of a reservation of rights should also state the specific terms of the policy on which a disclaimer of coverage may be based. *W.T.A. v. Yeager*, 832 So. 2d 1217 (La. Ct. App. 3d 2002).

Waiver/Estoppel

The failure to timely notify an insured of a disclaimer will not result in waiver or estoppel that would provide coverage for acts not included under the policy. *Balehi Marine, Inc. v. Firemen's Ins. Co. of Newark, N.J.*, 460 So. 2d 16 (La. Ct. App. 1st 1984).

However, "when an insurer, with knowledge of facts indicating noncoverage under

the insurance policy, assumes or continues the insured's defense without obtaining a nonwaiver agreement to reserve its coverage defense, the insurer waives such policy defense." *Steptore v. Masco Const. Co., Inc.*, 643 So. 2d 1213, 1216 (La. 1994).

As the Louisiana Third Circuit has noted, "a tacit waiver or interruption of prescription may be found if the insurer; (1) continues negotiations, thereby inducing the insured to believe the claim will be settled or not contested, (2) makes an unconditional offer of payment, or (3) performs acts of reparation or indemnity." *Bennett v. State Farm Ins. Co.*, 869 So. 2d 321, 329 (La. Ct. App. 3d 2004).

Attorney's Fees

An insurer may be liable to the insured for attorney's fees if it fails to properly defend the insured under a reservation of rights. In *Clemmons*,the insurer initially retained one attorney to represent the insured and itself in a direct action. As time went on, the retained attorney advised the insured that a conflict of interest might exist and that it should consider retaining separate counsel. Where coverage issues are presented, the insurer may require the use of a non-waiver agreement or reservation of rights or may bring a declaratory judgment action. In this instance, the insurer did not exercise any of these prerogatives, and failed to properly defend the insured. Thus, it was liable for the insured's attorney's fees incurred in defending the action. *Clemmons v. Zurich General Acc. & Liab. Ins. Co.*, 230 So. 2d 887 (La. Ct. App. 1st 1970).

Reimbursement for Defense Costs

The reservation of rights letter may provide the insurer with the right to seek reimbursement for defense costs it pays if it later establishes that those costs were incurred in defending non-covered claims. The reason for allowing an insurer to seek reimbursement of the cost associated with defending non-covered claims is that the insurer is required to defend both covered and non-covered claims but does not receive a premium for defense of the non-covered claims. *T.H.E. Ins. Co. v. Larsen Intermodal Servs., Inc.*, 242 F.3d 667 (5th Cir. 2001).

In *Resure, Inc.*,the insurer timely reserved its rights under the policy, and the reservation specifically referred to the possibility that the insurer might seek reimbursement for any and all costs of defense. The court found nothing in the record to suggest that the insured objected to the reservation. Accordingly, the court found the insurer entitled to reimbursement for all costs of defense. *Resure, Inc. v. Chem. Distribs., Inc.*, 927 F.Supp. 190 (M.D. La. 1996).

Reimbursement for Settlement

In *Sears Employers Mutual Liability Insurance Co.*,an insurance company defended the insured, without a reservation of rights or non-waiver agreement, based upon a vendor's endorsement. After settling the case, it sued the insured to recover the settlement based upon an exclusion to the vendor's endorsement. The court ruled that by defending and settling without protecting its non-coverage defenses or reserving its rights, the insurance company had waived its right to

seek recovery from the insured. *Emp'rs Mut. Liab. Ins. Co. of Wis. v. Sears, Roebuck & Co.*, 621 F.2d 746 (5th Cir. 1980).

Conflicts of Interest and Independent Counsel

No statutory provision mandates the use of *Cumis* counsel, however, Louisiana courts have specifically recognized the insured's right to retain counsel-at the insurer's expense-to defend its interests in connection with the liability aspect of a lawsuit when the insurance company has reserved its rights to deny coverage for a claim or suit.

In *Belanger*, the Louisiana First Circuit Court of Appeal specifically enforced a *Cumis* endorsement, contained in a policy of insurance issued by Lexington Insurance Company, which allowed an insured to retain counsel to defend its interests when the insurer reserved its right to deny coverage. "[I]f the insurer chooses to represent the insured but deny coverage it must employ separate counsel. If it fails to do so, the insurer is liable for the attorney fees and costs the insured may incur for defending the suit." *Belanger v. Gabriel Chems., Inc.*, 787 So. 2d 559, 565 (La. Ct. App. 1st), *writ denied*, 802 So. 2d 612 (La. 2001) (quoting *Dugas Pest Control of Baton Rouge, Inc. v. Mut. Fire, Marine & Inland Ins. Co.*, 504 So. 2d 1051, 1054 (La. Ct. App. 1st 1987) (internal quotation marks omitted).

More often than not, the separate counsel employed to represent the insured is selected by the insurer. However, in cases where an insurance company and its insured have a conflict of interest, the insured, rather than the insurance company, is entitled to assume control of the defense of the underlying action and select its own attorney, referred to as *Cumis* counsel. *See Trinity Universal Ins. Co. v. Stevens Forestry Serv., Inc.*, 335 F.3d 353 (5th Cir. 2003); *Belanger*, 787 So.2d 559.

In *Trinity*, the insurer agreed to defend the insured and provided counsel, but also reserved its rights to deny coverage and encouraged the insured to employ private counsel at the insured's own expense, which the insured did. After receiving a favorable verdict in the underlying action, the insured sought reimbursement for the attorney's fees and costs of the private counsel. The U.S. Court of Appeals for the Fifth Circuit distinguished *Belanger* on the grounds that here the insured did not reject the insurer-appointed counsel, but rather accepted that counsel and simultaneously kept its own. The court held that, absent some showing that the counsel provided by the insurer was incompetent or inadequate, the insurer had no duty to reimburse the insured for his additional counsel. 335 F.3d 353.

Time for Providing Insured with Coverage Position/Reservation of Rights

- "Failing to promptly provide a reasonable explanation of the basis in the insurance policy in relation to facts or applicable law for denial of a claim or for the compromise of a settlement" constitutes an unfair claim settlement practice. La. Rev. Stat. Ann. § 22:1214(14)(n) (2006).
- No case law interprets and no regulation governs "promptly provide."

· Thus, a good practice is to provide the insured with a coverage explanation within thirty days after the insurer's acknowledgement of the claim.

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PETRUCCELLI, MARTIN & HADDOW, LLP

Maine

Content

A reservation of rights letter should state the policy language and the facts on which a disclaimer would be based. *Patrons Oxford Ins. Co. v. Harris*, 905 A.2d 819, 822-823 (Me. 2006). A disclaimer of coverage should be expressed and should cite the language in the policy that supports the disclaimer. *Marston v. Merchs. Mut. Ins. Co.*, 319 A.2d 111, 113 (Me. 1974).

Insured's Right to Enter into Settlement

An insured being defended under a reservation of rights is entitled to enter into a reasonable, non-collusive, non-fraudulent settlement with a claimant, after notice to, but without the consent of, the insurer. The insurer is not bound by any factual stipulations entered as part of the underlying settlement, and is free to litigate the facts of coverage in a declaratory judgment action brought after the settlement is entered. If the insurer prevails on the coverage issue, it is not liable on the settlement. If the insurer does not prevail as to coverage, it may be bound by the settlement, provided the settlement, including the amount of damages, is shown to be fair and reasonable, and free from fraud and collusion. The issues of the fairness and reasonableness of the settlement, as well as whether it is the product of fraud and collusion, may be brought by the insurer in the same action in which it asserts its coverage defense. If the claimant cannot show that the settlement and the damages or the settlement amount are reasonable, the claimant may recover only that portion which he proves to be reasonable. If the claimant cannot prove reasonableness, the insurer is not bound. Likewise, if the settlement is found to be the product of fraud or collusion, the insurer is not bound. *Patrons Oxford*,905 A.2d at 822-823.

Control

When an insurer reserves its rights to contest coverage of a claim in litigation, it surrenders its right to control that litigation. *Patrons Oxford*,905 A.2d at 825-826. Beyond this, the issues surrounding conflict of interest and role of independent counsel have not yet been decided by the Maine judiciary or legislature.

Time for Providing Insured with Coverage Position/Reservation of Rights

- Failing to affirm or deny coverage, reserving any appropriate defenses, within a reasonable time after having completed its investigation related to a claim" constitutes an unfair claim settlement practice by an insurer. Me. Rev. Stat. Ann. tit. 24-A, § 2164-D(3)(B), (C), and (K) (2006).
- No case law interprets and no regulation governs "reasonable time."
- Thus, a good practice is to provide the insured with a coverage explanation within 30 days after the insurer's acknowledgement of the claim.

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BACON, THORNTON & PALMER L.L.P.
ATTORNEYS AT LAW

Maryland

Notice

Notice that an insurer is disclaiming coverage must be sent to the insured within a reasonable time. *Med. Mut. Liab. Ins. Soc'y of Md. v. Miller*, 451 A.2d 930 (Md. Ct. Spec. App. 1982). An insurer will be estopped from disclaiming liability if it does not repudiate liability within a reasonable time after becoming aware of the insured's failure to cooperate. *Travelers Ins. Co. v. Godsey*, 273 A.2d 431 (Md. 1970.)

In *Medical Mutual*, the court found that the insurer had knowledge of the breach of the cooperation clause almost a year before it attempted to disclaim liability. Accordingly the court held that the insurer was estopped from disclaiming liability due to its failure to notify the insured within a reasonable time. *Med. Mut.*, 451 A.2d 930.

Content

A reservation of rights or disclaimer letter must state all defenses "arising from the failure of the claimant to satisfy some technical condition subsequent" or those defenses will be deemed waived. Grounds for disclaiming coverage based on the "scope of the risks to be covered" that are not included in a reservation of rights or disclaimer letter are not deemed waived. *Creveling v. Gov't Emps. Ins. Co.*, 828 A.2d 229 (Md. 2003). Nevertheless, a proper reservation of rights or disclaimer letter should include all of the policy language and facts on which a denial of coverage is based. *Wolfe v. Anne Arundel County*, 761 A.2d 935 (Md. Ct. Spec. App. 2000).

In *Insurance Co. of North America v. Coffman*, the plaintiff in a declaratory judgment action argued that an insurer could not rely upon a policy exclusion that

it had failed to raise in a letter of rejection. The Court held that it was not important that the insurer failed to raise the exclusionary defense in the rejection letter, for the effect of applying a doctrine of waiver or estoppel in that circumstance would be to create insurance coverage by waiver, which the Maryland Court of Appeals has precluded as a matter of law. The Court also noted that "[t]here is a distinction in Maryland between defenses founded upon a lack of basic coverage and those arising from the failure of the claimant to satisfy some technical condition subsequent. The former may not be waived merely by the company's failure to specify them in its initial response to a claim, for the effect of that would be to expand the policy to create a risk not intended to be undertaken by the company." 451 A.2d 952 (1982).

Waiver/Estoppel

In *Inland Mutual Insurance Co.*, the insured misrepresented his age in order to obtain an insurance policy. The court held that this was a material misrepresentation. Even though the non-waiver agreement did not make specific reference to this ground for denying coverage, it was sufficient to prevent waiver or estoppel of the insurer to raise the misrepresentation. *Inland Mut. Ins. Co. v. Davenport*, 247 F.Supp. 387 (D.Md. 1965).

In *Columbia Casualty Co.*,after receiving notice of plaintiff's suit against the insured, the insurer wrote a letter to the insured stating that "the insurer will proceed with an investigation of the facts, but without waiving any of said rights." An investigation was commenced and the insurer retained exclusive control of the case for 51 days before the insured was notified of the insurer's policy defense. The court held that this particular non-waiver letter merely covered the investigation of facts. The insurer's exclusive control for 51 days must be considered without the reservation. A non-waiver agreement is not effective unless the insured agrees to it. This letter only related to the insurer's right to deny coverage during the investigation and did not necessarily extend to the insurer's defense of plaintiff's suit against the insured. The insured has the right to be informed, within a reasonable time after the reservation, of the insurer's position. The insurer's conduct was such that a jury could infer an intention of the insurer to waive the policy defense. *Columbia Cas. Co. v. Ingram*, 140 A. 601 (Md. 1928).

The right of an insurer to forfeit or void the policy *may be* waived. This requires the intentional relinquishment of a known right, and can be inferred from "conduct in the form of consistent reliance by an insurer on one condition or defense," which may constitute a waiver of other possible forfeitures or defenses. For this reason, the reservation of rights letter should be comprehensive. *St. Paul Fire & Marine Insurance Co. v. Molloy*, 433 A.2d 1135 (Md. 1991).

For example, in *Molloy*, the insured (an arsonist) argued that the arson defense had not been raised in his home owner insurer's rejection letter, and thus, the insurer had waived its right to reject coverage (and was estopped form doing so). After observing the aforementioned characteristics of waiver, the Court also noted that "whether waiver exists in a given case is normally a question for the trier of fact, and turns upon the intent of the party ostensibly waiving the right, a state of mind which is to be derived from the facts and circumstances

surrounding the purported relinquishment." In *Molloy*, the Court found no waiver because it found that the arson defense was encompassed within the general terms of the rejection letter, which provided: "The insurance company, of course, reserves its right to invoke any other terms, conditions, or exclusions of the policy which may be applicable to this loss upon facts now known or which may later be discovered." The Court also noted in a footnote that proper application of waiver is generally limited to those technical policy provisions or conditions the invocation of which results in a forfeiture of otherwise existing coverage. 433 A.2d 1135.

In addition, "in order for the doctrine of estoppel to bar an insurer from raising a defense [based on a policy provision], the insured must produce evidence of some prejudicial reliance upon some act, conduct, or non-action of the insurer." *See Phillips Way, Inc. v. American Equity Ins. Co.*, 795 A.2d 216 (2002).

Conflict of Interest and Independent Counsel

Generally, where the interest of the insured and insurer run parallel, an attorney may represent both without offending ethical mandates. Maryland courts regard such dual representation as "ethically permissible and, indeed...[a] typical consequence of common insurance contract language permitting the insurer to control the defense against third party lawsuits." Nor does the "mere fact of 'dual' representation" constitute a conflict of interest, and "further, that dual representation is essentially waived by policy language giving the insurer the right to control the litigation by choosing counsel." However, the fact that "an attorney in Maryland may, in conformance with ethical rules, simultaneously represent an insurer and its insured does not establish...that in all cases in which an attorney is hired by an insurer to represent an insured, the attorney does engage in such dual representation." *Pa. Nat'l Mut. Cas. Ins. Co. v. Perlberg*, 819 F.Supp.2d 449 (D. Md. 2011).

