Legal and Ethical Issues Arising With An Insurance Company's Preservation of Its Coverage Position Through A Reservation Of Rights Letter

Course Topic: This presentation examines the evolution and preparation of reservation of rights letters. This seminar covers the growth of non-waiver agreements, emergence of the reservation of rights letter, required elements of a reservation of rights letter, the consequences of sending reservation of rights letters and waiver and estoppel. This course is designed to provide the attendee with the skills necessary to create various reservation of rights letters based upon the unique facts of different situations. The goal of this seminar is to provide solid ideas and examples for practical application.

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About The Author

Peter G. Bora has over 25 years of experience representing clients in complex commercial litigation including insurance coverage, direct defense and contract matters. Martindale-Hubbell Law Directory awarded Peter the highest peer review rating bestowed upon an attorney, the rating of “AV”.

Peter gained extensive experience representing multinational insurance carriers as a partner with a large national insurance law firm. He has defended insurance clients in cases involving professional liability, construction defects, toxic tort, environmental and asbestos related bodily injury claims.

His insurance coverage experience extends to insurance issues under CGL policies, Environmental Impairment Liability (claims made), Professional Liability (mortgage brokers, veterinarians, home inspectors, architects and engineers), Commercial Automotive (rental and trucking policies), Employment Practices Liability and beyond.

Peter has served as approved lead counsel for CNA and AIG Companies, Atlantic Mutual, Zurich, Steadfast Insurance Co., London Underwriters, Prudential Reinsurance, Gibraltar Casualty Company and others.

Peter is an active speaker and continuing legal education presenter. He is a coauthor of “Writings at Trial” in the treatise Illinois Civil Trial Evidence (Illinois) 2004, 2009 Edition, published by the Illinois Institute for Continuing Legal Education. Mr. Bora is the author of “The Implied Covenant of Good Faith and Fair Dealing in Computer Contracts’, published in the Software Law Journal (1989).

John Marshall Law School in Chicago awarded Peter a Juris Doctor degree with distinction in 1989. He holds a Bachelor of Science in Political Science from Illinois State University.

Peter practices in Illinois and the United States District Court for the Northern District of Illinois. He has been admitted pro hac vice in Arizona, California, Kentucky, Indiana, Michigan, Missouri, New Jersey, Texas, Washington, West Virginia and Wisconsin.

Email Address: pbora@boralaw.com
Website: http://boralaw.com/
Mailing Address: 1699 Wall St, Mount Prospect, IL 60056
Phone Number: 312-618-7878

Analyzing and Understanding An Insurance Company's Preservation of Its Coverage Position Through A Reservation Of Rights Letter

Contents

Course Description

Course Presentation

This course provides an in-depth examination of the construction and use of reservation of rights letters to preserve an insurance coverage position. The relationship between an insurance company, its insurance coverage counsel and the insured and its defense counsel creates a multitude of legal and ethical relationships. In the multiverse of insurance coverage law, there can be conflicts of interest between the insurance company and the insured, defense counsel and the insured and defense counsel and the insurance company.

This course identifies how to recognize the requirements of a reservation of rights letter and how to recognize signs of deficient reservation of rights letters. The course examines the growth of the non-waiver agreement, recognizing components of a reservation of rights letter and the construction of reservation of rights letters together with the use of independent counsel when a conflict of interest arises. The course examines how to address multiple policies, multiple suits and avoid estoppel and related coverage defenses. The course examines insurance coverage investigation and defense fee issues such as defense fee reimbursement.

Course Material

This material is intended to be a guide in general and is not legal advice. If you have any specific question regarding the state of the law in any particular jurisdiction, we recommend that you seek legal guidance relating to your particular fact situation.

The course materials will provide the attendee with the knowledge and tools necessary to identify the current legal trends with respect to these issues. The course materials are designed to provide the attendee with current law, impending issues and future trends that can be applied in practical situations.