In *Perlberg*, an insurer moved to disqualify the insured's (defendant's) counsel in a declaratory judgment action brought by the insurer (plaintiff in the declaratory judgment action) on the basis that the defendant-insured's lawyer had been frequently hired by the plaintiff-insurer to defend its insured, while the attorney was with another law firm. However, the attorney had never participated in coverage cases and declaratory judgment actions involving the plaintiff-insurer. The court held that there were insufficient grounds to disqualify counsel for a conflict of interest on this basis, because dual representation is ethically permissible, commonplace, and essentially part of the policy contract. The court went on to note that this was particularly true in the scenario presented, where an insurer hired an attorney to defend its insured and "at no time...did the attorney undertake to represent *both* [insured and insurer] because the attorney was instructed at the outset of the representation not to consider the insurer's interest in planning the insured's defense and the attorney had an ethical obligation to advance only the insured's interests." 819 F.Supp.2d at 455 (emphasis in original).

When faced with the question of breach of a cooperation clause, however, the situation may change dramatically. If, in the course of the dual representation an actual conflict develops between the interests of the insured and those of the

insurer, the lawyer must either withdraw entirely from the case or continue to represent one of the clients only. Various courts have condemned such dual representation in these circumstances, and several have held that when it occurred, the insurance company had waived its right to disclaim or was estopped to do so. *Fidelity & Cas. Co. of New York v. McConnaughy*, 179 A.2d 117 (Md. 1962).

Independent counsel is often required in situations involving conflicts of interest. Maryland does not have a *Cumis* statute like Section 2860(a) of the California Civil Code. However, Maryland case law has addressed the issue and reached virtually the same conclusion.

In *Brohawn v. Transamerica Ins. Co.*, 347 A.2d 842 (Md. 1975), the Maryland Court of Appeals held that an insurer is not relieved of its contractual obligation to defend the insured merely because an actual conflict of interest arises between insurer and insured (such as a third party suit involving covered and non-covered claims). The insurer's assertion of reservation of rights does not necessarily create an actual conflict. *See Perlberg*, 819 F. Supp. 2d at 454; *Driggs Corp. v. Pa. Mfrs.' Ass'n Ins. Co.*, 3 F.Supp.2d 657, 659 (D.Md.1998).

When such an actual conflict of interest arises, the insurer is obligated to (1) notify the insured of the existence and nature of the conflict and (2) give the insured the right to either accept an independent attorney assigned by the insurer or select an attorney himself to conduct his own defense. If the insured selects his own lawyer to handle the case, the insurer is responsible for payment of reasonable costs associated with that attorney's representation. This issue is also addressed in *Southern Maryland Agricultural Ass'n v. Bituminous Casualty Corp.*, 539 F. Supp. 1295 (D.Md. 1982) (cited in the California *Cumis* decision).

Unlike the California Civil Code § 2860(a), the Court in *Brohawn* did not specifically provide that an insured may waive his right to independent counsel in writing in the case of a conflict of interest between insured and insurer.

Time for Providing Insured with Coverage Position/Reservation of Rights

- Failing "to provide promptly on request a reasonable explanation of the basis for a denial of a claim" constitutes an unfair claim settlement practice. Md. Code Ann., Ins. § 27-303(6) (2006).
- Under property and casualty insurance policies, failing "to affirm or deny coverage within 15 working days after receiving properly completed claim forms or other proofs of loss" constitutes an unfair claim settlement practice, "unless the provisions of Regulation .04B of this chapter apply or unless there is a time limit specified in the policy." Md. Code Regs. 31.15.07.03(12).
- If an insurer has not completed its investigation within 45 days of notification, it must (1) write to the insured and provide the "actual reason" that additional time is necessary to investigate the claim, and (2) write the insured every 45 days thereafter until the insurer either affirms or denies coverage. Md. Code Regs. 31.15.07.04(B) (2006).

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COUGHLIN · BETKE LLP

Massachusetts

Notice

A reservation of rights or a disclaimer must be made within a reasonable length of time. *Merrimack Mut. Fire Ins. Co. v. Nonaka*, 606 N.E.2d 904 (Mass. 1993). In *Merrimack*,the insurer was not estopped from disclaiming coverage in an action against insured, even though it defended the claim for approximately five months before providing the insured notice of its reservation of rights or disclaimer of coverage. The court noted that the insured did not rely to his detriment on anything the insurer did or did not do. *Merrimack*, 606 N.E.2d 904.

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"The non-waiver agreement embodies an agreement by both sides that no step taken by the insurer will constitute an implied waiver of its right to claim that the policy does not require it to take that step or to assert against the insurer any defense the policy may contain notwithstanding prior action that may be inconsistent with the defense. "The purpose of the language in a non-waiver agreement is to avoid waiver claims that frequently surface when an insurer "undertakes a defense without clearly stating limitations inherent in the undertaking." *Aetna Cas. & Sur. Co. v. George*, 3 Mass.L.Rptr. 247 (citing *Merrimack*, 606 N.E.2d at 907).

Waiver/Estoppel

A proper reservation of rights letter will protect an insurer "from a subsequent attack on its coverage position on waiver or estoppel grounds." *Med. Malpractice Joint Underwriting Assoc. of Mass. v. Goldberg*, 680 N.E.2d 1121, 1129 n.31 (Mass. 1997) (citing *Salonen v. Paanenen*, 71 N.E.2d 227 (1947).

In *DiMarzo*,the insurer asserted, among other things, the insured's failure to cooperate as a defense in a bad faith claim. Since the insurer had sufficient notice that the insured might not cooperate and made no effort to reserve its rights, it was held to have waived its defense of non-cooperation. Further, an attempt to enter into a reservation of rights agreement after the beginning of a jury trial was ineffective. Such reservation must be made at the beginning of the trial. *DiMarzo v. Am. Mut. Ins. Co.*, 449 N.E.2d 1189 (Mass. 1983).

When an insurer fails to take timely steps to disclaim liability or reserve its rights, then seeks to overcome that failure by arguing that the disappearance of the insurer obviates any requirement that it formally notify the insured before

proceeding to trial, a court will place the insurer under a duty to take affirmative steps to secure the cooperation of a the vanished policyholder. *Imperiali v. Pica*, 156 N.E.2d 44 (Mass. 1959).

Reimbursement for Settlement

Where an insurer defends under a reservation of rights to later disclaim coverage, it may later seek reimbursement for an amount paid to settle the underlying tort action, but only if (1) the insured has agreed that the insurer may commit the insured's own funds to a reasonable settlement with the right later to seek reimbursement from the insured, or (2) if the insurer secures specific authority to reach a particular settlement which the insured agrees to pay. The insurer may also notify the insured of a reasonable settlement offer and give the insured an opportunity to accept the offer or assume its own defense.

Where the original reservation of rights letter does not make any reference to settlement or to the insurer's right later to claim for reimbursement of any settlement, where any correspondence with the insured does not provide the necessary authority, or where the insurer fails to notify the insured of a settlement offer received by the insurer and does not give the insured an opportunity to either accept that settlement or assume its own defense, the insurer will be unable to seek reimbursement for settlement. *Med. Malpractice Joint Underwriting Ass'n of Mass. v. Goldberg*, 680 N.E.2d 1121 (Mass. 1997).

Conflicts of Interest and Independent Counsel

Where there is a potential clash of interests between the insurer and the insured, there should be separate representation of the insured at the expense of the insurer. *Magoun v. Liberty Mut. Ins. Co.*, 195 N.E.2d 514 (Mass. 1964).

In *Magoun*, the court was confronted with the unique question of whether the insurer must pay the insured's legal expenses, if the insurer (a) has a substantial ground for disclaimer of liability, (b) asks for the insured's consent to its defending under a reservation of right, (c) is denied that consent, and (d) then yields control of the defense to the insured at the latter's request.Stating that the courts had not specifically ruled on whether the insured may refuse such a defense, the court noted that the insured and the insurer had cooperated in the defense without any specific agreement on the subject. The facts revealed no agreement or reservations concerning the cost of the independent defense. And because the insurer could have included in the covenant to defend explicit provisions concerning the cost of defense in various situations, the court concluded that the uncertainty should be resolved against the insurer. Accordingly, it was held that under the circumstances, the covenant to defend is broad enough to require the insurer to pay the reasonable charges of the insured's counsel, who provided, with at least the insured's acquiescence, the defense that the insured itself was bound to furnish. *Id.*

If an insurer enters a reservation of right to disclaim liability, it cannot "insist[] on retaining control of the insured's defense." *Herbert A. Sullivan, Inc. v. Utica Mut. Ins. Co.*, 788 N.E.2d 522, 539 (Mass. 2003).
Massachusetts case law further provides that "[w]hen an insurer seeks to defend

its insured under a reservation of rights, and the insured is unwilling that the insurer do so, the insured may require the insurer either to relinquish its reservation of rights or relinquish its defense of the insured and reimburse the insured for its defense costs." *N. Sec. Ins. Co. v. R.H. Realty Trust*, 941 N.E.2d 688 (Mass. App. Ct. 2011) (quoting *Herbert A. Sullivan*, 788 N.E.2d 522).

In such an instance, the insurer must pay the reasonable charges of the insured's retained counsel. *Magoun*, 346 Mass. at 685. "Reasonable charges" does not mean "panel rate" but rather market rate. *N. Sec. Ins. Co.*,941 N.E.2d. at 690. An insurers unreasonable withholding of payment of reasonable attorneys' fees to independent counsel can result in violation of the Massachusetts Consumer Protection Statute (Mass. Gen. Laws ch. 93A) and lead to an award of double or treble damages. *Id.*

Time for Providing Insured with Coverage Position/Reservation of Rights

- "Failing to affirm or deny coverage of claims within a reasonable time after proof of loss statements have been completed" constitutes an unfair claim settlement practice by an insurer. Mass. Gen. Laws Ann. ch. 176D, § 3(e).
- "Failing to provide promptly a reasonable explanation of the basis in the insurance policy in relation to the facts or applicable law for denial of a claim or for the offer of a compromise settlement" constitutes an unfair claim settlement practice by an insurer. Mass. Gen. Laws Ann. ch. 176D, § 3(n).
- No case law interprets and no regulation governs "reasonable time."
- Thus, a good practice is to provide the insured with a coverage explanation within 30 days after the insurer's acknowledgement of the claim.

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COLLINS EINHORN

Collins Einhorn Farrell PC

Michigan

Notice

No statute governs the time required to provide the insured with a coverage position or reservation of rights. The best practice is to provide the insured with a coverage explanation as soon as possible after the insurer's acknowledgement of the claim.

Notice of a reservation of rights to an insured in connection with an insurer providing a defense must be timely in order to avoid an estoppel claim. A letter sent by the insurer on October 6, 1995, reserving its right to deny coverage

based on an exclusion in the policy, was timely notice to the insured regarding a lawsuit filed on September 14, 1995. *City of Grosse Pointe Park v. Mich. Mun. Liab. & Prop. Pool*, 702 N.W.2d 106 (Mich. 2005).

A notice of a reservation of rights sent two years after the defense began and seven months before the trial was too late to avoid the presumptive prejudice of both the insured's and, consequently, the plaintiff's rights, and therefore was too late to avoid estoppel. *Meirthew v. Last*, 135 N.W.2d 353 (Mich. 1965).

An insurer's four-month delay in sending a reservation of rights letter after undertaking the defense is not an unreasonable length of time and estoppel will not apply. *Fire Ins. Exch. v. Fox*, 423 N.W.2d 325 (Mich. Ct. App.), *appeal denied*, 431 Mich. 874 (1988).

An insurer's initial reservation of rights letter to the insured, sent less than three months into the underlying suit against the insured and shortly after the insurer was informed that the insured had been served in that action, constitutes a timely reservation of rights such that the insurer was not estopped from invoking a contractual basis for denial of coverage. *Amerisure Mut. Ins. Co. v. Carey Transp., Inc.*, 578 F. Supp. 2d 888 (W.D. Mich. 2008).

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Notice to an insured that an insurer will provide a defense under a reservation of rights typically states or references the policy language on which the insurer bases its opinion that coverage may not be afforded under the policy. The letter should state that some or all claims against an insured may not be covered, that the insurer reserves the right to not indemnify the insured in the event a judgment is entered against it, and also typically references the allegations against the insured. *City of Grosse Pointe Park v. Mich. Mun. Liab. & Prop. Pool*, 702 N.W.2d 106 (Mich. 2005).

A notice of reservation of rights should contain a specific reference to the language of the policy which forms the basis of the coverage defense, or the reservation of rights may be deemed ineffective. *Meirthew v. Last*, 135 N.W.2d 353 (Mich. 1965).

An insurer's second reservation of rights letter independently served as a timely and substantively adequate reservation of rights sufficient to avoid estoppel because that letter made clear that, notwithstanding the insurer's offer to defend the insured, it was proceeding with its rights reserved, including the right to invoke certain policy exclusions. *Amerisure Mut. Ins. Co. v. Carey Transp., Inc.*, 578 F. Supp. 2d 888 (W.D. Mich. 2008).

Reimbursement of Defense Costs

The reservation of rights letter also typically reserves the right to seek reimbursement for defense costs if it later is established that those costs were incurred in defending non-covered claims. The insurer may be able to recoup those defense costs. *See, e.g.*, *Travelers Prop. Cas. Co. v. R.L. Polk & Co.*, No. 06-12895, 2008 WL 786678 (E.D. Mich. S. Div. Mar. 24, 2008).

Conflicts of Interest and Independent Counsel

In Michigan, there is no statutory provision mandating the use of "independent" counsel for the defense of claims for which the insurer may contest its duty to indemnify. "No attorney-client relationship exists between an insurance company and the attorney representing the insurance company's insured. The attorney's sole loyalty and duty is owed to the client, not the insurer." *Michigan Millers Mut. Ins. Co. v. Bronson Plating Co.*, 496 N.W.2d 373, 378 (Mich. Ct. App. 1992), *aff'd*, 519 N.W.2d 864 (Mich. 1994), *overruled in part on other grounds*, *Wilkie v. Auto-Owners Ins. Co.*, 664 N.W.2d 776 (Mich. 2003). Therefore, any counsel retained by the insurer for the benefit of the insured is considered independent counsel.

Furthermore, "[t]he insured has no absolute right to select the attorney himself, as long as the insurer exercises good faith in its selection and the attorney selected is truly independent." *Cent. Michigan Bd. of Trustees v. Employers Reinsurance Corp.*, 117 F. Supp. 2d 627, 635 (E.D. Mich. 2000). If the insured shows that the insurer did not exercise good faith in the selection of counsel, then the insurer has failed in its duty to defend. Further, if the selected counsel was not truly independent, the insurer will be liable for breach of contract. *Id.*; *see also Lapham v. Jacobs Tech., Inc.*, Nos. 295482, 295489, 2011 WL 2848802 (Mich. Ct. App. July 19, 2011).

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JOHNSON & LINDBERG, P.A.

Minnesota

Notice

Minnesota's Unfair Claims Settlement Practices Act provides that it is an unfair settlement practice for an insurer to fail "to complete its investigation and inform the insured or claimant of acceptance or denial of a claim within 30 business days after receipt of notification of claim unless the investigation cannot be reasonably completed within that time." Minn. Stat. § 72A.201, subd. 4(3). There is no established deadline for issuing a reservation of rights letter, but the Minnesota Supreme Court has noted that an insurer must "expressly" provide notice of a reservation of rights to an insured under the threat of potential estoppel. *Remodeling Dimensions, Inc. v. Integrity Mut. Ins. Co.*, 819 N.W.2d 602 (Minn. 2012).

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Generally, an insurer will compare the allegations of a complaint to the policy

terms in order to determine whether a duty to defend exists. *Garvis v. Emp'rs Mut. Cas. Co.*, 497 N.W.2d 254 (Minn. 1993). However, facts outside of the complaint can be used in making this determination. *Haarstad v. Graff*, 517 N.W.2d 582 (Minn. 1994). In the event outside facts are relied upon, those facts should be outlined in the reservation of rights letter. *Id*.

A reservation of rights letter must clearly put the insured on notice that the insurer is reserving its rights rather than completely denying coverage. *Auto-Owners Ins. Co. v. NewMech Inc.*, 678 N.W.2d 477 (Minn. Ct. App. 2004). In *NewMech*, the insured interpreted a letter from its insurer as a complete denial of coverage. The Minnesota Court of Appeals considered the letter as a whole and concluded that the insured's interpretation was reasonable. The Court noted that the letter was not titled "reservation of rights," and it did not lead off with a clear statement that the insurer was reserving its rights and that the insured could seek counsel. Additionally, the early paragraphs looked like a complete denial of coverage.

When it is clear that coverage does not exist and an insurer wishes to deny coverage, or issue a disclaimer, the insurer must do so "seasonably" to avoid prejudicing the insured. *Sorenson v. Kruse*, 293 N.W.2d 56 (Minn. 1980). Under the Unfair Claims Settlement Act, an insurer must advise an insured in writing of the insurer's acceptance or denial of a claim within 60 business days after receiving a properly executed proof of loss. Minn. Stat. § 72A.201, subd. 4(11). Additionally, the Act sets forth a number of acts or omissions that may be considered unfair claim practices in the context of a notice of a claim denial, including failing to cite specific policy provisions relied upon in issuing the denial, failing to conduct a reasonable investigation, and denying a claim for a failure to exhibit the property unless a reasonable and timely written demand was issued to inspect the property. Minn. Stat. § 72A.201, subd. 8. However, it must also be noted that insurers are not estopped from denying coverage simply due to the violation of the Unfair Claims Practices Act. *TGA Dev., Inc. v. N. Ins. Co.*, 62 F.3d 1089 (8th Cir. 1995).

Estoppel

Generally, estoppel cannot be used to enlarge coverage under a policy of insurance. *Shannon v. Great Am. Ins. Co.*, 276 N.W.2d 77 (Minn. 1979). However, an exception exists in the context of notice to an insured of a coverage issue. When an insurer has knowledge of facts giving rise to a coverage issue and it undertakes to control the defense without a reservation of rights, it is estopped from subsequently denying coverage. *Faber v. Roelofs*, 250 N.W.2d 817 (Minn. 1977). In *Faber*, the Minnesota Supreme Court also concluded that prejudice will be conclusively presumed when the insurer exercises complete control over the defense without a reservation of rights. As the Court noted, "Because the insurer has available to him the simple procedure of give a notice of reservation of rights, to estop him from denying liability when he controls the defense without having given such notice is not a harsh result." *Id*. at 821.

"Where an insurance company denies coverage and withdraws from the defense before the case goes to trial, the defendant must show actual prejudice to his defense before the insurer is estopped from denying coverage." *Minn. Mut. Fire*

& Cas. Co. v. Benson, 195 N.W.2d 446 (Minn. 1972). In *Benson*, there was no evidence of actual prejudice, since the insured merely recited the loss of investigative opportunities without showing that these lost opportunities deprived him of any material information that would have been available to him had he been advised sooner that the insurance company would not defend him.

The Minnesota Supreme Court also refused to allow coverage by estoppel, in spite of a very late reservation of rights, in *St. Paul School District No. 625 v. Columbia Transit Corp.*, 321 N.W.2d 41 (Minn. 1982). In *St. Paul*, the insurer sent a reservation of rights letter more than three years after the accident and shortly before the trial of the main action. However, there was no indication of prejudice to the insured when it appeared that the insured's own attorneys worked with the insurance company's attorneys in preparing for trial. The insurer's late reservation of rights did not prejudice the ability of the insured to control the defense or to negotiate a settlement before the verdict. Accordingly, the insurer was not estopped from denying coverage.

Conflicts of Interest and Independent Counsel

Where there is a conflict of interest, the insured should retain its own counsel to defend itself against the plaintiff's claim and should be reimbursed by the insurer for that defense. *Prahm v. Rupp Constr. Co.*, 277 N.W.2d 389 (Minn. 1979).

A reservation of rights does not prove that there was an actual conflict of interest. *Mut. Serv. Cas. Ins. Co. v. Luetmer*, 474 N.W.2d 365 (Minn. 2003). As the Court of Appeals stated, a conflict of interest must be established by more "substantial evidence, such as actions which demonstrate a greater concern for the [insurer's] interests than the [insured's] interests." *Id.* at 369 (insured's showing that the insurer wished to remain fully informed of the progress of litigation in the main action, while the insurer was also litigating a declaratory judgment action, did not establish a conflict of interest).

Although not required, Minnesota courts have encouraged the use of a declaratory judgment action to determine coverage in the context of a reservation of rights. *Mut. Serv. Cas. Ins. Co. v. Luetmer*, 474 N.W.2d 365.

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Anderson Crawley & Burke, pllc
Attorneys and Counselors

Mississippi

Content

A reservation of rights letter should state that the insurer is investigating whether coverage exists for a claim and should recite the relevant portions of the policy

and the allegations of the Complaint against the insured. *Moeller v. Am. Guarantee & Liab. Ins. Co.*, 707 So. 2d 1062 (Miss. 1996). A non-waiver agreement must state that any action taken by the insurer does not "waive or invalidate any of the conditions" of the policy and does not "waive or invalidate any rights" of the insured or the insurer. *Taylor v. Fireman's Fund Ins. Co.*, 306 So. 2d 638, 640, 645 (Miss. 1974).

Estoppel

In *Southern Farm Bureau*, on the same day that the insurer wrote to the insured to deny a duty to defend, a default judgment was entered in favor of the plaintiff against the insured. The court held that the letter to the insured on the day of the default judgment rendered the insurer liable for the amount of the judgment. An insurer's assumption of the insured's defense may give rise to a duty to continue such defense. An insurer that withdraws from the defense of the insured is estopped to deny liability if the insurer's conduct results in prejudice to the insured. However, the insurer will not be estopped if no prejudice results to the insured. *S. Farm Bureau Cas. Ins. Co. v. Logan*, 119 So. 2d 268 (1960).

Reimbursement for Defense Costs

There is no Mississippi case or statutory authority specifically addressing this issue, although the Federal Fifth Circuit Court of Appeals has looked at the question in a case from the adjacent State of Louisiana, in the somewhat unique posture of consideration of the MCS-90 Endorsement to a Trucking policy. In *T.H.E. Ins. Co. v. Larsen Intermodal Servs., Inc.*, 242 F.3d 667 (5th Cir. 2001), the Court noted that the reservation of rights letter may provide the insurer with the right to seek reimbursement for defense costs it pays if it later establishes that those costs were incurred in defending non-covered claims. The reason for allowing an insurer to seek reimbursement of the cost associated with defending non-covered claims is that the insurer is required to defend both covered and non-covered claims but does not receive a premium for defense of the non-covered claims. Reservation of that right to recover those costs must be clear, and the insured must come forward to object or risk waiving the ability to do so subsequently. The court in that case held, however, that because the insurer had a legal duty to defend the insured, it had no right to recover defense costs incurred

Conflicts of Interest and Independent Counsel

The Supreme Court of Mississippi has held that an insurer, defending an insured under a reservation of rights, presents a "clear conflict of interest." *Moeller,* 707 So. 2d at 1071. Thus, if the insurer elects to defend while reserving its rights, it must allow the insured to select its own counsel to defend the claims that fall outside the policy's coverage. Additionally, the insurer becomes liable for payment of the reasonable legal expenses of such counsel. *Id.*; *see also Am. Guarantee & Liab. Ins. Co. v. 1906 Co.*, 273 F.3d 605, 621 (5th Cir. 2001) (applying Mississippi law) (where insurer agreed to defend insured only under a reservation of rights, and insured was potentially exposed to liability in excess of coverage, the insurer was obligated to indemnify the insured for insured-selected independent counsel); *Liberty Mut. Ins. Co. v. Tedford*, 644 F. Supp. 2d 753, 759

(N.D. Miss. 2009) ("*Moeller* stands for the proposition that when a conflict of interest arises between an insured and the insurer, particularly through a reservation of rights or the situation in which some claims are clearly not covered by the insurance policy, the insurer is under an obligation to permit the insured to select his or her own individual counsel with the fees and costs to be paid by the insurer.").

If a conflict of interest arises during the attorney's representation of the insurer and the insured, "defense counsel should withdraw from representation of either if there is any possibility that representing one and not the other may be injurious to the client that the attorney ceases to represent." *Moeller,* 707 So.2d at 1071. If the liability insurance policy covers only a portion of the claim against the insured or covers only one theory of liability, "[the attorney] should undertake to represent only the interest of the insurer for the part covered, and the insurer should afford the insured ample opportunity to select independent counsel to look after his/her interest." *Id.* at 1062.

Time for Providing Insured with Coverage Position/Reservation of Rights

- No case law, regulation or statute governs the time required to provide an insured with a coverage position or reservation of rights.
- The insurer clearly should enforce whatever obligations it has undertaken in the applicable insurance policy, however, in regard to "timely and thorough" investigation and response to a claim.

Particularly when suit has been filed, it is clearly required that the insurer provide the insured with a coverage explanation within the time frame to respond to the Complaint.

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RYNEARSON, SUESS, SCHNURBUSCH & CHAMPION, LLC
ATTORNEYS AT LAW

Missouri

Notice

An insurer must provide "notice to an insured that its defense of an action should not be construed as a waiver of any policy defense and the insured accepts the defense of the action without protest and with full knowledge of the position of the insurance company of its right to assert non-liability." Such a reservation puts the insured on notice that there may be a conflict between the insured's interest and those of the insurance company, along with the fact that the insured may be exposed to personal liability not covered by insurance. *Atlanta Cas. Co. v. Stephens*, 825 S.W.2d 330, 333 (Mo. Ct. App. 1992); *Brooner & Assoc. Constr. Co. v. W. Cas. & Sur. Co.*, 760 S.W.2d 445, 447 (Mo. Ct. App. 1988).

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The reservation of rights letter should identify the relevant portion of the policy that may lead to non-coverage. However, a general reservation may suffice, and courts have found a reservation of rights letter in which the insurer notified the insured that "any action arising out of the accident...would be under a reservation of rights under its policy" to be enforceable. *Atlanta Cas. Co. v. Stephens*, 825 S.W.2d 330, 334 (Mo. Ct. App. 1992); *Brooner & Assoc. Constr. Co. v. W. Cas. & Sur. Co*, 760 S.W.2d 445, 447 (Mo. Ct. App. 1988).

When issuing a disclaimer letter, an insurer must identify those defenses on which it plans to rely to disclaim coverage. An insurer, having denied liability on a specified ground, may not thereafter deny liability on a different ground. *Stone v. Waters*, 483 S.W.2d 639, 645 (Mo. App. 1972). That is, when an insurance company denies liability on specific grounds, it "waives all grounds not so specified." *Brown v. State Farm Mut. Auto. Ins. Co.,* 776 S.W.2d 384, 387 (Mo. 1989).

Estoppel

The insurance company is not automatically estopped by defending without a reservation of rights where it does not have knowledge of the non-coverage facts under the policy. It is only knowledge of non-coverage which can create an estoppel. *Mistele v. Ogle*, 293 S.W.2d 330 (Mo. 1956).

Insured's Refusal of a Reservation of Rights

In Missouri, the insured may refuse an insurer's offer of a defense under a reservation of rights. In this event, "the insurer has three options: (1) [it] may represent the insured without a reservation of rights defense; (2) [it] may withdraw from representing the insured altogether; or (3) [it] may file a declaratory judgment action to determine the scope of [the] policy's coverage. If the insurer chooses (1), i.e. to defend without reservation, it has the opportunity to control the litigation. If the insurer chooses (3), i.e. files a declaratory judgment action, the decision...is a risky one...[because it] is treated as a refusal to defend an insured, and, if unjustified, the insurer is treated as if it waived any control of the defense [and rights to participate in] the underlying tort action. If its decision concerning coverage is wrong [the insurer] should be bound by the decision it has made." *Truck Ins. Exch. v. Prairie Framing, LLC*, 162 S.W.3d 64, 88 (Mo. Ct. App. 2005) (quoting *State ex rel. Rimco, Inc. v. Dowd*, 858 S.W.2d 307, 309 (Mo. App. E.D. 1993)) (internal quotation marks and citations omitted).

In *Brooner & Associates*, the insurer offered to defend under a reservation of rights, but the insured indicated it would not accept such a tender, and demanded that the defense be undertaken without a reservation of rights. Nonetheless, the insurer continued to defend, and at no time did the insured indicate that it intended to assume exclusive control of the defense. Distinguishing prior cases, the court ruled that the insurance company's reservation of rights was sufficiently specific to advise the insured of the basis for the disclaimer of coverage. Further, the reservation of rights did not create a conflict of interest. Since the insured

never rejected the actual defense of the action by the insurance company, it waived the right to claim that the insurance company had improperly conducted the defense, and the reservation of rights defense was proper. *Brooner & Assocs. Constr. Co. v. W. Cas. & Sur. Co.*, 760 S.W.2d 445 (Mo. App. 1988).

In *Butters,* the insurer offered a defense under a reservation of rights, which was refused by the insured. As a result, the insurer refused to defend, and a settlement was entered into by the insured and the plaintiff. The court ruled that the insured was not obligated to accept a defense under a reservation of rights, particularly where the insurer was unwilling, as an alternative to an unqualified defense, to advise this insured of the circumstances of recovery which the insurer felt would be beyond coverage, responding to the insured's attorney only that: "You are a licensed attorney at law and therefore have knowledge of the subject matter at hand." Since the insurer refused to defend, it was liable for damages flowing from the breach. *Butters v. City of Independence*, 513 S.W.2d 418 (Mo. 1974).