Course Learning Objectives and Outcomes

This course is designed to provide the following learning objectives:

- Participants will learn to recognize the ethical issues that arise with the construction and use of reservation of rights letters to preserve an insurance coverage position.
- Participants will learn to recognize the ethical and legal obligations that arise from the relationship between an insurance company, its insurance coverage counsel and the insured and its defense counsel.
- Participants will learn to recognize ethical issues arising from a conflict of interest between the insurance company and the insured, defense counsel and the insured and defense counsel and the insurance company
- Participants will learn to recognize the requirements of a reservation of rights letter and signs of deficient reservation of rights letters.
- Participants will learn to identify the growth of the non-waiver agreement.
- Participants will learn to recognize components of a reservation of rights letter.
- Participants will gain skills to understand how to address multiple policies, multiple suits and avoid estoppel.
- Participants will gain skills to examine coverage defenses.
- Participants will learn about insurance coverage investigation and defense fee reimbursement.
- Upon completion of the course, participants should be able to apply the course material; improve their ability to research, plan, synthesize a variety of sources from authentic materials, draw conclusions; and demonstrate an understanding of the theme and concepts of the course by applying them in their professional lives.

Timed Agenda:

Presenter Name: Peter G. Bora

CLE Course Title: Legal and Ethical Issues Arising With An Insurance Company's Preservation of Its Coverage Position Through A Reservation Of Rights Letter

Time Format (00:00:00 - Hours:Minutes:Seconds)	Description
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00:00:37	CLE Presenter Introduction
00:01:00	CLE Substantive Material Presentation Introduction
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00:10:04	Place the Insured On Notice of Coverage Issues
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00:27:34	Montana Statute Addressing A Reservation of Rights Letter
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00:45:58	Failure to Issue A Reservation of Rights Letter
00:49:32	Insurer Seeking Reimbursement of Defense Fees
00:54:01	The Burden Upon An Insured To Prove a Reservation of Rights and Ethical Issues
01:03:48	The Ethical Issue of the Dual Role Adjuster
01:05:58	Presenter Closing
01:06:00	ApexCLE Company Closing Credits
01:06:05	End of Video

Legal and Ethical Issues Arising With An Insurance Company's Preservation of Its Coverage Position Through A Reservation Of Rights Letter

This course conducts an in-depth examination of the construction and use of reservation of rights letters to preserve an insurance coverage position. The relationship between an insurance company, its insurance coverage counsel and the insured and its defense counsel creates a multitude of legal and ethical relationships. In the multiverse of insurance coverage law, there can be conflicts of interest between the insurance company and the insured, defense counsel and the insured and defense counsel and the insurance company.

The course will identify how to recognize the requirements of a reservation of rights letter and how to recognize signs of deficient reservation of rights letters. It will discuss the growth of the non-waiver agreement, recognizing components of a reservation of rights letter and the construction of reservation of rights letters together with the use of independent counsel when a conflict of interest arises. It will examine how to address multiple policies, multiple suits and avoid estoppel and related coverage defenses. It will examine insurance coverage investigation and defense fee issues such as defense fee reimbursement.

When an insured is sued, typically it tenders the suit to its insurance carrier and requests a defense and indemnification. The insurer will evaluate the suit to determine whether there is a potential for coverage under an insurance policy. The insurer will then take the position that the matter is covered and assigned defense counsel, determined that the matter is not covered under the policy and deny coverage for the suit or, as is often the case, take the position that there is insufficient information to determine the status of coverage upon its initial evaluation of the complaint and policy. Under this circumstance, the insurer needs a mechanism to notify the insured that it may not indemnify the insured for the claims asserted within the complaint.

A reservation of rights notice is a declaration by an insurer, delivered to an insured stating that the insurer reserves the right to contest liability under a policy. Insurers generally use reservation of rights notices to preclude inferences that might otherwise be drawn by an insured or by a court from the conduct of the insurer. Keeton & Widiss, Insurance Law, Reservation of Rights and Nonwaiver Agreements, § 6.7(a). This notice suspends operation of waiver and estoppel when coverage issues exist.

Where there are facts which might exclude coverage, the insurer cannot always defend with complete fidelity. There must be a proceeding at which the insurer and the insured are each represented by counsel of their own choice to fight out their differences. Such a testing of the insurer's liability may take the form of a declaratory judgment. If the insurer refuses to defend and awaits the determination of its

obligation in a subsequent proceeding, it acts at its peril, and if it guesses wrong it must bear the consequences of its breach of contract. Kepner v. Western Fire Ins. Co., 109 Ariz. 329, 509 P.2d 222 (1973).