In *Mid Century Insurance*, the insurer tendered a defense with a reservation of rights. The insured demanded defense without any reservation of rights. While the case was pending, the insurance company sought to intervene in the underlying action while seeking a declaration that it was entitled to defend pursuant to a reservation of rights. The court ruled that since the reservation created a potential conflict of interest, the insured was not required to accept the defense under a reservation of rights. The insurer was not without remedy, since it could file a declaratory judgment action and seek a stay of the personal injury action pending the outcome of the declaratory judgment action. *State ex ref. Mid Century Ins. Co. Inc. v. McKelvey*, 666 S.W.2d 457 (Mo. App. 1984).

Conflicts of Interest and Independent Counsel

When the interests of an insurer come into conflict with those of its insured, the insurer is duty-bound to "sacrifice its interests in favor of those of the insured." *Truck Ins. Exch. v. Prairie Framing, LLC*, 162 S.W.3d 64, 95 (Mo. Ct. App. 2005) (internal quotation marks and citations omitted).

When an insurer tenders a defense with a reservation of rights, a potential conflict of interest arises. The insured may refuse to accept the defense with the reservation, as described above. If the insurer then refuses to defend without the reservation, it risks being held to have failed in its contractual duty to defend. If the insurer is found to have breached its duty to defend, it has additionally waived its right to control the litigation. *See Truck Ins. Exch. v. Prairie Framing, LLC*, 162 S.W.3d 64, 89 (Mo. Ct. App. 2005). This was the case in *Prairie Farming*, in which the Missouri Court of Appeals for the Western District affirmed a lower court's award of attorney's fees to the insured, who had settled the underlying action via independent counsel after the insurer violated its duty to defend.

Time for Providing Insured with Coverage Position/Reservation of Rights

- An insurer must advise an insured of its acceptance or denial of a claim

within 15 working days after the submission of all forms necessary to establish the nature and extent of any claim. Mo. Code Regs. Ann. tit. 20, § 100-1.050 (2006).

- If more time is required to investigate the claim, the insurer must write to the insured within 15 working days after the submission of the claim and explain why more time is needed. If the investigation remains incomplete, the insurer must write to the insured within 45 days from the date of the original notification and every 45 days thereafter, setting forth the reasons that additional time is needed. Mo. Code Regs. Ann. tit. 20, § 100-1.050 (2006).
- Failing to promptly provide a reasonable explanation of the basis for a denial or offers of a compromise settlement constitutes an improper claims practice. Mo. Ann. Stat. § 375.1007(12) (2006).

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Your House Counsel®

New Jersey

Notice

A reservation of rights letter must be timely. *Shotmeyer v. N.J. Realty Title Ins. Co.*, 948 A.2d 600, 609 (N.J. 2008). Once an insurer has had a reasonable opportunity to investigate, or has learned of grounds for questioning coverage, it then is under a duty promptly to inform its insured of its intention to disclaim coverage or of the possibility that coverage will be denied or questioned. *Griggs v. Bertram*, 443 A.2d 163, 168 (N.J. 1982).

Content

An insurer's reservation of rights must fairly inform the insured of the insurer's position. The letter should identify the relevant defense or policy provision that the insurer will rely on. *Gen. Acc. Ins. Co. v. N.Y. Marine & Gen. Ins. Co.*, 727 A.2d 1050, 1052 (N.J. Super. Ct. App. Div. 1999); *Hanover Ins. Grp. v. Cameron*, 298 A.2d 715, 718 (Ch. Div. 1973). That is, an insurer should set out all of the reasons of which it is aware, or should be aware at the time it issues the reservation of rights letter of why the insured might not be entitled to coverage. *Battista v. Western World Ins. Co.*, 545 A.2d 841, 846 (N.J. Super. Ct. Law Div. 1988), *aff'd and rev'd in part*, 594 A.2d 260 (N.J. Super. Ct. App. Div.), *certif. denied*, 606 A.2d 366 (1991).

In addition, a reservation of rights letter must specifically inform the insured that the offer to defend subject to the insurer's right to later disclaim indemnity may be accepted or rejected by the insured. *Sneed v. Concord Ins. Co.*, 237 A.2d

289, 293-294 (N.J. Super. Ct. App. Div. 1967). An insurer may not reserve its rights by unilateral action. If the carrier wishes to control the defense and simultaneously reserve a right to dispute liability, it can do so only with the consent of the insured. An agreement may be inferred from an insured's failure to reject an offer to defend on those terms, but to spell out acquiescence by silence, the letter must fairly inform the insured that the offer may be accepted or rejected. *Merch. Indem. Corp. v. Eggleston*, 179 A.2d 505 (1962).

If further investigation is required to ascertain whether coverage is available, the letter should state that the insurer reserves its right to disclaim based on further factual development.

Estoppel

In *Grips,* the insurer, after initially investigating the claim, did nothing. A year after the initial investigation, a lawsuit was filed, and the insurer for the first time advised the insured that there was no coverage and refused to defend. The court held that the insurer was estopped from denying coverage. Extending prior cases, the court ruled that principles of estoppel apply where the insurer has neither assumed the actual control of the case nor undertaken the preparation of any defense on behalf of the insured, even pre-suit, but instead has failed for an unreasonable period of time to inform its insured of the possibility of a disclaimer of coverage, notwithstanding the insurer's early notification of a possible claim and awareness of grounds for a disclaimer. The insurer is under a duty to properly inform its insured of its intention to disclaim coverage or of the possibility that coverage will be denied or questioned after it has had a reasonable opportunity to investigate or has learned of grounds for questioning coverage. In the setting where the insurer has not informed the insured of its coverage position, but still has the exclusive right under the policy to control the claim, the insured is effectively deterred from taking any action to protect himself, including meaningful steps towards an early settlement of the claim, because such steps could be the basis of additional grounds for disclaiming coverage. *Grips v. Bertrand*, 443 A.2d 163 (N.J. 1982).

In *Sussex Mutual Insurance Co.*, the court ruled that the filing of the answer and obtaining of the stay by the insurer did not estop the insurer from denying coverage based upon the alleged intentional acts of the insured. While the rule that an insurer who defends without a reservation of rights waives its coverage positions retains its full vigor, the actions taken by the insurer in this instance, including obtaining a stay, did no more than maintain the status quo pending adjudication of the coverage issue. In no sense could the insurer be deemed to have controlled the defense of the insured. Further, it was clear that the relationship between the insured and the insurer was an adversarial one almost from the beginning. *Sussex Mut. Ins. Co. v. Hala Cleaners, Inc.*, 380 A.2d 693 (N.J. 1977).

In *Sneed v. Concord Insurance Co.*, the insurer learned shortly after the incident that an exclusion of coverage applied to the insured. Nonetheless, the insurer continued to discuss settlement with the claimants, and its reservation of rights agreement contained no language apprising the policyholders that they were at liberty to accept or reject the company's defense under a reservation of rights.

When the insured was sued, the insurer refused to defend. The court ruled that the reservation of rights agreement was not effective. Defense under a reservation of rights requires the consent of the insured. Since the agreement in question did not indicate the rights of the insured to reject the defense, it was ineffective. *Sneed v. Concord Ins. Co.,* 237 A.2d 289 (N.J. Super. Ct. App. Div. 1967).

In the absence of the agreement, the real issue was whether estoppel existed where the insurer had disclaimed coverage from the beginning of the suit, but had controlled the pre-suit investigation. The court held that such pre-suit investigation, without a prior reservation, also constitutes an estoppel. In this instance, the court found that the insurer's correspondence indicated the insurer's intent to continue exclusive control of the handling of the claim against the insured, and as such, estoppel applied. *Sneed v. Concord Ins. Co.*, 237 A.2d 289 (N.J. Super. Ct. App. Div. 1967).

Reimbursement for Defense Costs

Sometimes an insurer will include a provision in its reservation of rights letter giving the insurer the right to seek reimbursement for defense costs it pays if it later establishes that those costs were incurred in defending non-covered claims. Courts have held this type of provision to be unenforceable*. Terra Nova Ins. Co. Ltd. v. 900 Bar, Inc.*, 887 F.2d 1213 (3d Cir. 1989).

The reason behind this rule is that the insurer should not be permitted to unilaterally amend the policy, especially when the insured may be unschooled in the issues. Also reservation on this issue places insured in position of making a Hobson's choice between accepting conditions on defense or losing right to defense.

Conflicts of Interest and Independent Counsel

There is no statute in New Jersey that relinquishes the insurer's right to choose defense counsel when there is a conflict of interest (i.e. both covered and arguably uncovered counts) or when the insurer issues a reservation of rights letter.

New Jersey case law does not recognize the insured's right to unilaterally select defense counsel to be paid concurrently by the carrier when a carrier issues a reservation of rights letter. Instead, the New Jersey Supreme Court in *Flomerfelt v. Cardiello*, 997 A.2d 991, 999 (N.J. 2010) interpreted *Burd v. Sussex Mutual Insurance Co.*, 267 A.2d 7 (N.J. 1970) to mean that an insurer has two choices when there are different theories of liability (some of which would not be covered under the policy) and where the interests of the insured and insurer are in conflict.

The first choice is that the "insurer could assume the defense if the insured agreed, with a reservation of its right to dispute coverage." *Flomerfelt*, 997 A.2d at 999. In *Burd*, the court said that if a carrier issues a reservation of rights letter, it cannot assume the defense unless the insured gives informed consent of the conflict. ("[I]f the trial will leave the question of coverage unresolved so

that the insured may later be called upon to pay, or if the case may be so defended by a carrier as to prejudice the insured thereafter upon the issues of coverage, the carrier should not be permitted to control the defense." *Id.*; *see also Merchs. Indem. Corp. v. Eggleston*, 179 A.2d 505, 512 (N.J. 1962).)

The second choice is that the insurer "could refuse to defend and dispute its obligations thereafter, so as to 'translate its obligation into one to reimburse the insured if it is later adjudged that the claim was one within the policy covenant to pay.'" *Flomerfelt*, 997 A.2d at 999 (quoting *Burd*, 267 A.2d at 10). In *Hartford Accident & Indemnity Co. v. Aetna Life & Casualty Insurance Co.*, 483 A.2d 402, 407 (N.J. 1984), the court stated that when there is a conflict of interest between the insured and insurer, "the insurer not only [is] within its rights in refusing to take over the defense on behalf of its insured but [is] in fact obligated to follow that course once it denied coverage. According to the court in *Hartford Accident*, "[t]he practical effect of *Burd* is that an insured must initially assume the costs of defense itself, subject to reimbursement by the insurer if it prevails on the coverage issue." *Id.* at 411, n.3. However, the insured is not always required to take on the defense initially if the coverage question can be decided before trial in a declaratory judgment proceeding. *See Flomerfelt*, 997 A.2d at 999; *Burd*, 267 A.2d at 11. Furthermore, with respect to how the insured's defense counsel is chosen, there is dicta in *Dunne v. Fireman's Fund Am. Ins. Co.*, 353 A.2d 508, 513 (N.J. 1976) that states that "the insured should select their own counsel, subject to the carrier's approval. [If] such approval is not forthcoming the selection should be made by the assignment judge."

In one case, the insurer accepted defense of covered claims but also sent the insured a reservation of rights letter regarding the uncovered claims and offered the insured the right to have its own defense counsel for the uncovered claims. *See Aquino v. State Farm Ins. Co.*, 793 A.2d 824 (N.J. Super.Ct. App. Div. 2002). However, the insured did not expressly agree to the reservation of rights. The court held that the insurer was responsible for the insured's defense counsel's fees, but only for the time period where the uncovered claims were viable. Nevertheless, the court made clear that although the insured was entitled to choose his own counsel, he "does not have the right to dictate to the insurers the hourly rate they must pay. The trial court here should have determined a reasonable hourly rate for defense work of this nature and set a fee accordingly." *Aquino v. State Farm Ins. Co.*, 793 A.2d 824, 832 (N.J. Super. Ct. App. Div. 2002).

Time for Providing Insured with Coverage Position/Reservation of Rights

- An insurer must accept or deny coverage within 30 days after receipt of proof of loss for first-party claims (other than personal injury or auto damage claims, which are subject to a 60-day time limit); 45 days to accept or deny coverage after receipt of proof of loss for third-party property damage claims; and 90 days to accept or deny coverage after receipt of proof of loss for third-party bodily injury claims.
- If more time is needed, the insurer must notify the insured of that and continue to do so every 45 days thereafter until a determination of coverage is made. N.J. Admin. Code § 11:2-17.6 to 11:2-17.8.

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New York

Notice

The reservation of rights letter must give fair notice that the insurer intends to assert coverage defenses or to pursue declaratory relief at a later date. *United Nat'l Ins. Co. v. Waterfront N.Y. Realty Corp.*, 948 F.Supp. 263, 268 (S.D.N.Y. 1996).

The reservation of rights can take the form of either a unilateral notice from the insurer to the insured or non-waiver agreement signed by both the insurer and the insured. Both are of equal effect. To be valid, both forms of reservation must be prompt and specific. The insurer issuing a reservation of rights should take as much care in the timeliness of the notice and the specificity of the grounds as it would in issuing a denial or disclaimer of coverage.

Content

The letter should state the possible defenses to coverage, referencing the specific policy provisions that form the basis for the insurer's reservation. *United Nat'l Ins. Co. v. Waterfront N.Y. Realty Corp.*, 948 F.Supp. 263, 268 (S.D.N.Y. 1996).

If further investigation of a claim is warranted, the insurer should notify the insured that the insurer reserves the right to disclaim coverage based upon further factual development. *Merchs. Mut. Ins. Co. v. Allcity Ins. Co.*, 664 N.Y.S.2d 690 (App. Div. 3d 1997).

Timeliness

When the insurer's disclaimer of liability under the policy was first made two years before the trial and again five months before the trial and the insured was given a full opportunity to join in the defense of the action, the court could not find as a matter of law that the insurer should be estopped from denying coverage of the policy in the absence of a showing that the delay in notification prejudiced the rights of the insured. *O'Dowd v. Am. Sur. Co. of N.Y.*, 144 N.E.2d 359 (N.Y. 1957).

In *Village of Waterford*,the court held that a reservation of rights letter sent three months after notice of lawsuit given by the insured was timely. *Village of Waterford v. Reliance Ins. Co.*, 640 N.Y.S.2d 671 (N.Y. App.Div. 3d 1996).

Bodily Injury or Death Claim

When disclaiming coverage in New York for a bodily injury or death claim, the insurer must issue its disclaimer as soon as reasonably possible. N.Y. Ins. Law. 3420(d). The denial of coverage must be issued to the injured person or any other claimant as well as the insured. N.Y. Ins. Law § 3420(d).

The notice "must promptly apprise the claimant with a high degree of specificity of the ground or grounds on which the disclaimer is predicated." *Gen. Accident Ins. Grp. v. Cirucci*, 387 N.E.2d 223, 224 (N.Y. 1979). A delay as short as 30 days has been held to be untimely. *W. 16th St. Tenants Corp. v. Pub. Serv. Mut. Ins. Co.*, 736 N.Y.S.2d 34 (App. Div. 1st), *appeal dismissed*, 773 N.E.2d 1017 (2002). However, a declaratory judgment action against an insured has been held sufficient to fulfill the insurer's obligation to disclaim under New York Insurance Law. An insurer may be deemed to have waived possible defenses when it issues its disclaimer based upon one provision and then later seeks to deny based on another provision. *Cirucci*, 387 N.E.2d at 224; *DeForte v. Allstate Ins. Co.*, 442 N.Y.S.2d 307 (App. Div. 4th), *appeal dismissed*, 54 N.Y.2d 1027 (1981).

Estoppel

Generally, an insurer's express reservation of its rights in its communications with the insured precludes arguments both as to waiver and as to equitable estoppel. *Globecon Grp., LLC v. Hartford Fire Ins. Co.*, 434 F.3d 165 (2d Cir. 2006).

If an insurer assumes a defense, with knowledge of facts that would permit it to contest coverage and without disclaiming liability or reserving its rights to deny coverage, then it will be precluded from later raising coverage defenses. *See, e.g.*, *Boston Old Colony Ins. Co. v. Lumbermens Mut. Cas. Co.*, 889 F.2d 1245, 1247 (2d Cir. 1989). Prejudice to the insured must be established, but proof of prejudice may be implied where the insurer has complete control of the defense. *Touchette Corp. v. Merchs. Mut. Ins. Co.*, 429 N.Y.S.2d 952 (App. Div. 4th 1980).

Where the court directed the insurer to defend the insured in the action, there was no prejudice to the insured by the insurer's disclaimer or denial. The case was not yet on the trial call and apparently it was not ready for trial. *Touchette Corp.*,429 N.Y.S.2d 952.

A reservation of rights is a sufficient preventative to the insured's claimed reliance on the insurer's defense even if the insurer later disclaims on a basis different from the ground originally asserted in the reservation of rights. *Federated Dep't Stores, Inc. v. Twin City Fire Ins. Co.*, 28 A.D.3d 32, 37-38 (N.Y. App. Div. 1st 2006); *see also Nat'l Rests. Mgmt. v. Exec. Risk Indem., Inc.*, 304 A.D.2d 387, 388-389 (N.Y. App. Div. 1st 2003) (where the insurer expressly reserved its

right to disclaim, neither its initial disclaimer on a different ground from that ultimately invoked, nor its later qualified acknowledgment of coverage, entitled the insureds to recover defense costs up until the time that the insurer ultimately disclaimed). Thus, if the insurer learns of additional grounds for denial of coverage after making the initial reservation, a supplemental reservation should be sent specifying the new defenses, but if no supplemental reservation is sent, the disclaimer can still be supported on the basis of the two cases just cited. But the insurer should nevertheless be prepared for a hostile court's holding that it waived any grounds not asserted in the original reservation of rights.

In *Albert J. Schiff Associates,* the court found the insurer did not lose its right to the defense of non-coverage by its initial disclaimer of liability based upon three policy exclusions, since the defense is never waived by a failure to assert it in a denial letter. There was no question of estoppel in this case since the insurer at all times denied liability to indemnify and refused to undertake the defense. Thus, the defense of non-coverage remained intact and was properly asserted. *Albert J. Schiff Assocs., Inc. v. Flack*, 417 N.E.2d 84 (N.Y. 1980).

An insurer who defends an action on behalf of an insured with knowledge of a defense to the coverage of the policy will be estopped from asserting that the policy does not cover the claim if the insured has been prejudiced by the insurer's actions. In *Hartford Insurance Group,* the insurer defended the insured for two years with knowledge of its non-coverage position. The court found that a disclaimer two years after knowledge of non-coverage, during which time the insurer had assumed the complete defense of the action and after the underlying action had been placed on the trial calendar, was not timely and prejudicial as a matter of law. *Hartford Ins. Grp. v. Mello*, 437 N.Y.S.2d 433 (App. Div. 2d 1981).

Control of Litigation

An insurance carrier may control the insured's defense and simultaneously reserve a right to dispute its liability on any aspect of the litigation. It should do so only with the consent of the insured or upon notice to the insured which would afford the insured an opportunity to actively participate in the defense of the action through counsel of his own choosing. In *Caprari*,the court found that the insured was prejudiced as a matter of law and the insurer was estopped from asserting non-coverage when the insurer controlled the defense of the action exclusively until the morning of the trial. *Caprari v. Hartford Accident & Indem. Co.*, 330 N.Y.S.2d 206 (Sup. Ct. Broome County 1972).

Conflicts of Interest and Independent Counsel

There is no statute in New York that relinquishes the insured's right to choose independent defense counsel when there is a conflict of interest (i.e. both covered and arguably uncovered counts) or when the insurer issues a reservation of rights letter.

Under case law, New York does not recognize the insured's right to unilaterally select defense counsel to be paid concurrently by the carrier when the carrier issues a reservation of rights letter. Instead, it has long been well-settled law in New York that the insured has a right to independent counsel only when a conflict

of interest arises on the part of the insurer due to a reservation of rights. *Pub. Serv. Mut. Ins. Co. v. Goldfarb*, 53 N.Y.2d 392 (1981); *Prashker v. U.S. Guarantee Co.*, 1 N.Y.2d 584 (1956). In *Goldfarb*, the court made clear that not every coverage issue or reservation of rights gives rise to an insured's right to independent counsel. Rather, it is only those that may allow defense counsel to unethically steer the outcome of the case toward liability premised upon a non-covered cause of action, as opposed to those coverage issues that are "not intertwined with the question of the insured's liability." Both *Goldfarb* and *Prashker* are decisions from the New York Court of Appeals, the highest appellate court in the state.

Following *Prashker* and *Goldfarb*, many other New York courts have recognized that, under New York law, a policyholder has a right to independent counsel paid for by the insurance company, for the reasons stated above, where a conflict of interest arises because a complaint contains allegations possibly both within and outside the coverage of the insurance policy. Other examples of such conflicts giving rise to a right to independent counsel are conflicting trial strategies; *69th St. & 2nd Ave. Garage Assocs. v. Ticor Title Guar.*, 622 N.Y.S.2d 13 (App. Div. 1st 1995); *Ansonia Assocs. v. Pub. Serv. Mut. Ins.*, 693 N.Y.S.2d 386 (Sup. Ct. 1998), *aff'd*, 692 N.Y.S.2d 5 (App. Div 1st 1999); and claims exceeding the policy limits and including punitive damages. *Parker v. Agric. Ins.*, 440 N.Y.S.2d 964, 968-969 (Sup. Ct. N.Y. County 1981).

Recently, the Second Circuit emphatically stated that an insured cannot reject a proposed defense firm merely because the insured believes that they are too small to handle a "bet the company" case. The court also restated New York's interpretation of *Cumis*, that a right to independent counsel should only arise where an insurer has reserved rights on coverage issues that are of a sort that might influence appointed defense counsel to try the case in such a manner that could result in an uninsured verdict (i.e. where a conflict of interest exists). *N.Y. Marine & Gen. Ins. Co. v. Lafarge N. Am., Inc.*, 599 F.3d 102 (2d Cir. 2010).

The remaining controversy, however, lies in just what are the communication obligations of the insurer in this area. In *Elacqua v. Physicians' Reciprocal Insurers*, 860 N.Y.S.2d 229 (App. Div. 3d 2008), the Third Department held that an insurer has an affirmative obligation to inform the insured of its right to have an independent defense counsel (i.e., not one from the insurer's "panel," approved list, or its own staff counsel) defend in a claim situation where the insurer has reserved its rights to deny coverage. Further, and somewhat remarkably, the court held that failure to so inform the insured was a deceptive trade practice under applicable New York law and remitted the case to the trial court for a determination of the appropriate damages. Contrary to *Elacqua*, another intermediate appellate court in New York held in *Sumo Container Station v. Evans, Orr, Pacelli, Norton & Laffan*, 719 N.Y.S.2d 223 (App. Div. 1st 2001), that an insurer had no obligation to advise its insured of its right to independent counsel when such right exists. Though it has yet to definitively address the issue, the Second Department favorably mentioned *Elacqua* in *Wilner v. Allstate Ins. Co.*, 893 N.Y.S.2d 208, 213 (2010). This conflict between the First and Third Departments of the Appellate Division in New York has yet to be resolved in an appropriate case to be brought before the New York Court of Appeals. Until then, *Elacqua* serves as a cautionary tale for insurers dealing with these rights to independent counsel scenarios.

Case law indicates only that the fee charges for independent counsel selected by the insured must be "reasonable." *Prashker v. U.S. Guarantee Co.*, 136 N.E.2d 871, 875 (N.Y. 1956); *N.Y. State Urban Dev. Corp. v. VSL Corp.*, 738 F.2d 61, 66 (2d Cir. 1984). The insured will have the absolute right to choose counsel where a conflict exists when the governing insurance contract fails to expressly indicate that the insurer will only be obligated to pay for defense costs if it is permitted to participate in the selection of counsel. *Klein v. Salama*, 545 F.Supp. 175, 179 (E.D.N.Y.1982); *Pub. Serv. Mut. Ins. Co. v. Goldfarb*, 53 N.Y.2d at 401; *Prashker*, 1 N.Y.2d at 593. However, New York courts have noted that an insured's right to be accorded legal representation is a contractual right. As such, where the insurance contract states that the insurer will only be obligated to pay for defense costs if it is permitted to participate in the selection of counsel, the terms of the contract govern unless they are against public policy. *Int'l Paper Co. v. Cont'l Cas. Co.*, 35 N.Y.2d 322, 325 (1974); *Emons Indus., Inc. v. Liberty Mut. Ins. Co.*, 749 F.Supp. 1289 (S.D.N.Y. 1990); *Cunniff v. Westfield, Inc.*, 829 F.Supp. 55 (E.D.N.Y. 1993).

Time for Providing Insured with Coverage Position/Reservation of Rights

- Within 15 days after receipt of proof of loss, an insurer must accept or deny coverage, unless more time is needed, in which case the insurer must notify the insured of that and continue to do so every 90 days thereafter until a determination of coverage is made. N.Y. Admin. Code § 216.4 to § 216.6.

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BAILEY B&D DIXON

North Carolina

A reservation of rights letter may be used to prevent an insurer from being estopped from denying coverage under the policy once a defense is conducted with knowledge of facts taking the loss outside the coverage. *Nat'l Mortg. Corp v. Am. Title Ins. Co.*, 255 S.E.2d 622, 630 (N.C. Ct. App. 1979), *rev'd on other grounds*, 261 S.E.2d 844 (1980).

Notice/Content

The reservation of rights should provide the insured with notice so that it understands that the insurer will not pay the costs of an action based on an incident not covered by the policy and to which the insurer has no duty to defend. *N.C. Farm Bureau Mut. Ins. Co. v. Fowler*, 589 S.E.2d 911, 914 (N.C. Ct. App. 2004).

In *North Carolina Farm Bureau*, the court ruled that a non-waiver agreement entered into by the insured that stated "no action heretofore or hereafter taken by

[plaintiff] shall be construed as a waiver of the right of [plaintiff], if in fact it has such right, to deny liability and withdraw from the case," was sufficient to put the insured on notice that the insurer would not indemnify an incident not covered by the policy. *N.C. Farm Bureau Mut. Ins. Co.*, 589 S.E.2d at 914.

Estoppel/Prejudice

Where an insurer denies liability for a loss on one ground, at the time having knowledge of another ground of forfeiture, it cannot thereafter insist on such other ground if the insured has acted on its asserted position and incurred prejudice or expense by bringing suit, or otherwise. That means that the insurer must be specific as to the exact terms to which the insurer is relying on to deny coverage to the insured. *Council v. Metro. Life Ins. Co.*, 256 S.E.2d 303, 306 (N.C. Ct. App. 1979).

Similarly, where an insurer assumes the defense of the insured without a reservation of rights denying liability under any grounds, that insurer is estopped from later denying coverage under the policy. *Early v. Farm Bureau Mut. Auto. Ins. Co.*, 29 S.E.2d 558 (1944).

In *Nationwide Mutual Insurance Co.*, the insurer settled two of several claims against the insured and defended the insured as to other claims pursuant to a reservation of rights. The court rejected the insured's contention that by settling two of the claims, the insurer had waived its reservation of rights as to the other remaining claims. The settlements of the claims in no way prejudiced the insured in the defense, in fact, the court noted that these settlements were actually favorable to the insured. Accordingly, there was no estoppel. *Nationwide Mut. Ins. Co. v. Aetna Cas. Sur. Co.*, 159 S.E.2d 268 (N.C. Ct. App. 1968).

Conditional Tender of Defense

An insured is not required to accept a conditional tender of defense by the insurer under a reservation of rights. Such a refusal is sometimes justified because of the insured's fear that the insurer may not be motivated to provide a vigorous defense despite its duty to use good faith in its undertaking. The insurer's conditional tender of defense does not absolve it of its duty to defend. The insured may reject a conditional offer to defend and still seek indemnity for the costs incurred in its own defense. *Nat'l Mortg. Corp. v. Am. Title Ins. Co.*, 255 S.E.2d 622 (N.C. Ct. App. 1979), *rev'd on other grounds*, 261 S.E.2d 844 (N.C. 1980).

Conflicts of Interest and Independent Counsel

North Carolina has no statutory requirement for *Cumis* counsel, nor have any higher courts addressed the possibility of an insured's right to independent, self-selected representation at the insurer's expense. However, caselaw has discussed the nature of the tripartite relationship between the insurer, the insured, and the attorney retained by the insurer to represent the insured. *See Nationwide Mut. Fire Ins. Co. v. Bourlon*, 617 S.E.2d 40 (N.C. Ct. App. 2005), *aff'd*, 625 S.E.2d 779 (N.C. 2006). Courts have confirmed that an insurer who undertakes to provide a defense-even under reservation of rights-owes a duty to the insured to

act diligently and in good faith. *Connor v. State Farm Mut. Ins. Co.*, 143 S.E.2d 98 (N.C. 1965).

Additionally, the North Carolina State Bar emphasizes the insurer-retained counsel's role in respecting possible conflicts of interest in counsel's representation of both the insurer and the insured. *See*, *e.g.*, N.C. State Bar, RPC 92, 111, 112 ("Representation of Insured and Insurer"), RPC 91 ("Conflict Between Insured and Insurer").

Thus, it appears that North Carolina courts trust that the insurer-retained counsel will honor their ethical obligations to the insured, such that the insured has no need for a right to independently-selected counsel.

Time for Providing Insured with Coverage Position/Reservation of Rights

- Failing to affirm or deny coverage within a reasonable time after proof of loss constitutes an unfair claim settlement practice. N.C. Gen. Stat. Ann. § 58-63-15 (2006).
- North Carolina has not implemented any rules providing specific timelines for communications with insureds.
- The best practice is to accept or deny coverage within 30 days after receipt of proof of loss.
- If claims filed with a third party administrator or insurer are not paid within 30 days, the administrator or insurer must send a status report to the claimant within that time period. 11 N.C. Admin. Code 21.0106.

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Mazanec Raskin & Ryder Co., L.P.A.

Ohio

Notice

The reservation of rights must be timely. *Dietz-Britton v. Smythe, Cramer Co.*, 139 Ohio App. 3d 337, 345 (8th 2000), *appeal not allowed*, 91 Ohio St. 3d 1419 (2001).

In *Collins v Grange Mutual Casualty Co.,* the court of appeals held that a sixteen-month period constituted a waiver of a reservation of rights. *Collins v. Grange Mut. Cas. Co.*, 124 Ohio App. 3d 574 (12th 1997)

In *Dietz-Britton v. Smythe, Cramer Co.*,the court held that a reservation of rights was untimely and created a waiver where the insurer, instead of taking prompt action to reserve its rights at the time, waited until four weeks before trial, more

than two years after notice of the lawsuit, to reserve its rights. *Dietz-Britton v. Smythe, Cramer Co.*, 139 Ohio App.3d 337, 743 N.E.2d 960 (8th 2000).

In *Turner Liquidating Co. v. St. Paul Surplus Lines Insurance Co.*,the court held that providing a defense for nearly one year without reserving rights may give rise to a claim of estoppel. *Turner Liquidating Co. v. St. Paul Surplus Lines Ins. Co.*, 93 Ohio App.3d 292, 638 N.E.2d 174 (9th 1994).

Content

When the insurer disclaims coverage, it must do so on circumstances that furnish reasonable justification. *Goodrich Corp. v. Commercial Union Ins. Co.*, 2008 Ohio 3200, P12 (Ct. App. 2008). This includes providing the insured with the reasons for the insurer's disclaimer. *Stiggers v. Erie Ins. Co.*, 2008 Ohio 1702, P25 (Ct. App. 2008).

A potential conflict of interest exists when an insurer assumes control of a defense of an insured but also intends to challenge its duty to indemnify if the defense is unsuccessful. Accordingly, the reservation of rights should put the insured on notice that it may be in the insured's best interest to retain personal counsel. *Patitucci v. McNeal Schick Archibald & Biro*, 2006 Ohio 5727 (Ct. App. 8th 2006), *appeal not allowed*, 2007 Ohio 1266 (2007).

If the insurer accepts to defend the insured pursuant to a reservation of rights, nothing prevents the insurer from utilizing discovery to attempt to clarify the nature of the claim against the insured. *City of Willoughby Hills v. Cincinnati Ins. Co.*, 459 N.E.2d 555 (Ohio 1984).

Estoppel

In *Borovich v. Fountain*, the named insured and the permissive user of his vehicle were sued following an accident. The insurer defended the named insured owner without a reservation of rights, but failed to defend the permissive user, although it was clear that the permissive user was an insured under the policy. The court held that it was clear that by defending the named insured the insurer would be estopped from raising any defense of non-compliance of the terms of the policy against the named insured. It also ruled, however, that since the insurance company was estopped from denying coverage as to the named insured, it was also estopped from denying coverage as to the permissive user. *Borovich v. Fountain*, 199 N.E.2d 753 (Ohio App. 8th 1964).

In *Motorist Mutual Insurance Co.*, the insurer chose to try to set up a bilateral non-waiver agreement, which the insured never executed, as opposed to a unilateral reservation of rights letter. Without the non-waiver agreement, the insurer refused to defend. The court ruled that since the insurer had neither entered into a bilateral non-waiver agreement nor given a unilateral reservation of rights notice, it had not given any reservation of rights notice at all. When the insureds were defaulted for lack of a defense, the court held that the insurer had breached its duty to defend and was liable for appropriate damages, including the attorney's fees incurred in defending the declaratory judgment action. *Motorist Mut. Ins. Co. v. Trainor*, 294 N.E.2d 874 (Ohio 1973).

Reimbursement for Defense Costs

The reservation of rights letter may provide the insurer with the right to seek reimbursement for defense costs it pays if it later establishes that those costs were incurred in defending non-covered claims. The reason for allowing an insurer to seek reimbursement of the cost associated with defending non-covered claims is that the insurer is required to defend both covered and non-covered claims but does not receive a premium for defense of the non-covered claims. *United Nat'l Ins. Co. v. SST Fitness Corp.*, 309 F.3d 914 (6th Cir. (Ohio) 2002).

Conflicts of Interest and Independent Counsel

An insurer's duty to defend is broader than its duty to indemnify. *Red Head Brass, Inc. v. Buckeye Union Ins. Co.*, 735 N.E.2d 48, 54 (Ohio App. Ct. 9th 1999) (citing *Socony-Vacuum Oil Co. v. Continental Cas. Co.*, 59 N.E.2d 199 (Ohio 1945)). If the complaint "contains some claim which is arguably within the scope of the policy coverage," the insurer must defend the insured against all claims therein. *Id.* (citing *Sanderson v. Ohio Edison Co.*, 635 N.E.2d 19 (Ohio 1994)).

An insurer's reservation of rights does not automatically create a conflict of interest such that the insurer is obligated to pay for the insured's private counsel. However, where the possibility of conflict exists (such as when an insurer believes a claim may not be covered by the insured's policy), the insurer must defend the claim and reserve its rights to indemnification. *Dietz-Britton v. Smythe, Cramer Co.*, 743 N.E.2d 960, 966 (2000). The reservation of rights serves to put the insured on notice of the possible conflict of interest and allows them to "make a knowing choice whether to proceed with representation and the possible conflict, or obtain independent counsel." *Id.*; *see also Fairfield Mach. Co., Inc. v. Aetna Cas. & Sur. Co.*, 2001-Ohio-3407 (Ct. App. Dec. 28, 2001) (affirming that whenever an insurer fulfills its duty to defend by assuming control of the defense for the insured, but also intends to challenge its duty to indemnify if the defense is unsuccessful, a potential conflict of interest is created which, in order to cure, the insurer must warn the insured of the potential conflict by reserving its rights under the policy).

An insurer must pay for independent counsel for the insured if the insurer's and insured's respective interests are "mutually exclusive." If the interests are mutually exclusive, the insured retains his own counsel, and gives notice to the insurer thereof, the insurer is obligated to pay the cost of the insured's counsel. *Red Head Brass, Inc. v. Buckeye Union Ins. Co.*, 135 Ohio App. 3d 616, 626, 735 N.E.2d 48, 55 (1999) (citing *Socony-Vacuum Oil Co. v. Continental Cas. Co.*, 59 N.E.2d 199 (Ohio 1945)). *See also Sturt v. Grange Mut. Cas. Co.*, 145 Ohio App. 3d 70, 74, 761 N.E.2d 1108, 1112 (2001) (stating that "[when] the two parties [insurer and insured] have differing interests, having two independent attorneys working together for the common interests, but separately for the separate interests is appropriate," therefore fees for the insured's attorney are appropriately allocated to the insurer).

Time for Providing Insured with Coverage Position/Reservation of Rights

- Within twenty-one days after receipt of proof of loss, the insurer must accept or deny coverage, unless more time is needed, in which case the insurer must notify the insured of that and continue to do so every 45 days thereafter until a determination of coverage is made. Ohio Admin. Code § 3901-1-54.

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Oklahoma

Notice

An insurer cannot deny coverage based on a particular coverage defense unless the insurer provides notice of its reservation of rights to assert a coverage defense within 45 days after receipt of proof of loss. Okla. Admin. Code § 365:15-3-5 to § 365:15-3-7.

Content

The reservation of rights letter should identify those relevant provisions of the policy on which the insurer may rely to disclaim coverage. In addition, the insurer should make apparent that any further actions taken by it shall not be construed as a waiver of any rights or defenses. *Melton Truck Lines, Inc. v. Indem. Ins. Co. of N. Am.*, 2006 U.S. Dist. LEXIS 43179, *9-10 (N.D. Okl. 2006).

An insurer "must disclose the rationale for coverage denial within a reasonable time." The disclaimer must make "specific reference to the policy defense being relied upon by the insurer." *Cust-O-Fab Serv. Co., LLC v. Admiral Ins. Co.*, 158 Fed. Appx. 123, 129 (10th Cir. 2005).

Conflicts of Interest and Independent Counsel

In Oklahoma, no statute or case law requires an insurer to pay for independent counsel whenever it asserts a reservation of rights.

In *Nisson v. American Home Assurance Co.*, an insurer retained one counsel to represent multiple insureds (psychiatrists practicing in the same office) who had conflicting interests. One insured became concerned and retained his own counsel, then sought to have the insurer pay for that representation. The court found that the insurer "did not owe [the insured] a duty to provide independent counsel when a *potential* conflict arose over extent of coverage." 917 P.2d 488, 490 (1996 OK Civ. App. 40) (emphasis added). However, when it became apparent that the insurer and insured would pursue conflicting defense strategies,

the insurer "had a duty to pay reasonable fees for the independent representation of [the insured] under the duty to defend clause of the insurance contract." *Id.*at 490-491.

Time for Providing Insured with Coverage Position/Reservation of Rights

- Within 45 days after receipt of proof of loss, the insurer must accept or deny coverage, unless more time is needed, in which case the insurer must notify the insured of that and continue to do so every 45 days thereafter until a determination of coverage is made. Okla. Admin. Code § 365:15-3-5 to § 365:15-3-7.

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SMITH FREED & EBERHARD P.C.
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Oregon

Notice

The insurer must submit a reservation of rights letter to the insured in a timely manner. *Ranger Ins. Co. v. Globe Seed & Feed Co.*, 865 P.2d 451, 457 (Or. Ct. App. 1993).

Consent

The insurer, when tendered the defense of an action, cannot, as a condition of its assumption of the defense, reserve the right to later question coverage. The insured is required to agree to such a reservation either impliedly or expressly. *Ferguson v. Birmingham Fire Ins. Co.*, 460 P.2d 342, 346 (Or. 1969).

Content

Incorporated in the letter must be an identification of the policy terms in dispute. The letter must identify relevant policy provisions on which the insurer is relying to disclaim coverage. *Dillingham Corp. v. Employer's Mut. Liab. Ins. Co. of Wisconsin*, 503 F.3d 1181, 1185 (9th Cir. 1974). In addition, if there are terms that may arise in the future, giving cause for non-coverage, the insurer must provide a general reservation stating that the insurer reserves the right to withdraw "at any time in the future." *United Pac. Ins. Co. v. Pac. Nw. Research Found.*, 593 P.2d 1278, 1280 (Or. Ct. App. 1979).

Estoppel

If an exclusion is known to the insurer at the time of the reservation of rights, it must identify it in the reservation letter. The insurer's failure to apprise the

insured fully of its position will estop the insurer from asserting any defense other than those brought to the notice of the plaintiff. That is, the insurer is required to assert all possible reasons as to why it is denying coverage or it may be estopped from asserting them at a later time. *United Pac. Ins. Co. v. Pac. Nw. Research Found.*, 593 P.2d 1278, 1280 (Or. Ct. App. 1979).

In *United Pacific Insurance Company,* an insurer's reservation of rights letter reserved the right to withdraw from the defense at any time it became "apparent" that an exclusion would apply. The court noted that where a company expressly reserves the right to withdraw from the defense, the insured cannot legitimately claim prejudice when the company exercises that right. However, there is an objective standard on the company's right to withdraw; that is, it must be objectively apparent that the exclusions apply. The court therefore remanded for a determination as to whether the exclusions were applicable based upon underlying facts. *United Pac. Ins. Co. v. Pacific Northwest Research Found.*, 593 P.2d 1278.

Reimbursement of Settlement Payment

An insurer has the ability to enter an agreement with the insured reserving its right to assert a defense of non-coverage even if it accepts a settlement offer on behalf of the insured. If, having reserved such rights and having accepted a reasonable offer, the insurer subsequently establishes the non-coverage of its policy, it would be free to seek reimbursement of the settlement payment from its insured. *Forum Ins. Co. v. County of Nye*, *Nev.*, 26 F.3d 130 (9th Cir. Nev. 1994).

Conflicts of Interest and Independent Counsel

An insurer may not decline to defend an insured due to a conflict of interest. *Casey v. Nw. Sec. Ins. Co.*, 491 P.2d 208, 209 (1971) (citing *Ferguson v. Birmingham Fire Ins.*, 460 P.2d 342 (Or. 1969)). In *Ferguson*, the Oregon Supreme Court "adopted the rule that a failure of an indemnitor to defend its indemnitee estops the indemnitor in a subsequent indemnity action only if the interests of the indemnitor or indemnitee were identical and not conflicting." 460 P.2d 342. Oregon courts have not yet directly addressed the possible role of independent counsel.

Time for Providing Insured with Coverage Position/Reservation of Rights

- Failing to affirm or deny coverage within a reasonable time after proof of loss" constitutes an unfair claim settlement practice. Or. Stat. Ann. § 746.230.
- Within 30 days after receipt of proof of loss, the insurer must accept or deny coverage, unless more time is needed, in which case the insurer must notify the insured of that and continue to do so every 45 days thereafter until a determination of coverage is made. Or. Admin. R. § 836-080-225 to -235.

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Pennsylvania

Notice

Notice must be given in a timely manner. *Beckwirth Mach. Co. v. Travelers Indem. Co.*, 638 F. Supp. 1179, 1187 (W.D. Pa. 1986), *appeal dismissed*, 815 F.2d 286 (3d Cir. 1987).

Content

The reservation of rights letter must fairly inform the insured of the insurer's position. *Beckwirth Mach. Co. v. Travelers Indem. Co.*, 638 F. Supp. 1179, 1187 (W.D. Pa. 1986), *appeal dismissed*, 815 F.2d 286 (3d Cir. 1987); *Brugnoli v. United Nat'l Ins. Co.*, 426 A.2d 164, 167-168 (Super. Ct. 1981).

The notice must allow the insured to protect its interests and avoid detrimentally relying on the insurer to indemnify it. *Nichols v. Am. Cas. Co.*, 225 A.2d 80 (Pa. 1966).

Consent

Assent of the insured is not required for the insurer to reserve its rights. *Beckwirth Mach. Co. v. Travelers Indem. Co.*, 638 F. Supp. 1179, 1187 (W.D. Pa. 1986), *appeal dismissed*, 815 F.2d 286 (3d Cir. 1987); *Draft Systems Inc. v. Alspach*, 756 F.2d 293 (3d Cir. 1985).

Estoppel

An insurer may be estopped from disclaiming on grounds not identified in its initial disclaimer. This will only occur if the insured was misled or lulled by the insurer's initial disclaimer. *Slater v. Gen. Cas. Co. of Am.*, 25 A.2d 697, 699 (Pa. 1942).

An insurer will not be estopped from raising a policy defense, notwithstanding the insurer's participation in the defense of an action against the insured, if the insurer gives timely notice to the insured that it has not waived the benefit of its defense under the policy. The insurer must fairly inform the insured of the insurer's position. A delay in giving notice will be excused where it is traceable to the insurer's lack of actual or constructive knowledge of the available defense. *Brugnoli v. United Nat'l Ins. Co.*, 426 A.2d 164 (Pa. Super. 1981).

In *Douglas v. Evans,* the court refused to allow insurer's retained counsel to withdraw from the defense of the insured after defending for 16 months without a reservation of rights. The insurer had waived the right to raise the issue of coverage. *Douglas v. Evans*. 445 A.2d 540 (Pa. Super. 1982).

Reimbursement for Defense Costs

Sometimes an insurer will include a provision in its reservation of rights letter giving the insurer the right to seek reimbursement for defense costs it pays if it later establishes that those costs were incurred in defending non-covered claims. Courts have held this type of provision to be unenforceable. *Terra Nova Ins. Co. Ltd. v. 900 Bar, Inc.* 887 F.2d 1213 (C.A.3 (Pa.), 1989).

The reason behind this rule is that the insurer should not be permitted to unilaterally amend the policy, especially when the insured may be unschooled in the issues. Also reservation on this issue places insured in position of making a Hobson's choice between accepting conditions on defense or losing right to defense.

Conflicts of Interest and Independent Counsel

No Pennsylvania statute requires the use of independent counsel in a reservation of rights context. The Federal Court of Appeals for the Third Circuit has touched on the subject of conflicts of interest and right to independent counsel more generally:

> [I]f an insurance company breaches its duty to defend, it is liable to reimburse the [insured] the costs the latter incurred in conducting its own defense.... An insurance company breaches its duty to defend when a conflict of interests arises between the insurer and its insured such that the company's pursuit of its own best interests in the litigation is incompatible with the best interests of the [insured].... One appropriate resolution in this circumstance is for the insurer to obtain separate, independent counsel for each of its insureds, or to pay the costs incurred by an insured in hiring counsel.

Rector, Wardens and Vestryman of St. Peter's Church v. Am. Nat'l Fire Ins. Co., 2002 U.S. Dist. LEXIS 625, at *25-26 (E.D. Pa. Jan. 14, 2002) (quoting *St. Paul Fire & Marine Ins. Co. v. Roach Bros. Co.*, 639 F. Supp. 134, 138-139 (E.D. Pa. 1986)) (internal quotation marks and citations omitted), *aff'd*, 97 Fed. Appx. 374, 2004 U.S. App. LEXIS 8967 (3d Cir. 2004).

In Eckman v. Erie Insurance Exchange, the Superior Court of Pennsylvania disagreed with the idea that anytime an insurer reserves its rights, a conflict of interest is created between the insured and insurer. 21 A.3d 1203, 1209 (Pa. Super. Ct. 2011). Essentially, the insurer-selected counsel is expected to adhere to professional ethical standards and represent the insured accordingly.

Time for Providing Insured with Coverage Position/Reservation of Rights

- "Failing to affirm or deny coverage within a reasonable time after proof of loss" constitutes an unfair claim settlement practice. 40 Pa. Stat. Ann. § 1171.5.
- Within 15 days after receipt of proof of loss, the insurer must accept or deny

coverage, unless more time is needed, in which case the insurer must notify the insured of that and continue to do so every 45 days thereafter until a determination of coverage is made. 31 Pa. Code § 146.5 to § 146.7.

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HANSON CURRAN LLP
COUNSELORS AT LAW

Rhode Island

Notice

A reservation of rights letter must be issued timely. *Pickering v. Am. Emp'rs Ins. Co.*, 282 A.2d 584, 592-593 (R.I. 1971).

Content

The letter should have some specificity. Simply alleging that there is a "manifest disregard of the terms and conditions of the policy" will not be held sufficient. Moreover, courts will strike down a reservation if it states that "coverage neither exists nor applies in manner and form as you have alleged," without any identification of the policy terms in question. *Pickering v. Am. Emp'rs Ins. Co.*, 282 A.2d 584, 592-593 (R.I. 1971).

However, where an insurer lacks adequate knowledge to make a determination regarding coverage issues, a reservation that states the following has been held sufficient: "we will agree to take part in the defense of this claim, from the date it was reported to [us], under a full reservation of rights, of all our policy terms, and should we determine that we have no coverage for this claim, we can withdraw from the defense upon providing written notice." *Textron, Inc. v. Liberty Mut. Ins. Co.*, 639 A.2d 1358, 1363 n.4 (R.I. 1994).

When disclaiming coverage, the insurer must identify the reasons for its disclaimer. *Gregelevich v. Progressive Nw. Ins. Co.*, 882 A.2d 594, 595 (R.I. 2005). The letter should make apparent that the insurer is denying coverage to the insured. *Rumford Prop. & Liab. Ins. Co. v. Carbone*, 590 A.2d 398, 401 (R.I. 1991).

Conflicts of Interest and Independent Counsel

A conflict of interest may arise where the insured faces potential liability for conduct both covered and not covered by the policy. *Aetna Cas. & Sur. Co. v. Kelly*, 889 F. Supp. 535, 541 (D.R.I. 1995).

Where there is a conflict of interest, the insurer must disclose it to the insured, who then has the choice of consenting to continuing representation by the insurer-retained counsel or refusing such representation. Where the insured

chooses to exercise its "legitimate right" to refuse the representation, it the insurer must relinquish control of the defense in favor of the insured's interests. This allows the insured to seek independent counsel, to be reimbursed by the insurer. *Emp'rs' Fire Ins. Co. v. Beals*, 240 A.2d 397, 404 (R.I. 1968).

However, because the insurer retains an interest in the conclusions of the defense and is responsible for costs, it retains a right to approve the independent counsel. "Such approval, however, should not be unreasonably withheld." *Beals*, 240 A.2d at 403.

A complaint must have actually been filed prior to the insured's retention of independent counsel. *Quality Concrete Corp. v. Travelers Prop. Cas. Co. of Am.*, 43 A.3d 16, 21 (R.I. 2012); *see also Labonte v. Nat'l Grange Mut. Ins. Co.*, 810 A.2d 250 (R.I.2002).

In *Kelly*, the court observed that having the insurer assign independent counsel to the insured would be preferable to declaratory judgment action as a means of resolving the potential conflict of interest in the underlying litigation. This is because declaratory judgment proceedings turn insurer and insured into adversaries, when they should cooperate on the underlying action. 889 F. Supp. at 541.

Time for Providing Insured with Coverage Position/Reservation of Rights

- Failing to affirm or deny coverage of claims within a reasonable time after having completed its investigation related to the claim or claims constitutes an unfair claims practice by an insurer. R.I. Gen. Laws § 27-9.1-4 (7).

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CARNAHAN ★ THOMAS
ATTORNEYS AT LAW

Texas

Texas Supreme Court Abrogates the Wilkinson Rule

Before 2008, Texas courts recognized the well-established *Wilkinson* rule, which provided that if an insurer assumes the insured's defense without obtaining a reservation of rights or a non-waiver agreement and with knowledge of the facts indicating noncoverage, all policy defenses, including those of noncoverage, are waived, or the insurer may be estopped from raising them.*Farmers Tex. County Mut. Ins. Co. v. Wilkinson*, 601 S.W.2d 520, 521-522 (Tex. Civ. App. Austin 1980),abrogated by *Ulico Cas. Co. v. Allied Pilots Ass'n*, 262 S.W.3d 773 (Tex. 2008). Under the *Wilkinson* rule, a reservation of rights letter is essential to protect an insurer against claims not covered under the policy. Without a reservation of rights letter, there is a risk that the doctrine of waiver can be used

to create insurance coverage for the insured where none exists by the terms of the policy.

In 2008, the Texas Supreme Court abrogated the *Wilkinson* rule. In *Ulico*, the Court held that "the doctrines of waiver and estoppel cannot be used to re-write the contract of insurance and provide contractual coverage for risks not insured." *Ulico*, 262 S.W.3d at 775. The Court expressly disagreed with *Wilkinson*'s statement that noncoverage of a risk is the type of right an insurer can waive and thereby effect coverage for a risk not contractually assumed. *Id.* at 781.

Based on the Court's decision in *Ulico*, although an insurer may still be estopped from denying benefits that would be payable under its policy as if the risk had been covered if an insurer's actions prejudice its insured, it appears a reservation of rights letter is no longer essential to protect an insurer from ***waiving*** defenses against claims not covered under a policy. Thus, "the question on which the insurer's liability should turn is whether an insured is prejudiced as a result of the conflict, an inadequate or absent disclosure, or other actions of the insurer." *Id.* at 786-787.

Actual Prejudice

Prejudice is no longer presumed from an apparent conflict of interest between the insurer and the insured. *See id.* at 782. Rather, the insured must show he is ***actually prejudiced*** by the insurer's actions. *Id.* at 785 (emphasis added).

The Texas Supreme Court offers *Tilley* as an illustration of actual prejudice. *See id. Tilley* involved a suit in which the insurer, Employers, sought a declaratory judgment that it did not have coverage for a personal injury suit in which its insured, Joe Tilley, was a defendant. *Emp'rs Cas. Co. v. Tilley*, 496 S.W.2d 552, 554 (Tex. 1973). When Tilley reported that he had been sued, Employers and Tilley entered into a standard non-waiver agreement and Employers retained an attorney to defend him. Employers questioned whether Tilley had timely reported the accident on which the suit was based, but it did not specifically advise Tilley that a conflict of interest existed because of the late notice issue. Also, the defense attorney did not advise Tilley that the attorney had a conflict of interest in that he was simultaneously defending Tilley and gathering coverage information favorable to Employers. Employers later denied coverage, in part, on the basis of evidence developed by the defense attorney. The Court held, largely on public policy grounds, that Tilley was prejudiced by Employers' actions and Employers was estopped to deny coverage. *Id.* at 561.

In 2010, the Texas Supreme Court applied the *Tilley* standard for prejudice in *Gilbert* and distinguished *Gilbert* as being a case where no actual prejudice occurred. *See Gilbert Tex. Constr., L.P. v. Underwriters at Lloyd's London*, 327 S.W.3d 118, 137 (Tex. 2010). First, unlike the insurer in *Tilley*, the insurer, Underwriters, did not retain the defense attorney for its insured, Gilbert. There was no claim by Gilbert that the defense attorney simultaneously defended Gilbert and represented Underwriters in regard to coverage, had a conflict of interest with Gilbert, developed and provided evidence to Underwriters that harmed Gilbert's coverage position without advising Gilbert, or in any other way breached his duty to Gilbert. To the contrary, the defense attorney advised

Gilbert to obtain coverage counsel and Gilbert knew the defense attorney was not involved in coverage issues. Second, Underwriters consistently advised Gilbert during the pendency of the case that coverage would be based on the actual facts underlying the plaintiff's claims as they were determined to exist. Thus, the Court held there was no evidence of actual prejudice in this case. *Id.* at 138.

The Texas Supreme Court also refers to *Acel* as an example of actual prejudice. *See Ulico*, 262 S.W.3d at 786. *Acel* involved a declaratory judgment action to determine liability coverage for an airplane accident. *Pac. Indem. Co. v. Acel Delivery Serv., Inc.*, 485 F.2d 1169, 1171 (5th Cir. 1973). The incident was not covered by the policy. However, the court found that the insurer was estopped from denying coverage for the judgment because it assumed defense of the suit without a valid non-waiver agreement or reservation of rights when it had knowledge of facts indicating possible lack of coverage and the insured was prejudiced. *Id.* at 1176. The court determined the insured was prejudiced in several ways:

> 1. The insurer failed to notify the insured of possible lack of coverage so it could take measures to defend itself;
> 2. The defense was conducted poorly before the insurer withdrew. For instance, the insurer failed to adequately answer Plaintiff's interrogatories, resulting in sanctions detrimental to insured's case;
> 3. Defense counsel withdrew just before trial; and
> 4. The insurer failed to notify the insured of the apparent conflict of interests that arose when the insurer assumed the defense with doubts as to coverage.
>
> *Id.* at 1175-1176.

In sum, recent Texas Supreme Court decisions do not appear to require an insurer to send a reservation of rights letter to avoid waiving or being estopped from using policy defenses as long as the insurer does not actually prejudice the insured by its actions. However, sending a reservation of rights letter is still an effective method to avoid actual prejudice and protect against estoppel. Therefore, the best practice for an insurer to protect against estoppel is to send a proper reservation of rights letter.

Timeliness

The Texas Insurance Code requires an insurer to submit a reservation of rights to a policyholder within a reasonable time. Tex. Ins. Code Ann. § 541.060(a)(4)(B). The statute does not define "reasonable," and Texas has not implemented any rules providing specific timelines for issuing a coverage position. Texas courts have demonstrated that each case will be resolved based upon its specific set of facts as to whether the issuance of a reservation of rights letter is timely.

As discussed above, the main consideration in determining timeliness is whether a delay in sending a reservation of rights letter actually prejudices the insured. Accordingly, it is best practice for the insurer to send a reservation of rights letter as soon as possible after receiving notice of the lawsuit. However, a handful of Texas state and federal cases decided before *Ulico* provide some guidance as to

what Texas courts consider to be timely.

In *Paradigm Insurance Co. v. Texas Richmond Corp.*, there was no genuine issue of material fact as to prejudice where **the insurer** sent a reservation of rights letter fifteen days after an answer was filed on the insured's behalf. 942 S.W.2d 645, 652 (Tex. App. Houston 1997).

In *Stonewall Ins. Co. v. Modern Exploration, Inc.*, the primary insurer notified Stonewall that the insured had made a claim against the primary insurer arising out of the Modern Exploration claim by letter dated July 20, 1982. 757 S.W.2d 432, 436 (Tex. App. Dallas 1988). Stonewall sent a reservation of rights letter to the insured four months after receiving notice. The court held Stonewall's actions were adequate to prevent Stonewall from waiving or be estopped from asserting its policy defenses.

In *Columbia Casualty Co. v. Georgia & Florida RailNet, Inc.*,the insurer's reservation of rights letter to the insured was sufficient to reserve the insurer's right to affirm or deny coverage of the indemnity claim, given that the court proceedings in the underlying case against the railroad by the railroad employee had not yet started at the time the letter was sent. 542 F.3d 106, 114 (5th Cir. 2008) (applying Texas law).

In *Pennsylvania National Mutual Casualty Insurance Co. v. Kitty Hawk Airways, Inc.*, the insurer assumed and continued the defense of the insured for one year and two months before obtaining an effective reservation of rights letter. 964 F.2d 478, 480-481 (5th Cir. 1992) (applying Texas law). The insurer was still able to rely on its reservation of rights letter because the insured could not demonstrate an affirmative showing of prejudice. *Id.* at 483.

In *Ideal Mutual Insurance Co. v. Myers*, the insurer was allowed to rely on its reservation of rights letter, delivered two years after the accident took place, because the insureds failed to demonstrate that a delay between the insurer's discovery of a possible basis for non-coverage and its delivery of the letter prejudiced the insured. 789 F. 2d 1196, 1201 (5th Cir. 1986) (applying Texas law).

Content

Any defects in the contents of the reservation of rights letter will not result in estoppel without a showing of actual prejudice to the insured. That notwithstanding, the provisions of a reservation of rights letter will be construed strictly against the insurer and will not be extended by implication beyond their exact terms. *W. Cas. & Sur. Co. v. Newell Mfg. Co.*, 566 S.W.2d 74, 76 (Tex. Civ. App. San Antonio 1978). The reservation of rights letter must be sufficient to inform the insured of the insurer's position. *Am. Eagle Ins. Co. v. Nettleton*, 932 S.W.2d 169, 174 (Tex. App. El Paso 1996). Accordingly, the letter should detail specific coverage problems that the insured might face, inform the insured that a conflict of interest exists, and inform the insured that they have the right to seek outside counsel. The letter should set out the policy provisions or exclusions that the insurer is relying on to disclaim coverage. *See*, *e.g.*, *Nguyen v. State Farm Lloyds, Inc.*, 947 S.W.2d 320, 322 (Tex. App. Beaumont 1997). The letter should also identify the name of the insurer reserving its rights under the policy at issue.

Canal Ins. Co. v. Flores, 524 F. Supp. 2d 828, 835 (W.D. Tex. 2007) (applying Texas law).

In *Ideal Mutual Insurance Co.*, the Fifth Circuit, applying Texas law, found that the insurer's reservation of rights letter was adequate and noted the following qualities:

1. the letter specifically identified the policy in question;
2. the letter specifically informed the insured that an attorney had been retained to defend the case;
3. the letter specifically apprised the insured of the initial results of the insurer's investigation;
4. the letter specifically identified the insurer's reservation of rights under the policy, i.e., policy exclusions and exceptions relied upon;
5. the letter specifically identified the insurer's reservation of its right to withdraw from the defense of the Plaintiff's cause of action;
6. the letter specifically advised the insured that they were at liberty to secure counsel of their own choice, at the insured's expense, to represent the insured in regard to the amount sued which is in excess of the insured's insurance coverage;
7. the letter specifically advised the insured that as to such excess there could be a conflict of interest between the insurer and the insured; and
8. the letter specifically advised that if the negligence of the insurer causes a judgment to be rendered against the insured in excess of the insurance limits, it could be that the insurer might be responsible for the excess judgment.

Ideal Mut. Ins. Co., 789 F. 2d at 1201.

Lastly, the reservation of rights letter may provide the insurer with the right to seek reimbursement for defense costs it pays if it later establishes that those costs were incurred in defending non-covered claims. If the insurer intends to seek reimbursement, it should give notice in the reservation of rights letter that it intends to seek reimbursement from the insured for defense costs of uncovered claims to avoid being precluded from later pursuing such a claim against the insured. *See Alliance Gen. Ins. Co. v. Club Hospitality, Inc.*, No. 3:97-CV-2448-H, 1999 WL 500229, at *1 (N.D. Tex. July 14, 1999).

Insured's Consent

The insured is under a duty to respond to an insurer's offer to defend under a reservation of rights. The insured's silence amounts to consent. "If, with knowledge of the offer, the insured stands by, expressing no objection, and allows the insurer to defend the action, there is no difficulty, under ordinary rules of contract law, in implying the consent of the insured to the offer. On the other hand, if the insured refuses to accept the offer of a defense under such conditions, and so notifies the insurer, the insurer cannot stubbornly continue with the defense and still preserve its right to assert policy defenses." *W. Cas. & Sur. Co.*, 566 S.W.2d at 76.

Conflicts of Interest and Independent Counsel

Unlike California, Texas does not have a statute requiring an insurer to provide independent counsel to represent its insured in a lawsuit when a conflict of interest arises between the insurer and the insured. *Cf.* Cal. Civ. Code § 2860. However, in some circumstances, an insured does have a right to select its own independent counsel. Texas courts have provided some guidance as to what triggers this right.

In 2004, the Texas Supreme Court addressed what constitutes a sufficient reason for an insurer to lose its right to conduct the insured's defense, while remaining obligated to pay for it. *N. County Mut. Ins. Co. v. Davalos*, 140 S.W.3d 685, 686 (Tex. 2004). In *Davalos*, the Court stated that generally, an insurer may insist upon its contractual right to control the defense of its insured, which includes authority to select the attorney who will defend the claim. *See id.* at 688. However, an insurer may not insist upon its contractual right to control the defense where a disqualifying conflict of interest exists. A disqualifying conflict of interest exists under the following circumstances:

1. The facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends;
2. The defense tendered by the insurer is inadequate; or
3. The defense is conditioned on an unreasonable, extra-contractual demand that threatens the insured's legal rights.

See id. at 689.

The most common conflict between an insurer and an insured is whether a claim is within policy limits and the coverage provided. *Unauthorized Practice of Law Comm. v. Am. Home Assurance Co., Inc.*, 261 S.W.3d 24, 40 (Tex. 2008). However, coverage often cannot be determined when a claim is first filed, and even after the basis for the claim is explored in discovery, it may be difficult to quantify damages and determine whether they fall within policy limits. Other coverage issues may also depend on facts developed in the litigation. Therefore, it is not clear under Texas law exactly when a coverage issue becomes a disqualifying conflict of interest triggering an insured's right to independent counsel.

In regard to reservation of rights, the Texas Supreme Court stated in *Unauthorized Practice of Law Committee* that a reservation of rights letter does not by itself create a conflict between the insured and the insurer. The Court noted that declining representation is the safer course to avoid conflicts that destroy the congruence of interest between the insurer and the insured. However, it should be noted that the Court did not say as a blanket rule that a staff attorney can never represent an insured under a routine reservation of rights.

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Notice

Where an insurer desires to reserve the right to contest liability under a liability policy before defending an action, notice is required to the insured that the insurer is defending under a reservation of its rights. *Associated Indem. Corp. v. Wachsmith*, 99 P.2d 420 (Wash. 1940). This means that the insured must have actual notice of the reservation of rights before it will be considered valid. *Van Dyke v. White*, 349 P.2d 430 (Wash. 1960).

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Notice requires that the insurer fully inform the insured of the reasons for its reservation and of developments relevant to coverage under the policy in a timely manner. *Red Oaks Condo Owners Ass'n v. Am. State Ins. Co.*, 139 Wash. App. 1079, 2007 WL 2171435 (Wash. App. Div. 1 2007). Thus, the insurer should issue a letter identifying the relevant facts and portions of the policy that it is relying upon.

Not only must the insured have actual notice of the reservation, the reservation must be a "specific and clearly stated" reservation. Failing to specifically describe the basis for the reservation estops the insurer from asserting that coverage defense. *Tank v. State Farm Fire & Cas. Ins. Co.*, 715 P.2d 1133 (Wash. 1986).The reservation should contain the relevant policy language, the nature of the reservation and any known facts supporting the reservation.In fact, a general reservation of rights may constitute bad faith. *Weber v. Biddle*, 483 P.2d 155 (Wash. Ct. App. Div. 1 1971).

The letter must contain all possible reasons for disclaiming coverage known to the insurer at the time the insurer issues the letter. "[I]f an insurer denies liability under the policy for one reason, while having knowledge of other grounds for denying liability, it is estopped from later raising the other grounds in an attempt to escape liability, provided that the insured was prejudiced by the insurer's failure to initially raise the other grounds." This has been extended not only to what the insurer knows, but what the insurer could have known had it pursued a diligent inquiry. *Bosko v. Pitts & Still, Inc.*, 454 P.2d 229, 234 (Wash. 1969).

A reservation of rights need not be in the form of a non-waiver agreement or any particular form. All that is required is notice to the insured that the insurer will defend under a reservation of rights. Thus, even though the minor plaintiff disclaimed a non-waiver agreement after reaching majority, he still had notice that the defense undertaken by the insurer was under a reservation of rights, and there was no waiver or estoppel. *Associated Indem. Corp. v. Wachsmith*, 99 P.2d 420 (Wash. 1940).

Timeliness

Further, the reservation of rights must be asserted in a timely manner. No specific time period has been established by statute or case law, courts have held that ten months is too long, but two months may not be too long. *Transamerica Ins. Group v. Chubb & Son, Inc.*, 554 P.2d 1080 (Wash. Ct. App. Div. 1 1976); *Safeco Ins. Co. of Am. v. Butler*, 823 P.2d 499 (Wash. 1992).

Prejudice/Estoppel

In cases where a question of fact exists as to whether the insured is prejudiced by the late issuance of a reservation, the insured must show prejudice with substantial proof. *R.A. Hanson Co., Inc. v. Aetna Cas. & Sur. Co.*, 550 P.2d 701 (Wash. Ct. App. Div. 3 1976).

In *R.A. Hanson Co. v. Aetna Cas. & Sur. Co.*, an insurer defended a claim for approximately two and one-half months, before withdrawing on the basis of non-coverage. Prejudice to the insured arising from withdrawal is not presumed, even though the defense is undertaken without a reservation of rights. The insurer is not estopped from later raising non-coverage under the policy without substantial proof that the insured will actually be prejudiced by the withdrawal. Only in extreme cases will prejudice be presumed, as where the insurer claims non-coverage after judgment and surrender of all right of appeal, making actual proof of prejudice impossible. In this instance, there was no evidence of prejudice, and the insurer was not estopped from asserting its coverage position. 550 P.2d 701.

In *Transamerica Insurance Group v. Chubb & Sons. Inc.*, the court ruled that acceptance of the defense for approximately ten months without a reservation of rights, and before withdrawing from the case, was sufficient for prejudice to be presumed. The court ruled that as a result of the failure to reserve rights, the insurance company was estopped to deny coverage. 554 P.2d 1080 (Wash. Ct. App. Div. 1 1976), *review denied*, 88 Wash. 2d 1015 (1977).

The insured disappeared, and the insurer undertook significant efforts to locate him. The insurer also sent reservation of rights letters to his last known locations. Under the circumstances, there was nothing more the insurer could have done, and it was not estopped from relying upon the breach of cooperation by reason of a claimed failure to properly reserve its rights. *Edible v. Hayes*, 55 P.2d 1072 (Wash. 1936).

Reimbursement of Defense Costs

Recently, the Washington Court of Appeals ruled that a liability insurer defending under a reservation of rights letter is not entitled to reimbursement in the absence of policy language expressly reserving such a right. Up until the case of *National Surety Corp. v. Immunex Corp.*, this remained an unanswered question in Washington insurance law. After agreeing that there was no coverage for the underlying claims, the Court of Appeals affirmed that National Surety remained obligated for defense costs incurred up until the trial court's summary judgment rulings unless National Surety could prove actual prejudice.

Relying upon Washington cases noting the broader scope of a liability insurer's duty to defend, the court reasoned that "payment of defense costs for claims that are potentially covered is part of the bargained-for exchange between the insurer and the insured" and the reservation of rights defense provides an insurer with "the benefit of insulating itself from a bad faith claim and possibly coverage by estoppel."

Notably, the court indicated that its decision may have been different had National Surety's policy included express language reserving to the insurer the right to reimbursement in the event that it defends a claim under a reservation of rights and then obtains a court determination of no coverage. *National Sur. Corp. v. Immunex Corp.,* 256 P.3d 439 (Wash. Ct. App. Div. 1 2011). Whether the Court of Appeals would actually enforce such a provision remains to be seen. But liability insurers now should give careful consideration as to whether to include a reimbursement provision in policies issued to Washington insureds.

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Under Washington case law, a conflict of interest does not automatically arise in reservation of rights situations. However, the *potential* for a conflict of interest is inherent when an insurer undertakes a defense under a reservation of rights. Therefore, the insurer is subjected to an enhanced obligation of good faith toward the insured. The criteria of this enhanced obligation were outlined in *Tank v. State Farm Fire & Cas. Co.*:

> First, the company must thoroughly investigate the cause of the insured's accident and the nature and severity of the plaintiff's injuries. Second, it must retain competent defense counsel for the insured. Both retained defense counsel and the insurer must understand that only the insured is the client. Third, the company has the responsibility for fully informing the insured not only of the reservation-of-rights defense itself, but of all developments relevant to his policy coverage and the progress of his lawsuit. Information regarding progress of the lawsuit includes disclosure of all settlement offers made by the company. Finally, an insurance company must refrain from engaging in any action which would demonstrate a greater concern for the insurer's monetary interest than for the insured's financial risk.
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> 715 P.2d 1133, 1137 (Wash. 1986)

For example, in *Mutual of Enumclaw Insurance Co. v. Dan Paulson Construction, Inc.*, the insurer had been excluded from the settlement arbitration proceedings between insured and plaintiff in underlying action. Nonetheless, the insurer submitted two ex parte letters to the arbitrator regarding its policy dispute with insured. The Supreme Court of Washington found this conduct to be evidence of the insurer's "greater concern for [its own] monetary interest than for the insured's financial risk." 169 P.3d 1, 9 (Wash. 2007).

In addition, insurer-retained defense counsel must meet specific criteria. Counsel

must be loyal to its client, which is the insured, not the insurer. It also has a duty to disclose to the insured all potential conflicts of interest and all information relevant to the proceedings, particularly all settlement activity, in recognition of the fact that the insured is ultimately to decide any settlement. *Tank*, 715 P.2d at 1137.

The insured only acquires the right to retain independent counsel when it is apparent that the insured cannot fulfill its enhanced obligation. As the Washington Court of Appeals stated, "the insurer has no obligation before-the-fact to pay for its insured's independently hired counsel. Any breach of the 'enhanced obligation of fairness' in a reservation of rights situation might lead to after-the-fact liability of the insurer, retained defense counsel, or both." *Johnson v. Cont'l Cas. Co.*, 788 P.2d 598, 601 (Wash. Ct. App. Div. 2 1990).

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Sincerely,

Howard Shafer
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