The Ethical Wall

The issue of whether an ethical wall must be maintained between a liability claims handler and an insurance coverage claims handler often arises when one insurer analyst is handling the liability aspect of the claim and an analyst sitting right next to them handling the coverage aspect of the same file. Aetna was involved in an ethical wall dilemma due to the existence of a standard procedure in these situations. In Aetna Cas. & Sur. Co. v. Mitchell Bros., Inc., 814 So.2d 191 (Ala.,2001), Aetna's internal rules called for the erection of an ethical wall between personal handling the coverage dispute with its insured and personal handling the liability defense of the insured. The court held that a trier of fact could determine that Aetna breached its own rules. There are no set rules that can be implied in these cases. Each ethical question must be analyzed on a case by case basis.

In, Flynn's Lick Community Center & Volunteer Fire Dept. v. Burlington Ins. Co., 2003 WL 21766244 (Tenn.Ct.App., Jul 31, 2003), the insured argued that its insurer permitted the coverage adjuster and defense adjuster to "cross over" the wall between the defense and coverage aspects of the claims, argued that this established that the insurer acted unfairly and improperly. The court found that sufficient evidence supported the coverage position. Although this decision does not provide a test or sufficient guidance, it does demonstrate the increasing use of the "Ethical Wall" bad faith claim.

This issue was reviewed in State Farm Fire & Casualty Co. v. Superior Court, 265 Cal.Rptr. 372 (Cal.App. 4 Dist.,1989). In Superior Court, State Farm defended an insured under a reservation of rights and assigned a single adjuster to handle both the liability portion of the claim as well as the coverage issues. The insured argued that not only should the counsel involved in the cases be independent, but, in a "Cumis" situation, the adjusters assigned to each case (the "liability" case as distinguished from the "coverage" case) should be separate. Amicus Curiae agued that an ethical wall should be erected between the insurance company's administration of the two cases. The court held that in this case, "Cumis" counsel was assigned and therefore protected any confidential information from reaching the duel role adjuster. The concurring opinion stated that there was nothing in the implied covenant to prohibit an insurer, under the circumstances of this case, from using a single adjuster for both liability and coverage. This view was restated in Employers Ins. of Wausau v. Albert D. Seeno Const. Co., 945 F.2d 284 (9th Cir.1991).

The insurance adjuster is the agent of the insurer. That the adjuster can under particular fact situations become also the agent of the insured is clear, and this most usually will occur when no issue as to coverage arises. Where coverage is in issue,

however, it is obvious that the adjuster's loyalties are divided and the insured and his counsel cannot reasonably expect that he represents only the interest of the insured....” (State Farm Fire & Casualty Co. v. Superior Court (1989) 216 Cal.App.3d 1222, 1227, 265 Cal.Rptr. 372; see also Doctors' Co. v. Superior Court (1989) 49 Cal.3d 39, 48, 260 Cal.Rptr. 183, 775 P.2d 508; Gruenberg v. Aetna Ins. Co. (1973) 9 Cal.3d 566, 576, 108 Cal.Rptr. 480, 510 P.2d 1032.) as cited in Thompson v. Cannon, 224 Cal. App. 3d 1413, 1416, 274 Cal. Rptr. 608, 610 (Ct. App. 1990).

A Texas court explored the ethical conflict of interest issues at length as it discussed automobile insurance:

> Serious ethical problems arise when an insurance company seeks to participate in the defense of an uninsured motorist. There may be (1) a potential or actual conflict of interest between the insurance company and its own insured and (2) there may be a potential or actual conflict of interest between the insurance company and the uninsured motorist. As the representative of the uninsured motorist the company stands in a fiduciary relationship to him. As the insurer of one suing the uninsured motorist it has, contractually, not only the right but also the duty to represent its insured in defense of any claim that may be asserted against him as a result of the collision in question, and thus stands in a fiduciary relationship to him. Thus to permit the insurance company to defend the uninsured motorist is to permit it to assume a fiduciary relationship to two parties having conflicting interests in the subject matter of the trust. We consider first the conflict of interest between the insurance company and the uninsured motorist.
>
> Under the Texas statute the insurance company is subrogated to the rights of its insured. If the insurance company pays a claim to its insured under the policy, it may attempt to recover that amount from the uninsured driver. In an instance where the company has directly defended the uninsured motorist in a suit instituted by the insured, and then purposes its subrogation claim, it would be seeking a judgment against its former client. This serious ethical problem is not presented under the facts presented in the instant case. A kindred problem does arise under what will hereafter be discussed.
>
> Of immediate concern is the conflict of interest between the company and its own insured. If the insured brings suit against the uninsured motorist and the company is permitted to defend such uninsured motorist, the company would attempt to prove either the negligence of its own insured, or the uninsured motorist's freedom from negligence. Either determination would inure to the benefit of the insurance company. The company interests are therefore opposed to those of its own insured.
>
> Although a counterclaim was not asserted by the uninsured motorist here, the possibility of such a counterclaim's being asserted in

other cases cannot be overlooked for such action compounds the conflict of interest problems. If the insurance company undertakes to represent the uninsured motorist who later decides to file a cross-action against the insured, what then is the insurance company's course of action? In defending its own insured against such cross-action the company will attempt to establish that its insured was not negligent or to establish that the uninsured motorist was also negligent. Either of these contentions are opposed to the position the insurance company takes as an intervening party defendant in the original action by the insured against the uninsured motorist. Either contention is opposed to the insurance company's position in representing the uninsured motorist.

Interestingly, in any situation where the insurance company is permitted to undertake a dual representation the most favorable result for the company is for both its insured and the uninsured motorist to be found contributorily negligent. Such a determination would preclude the insurance company's liability. To contend for this most favorable result, however, makes for a conflict of interest between the insurance company and both the insured and the uninsured motorist.

The textwriters and the courts caution against accepting any case where a conflict of interest might arise in the future. When the uninsured motorist first seeks counsel, the posture of the parties is not clearly established, yet in every instance the possibility exists that he will assert a claim or a counter-claim against the insured. Thus, if an insurance company undertakes to defend or assist in the defense of an uninsured motorist a potential conflict of interest is always present.

As has been heretofore indicated some, though by no means all, jurisdictions permit intervention or participation by the insurance company. In some of these states intervention is held to be a matter of right and in others it depends on the permission of the court. We are of the opinion, however, that the conflict of interest that is in every case potentially present compels a determination that the insurance company must refrain from representing the uninsured motorist or from intervening in an uninsured motorist case such as the one here presented. Only such determination will eliminate the possibility of the conflict of interest arising.

There are other considerations which support this determination. Aside from the conflict of interest problem it would scarcely be countenanced if the insurance company actually undertook to represent both the uninsured motorist and its own insured. And while there may be some question concerning the insurance company's position in regard to the uninsured motorist, there is little controversy relative to its obligation to its own insured. The primary obligation of the

> company issuing automobile liability coverage is to defend the insured against suits alleging damages within the terms of the policy, even though such suit may be groundless, false or fraudulent. The uninsured motorist provision on the other hand relates to a considerably more restricted liability under an ancillary provision in the policy. We do not believe that an insurance company should be permitted to voluntarily place itself in a position under an ancillary policy provision where it cannot ethically fulfill its basic contractual obligation to defend its insured.

450 S.W.2d 668, 671–73 (Tex. App.—Houston [14th Dist.] 1970) (citations omitted), aff'd, 469 S.W.2d 151, 152–53 (Tex. 1971) (approving reasoning of court of civil appeals and imposing upon UM insurer the burden "to show no substantial conflict of interest"), as cited in Blevins v. State Farm Mut. Auto. Ins. Co., 02-17-00276-CV, 2018 WL 5993445, at *33–34 (Tex. App. Nov. 15, 2018).

Further, the California Insurance Law Handbook § 46.07(1) (2003 ed.) states that A liability insurer is not required to have separate adjusters for the liability and coverage cases against its insured. State Farm Fire & Casualty Co. v. Superior Court, 216 Cal.App.3d 1222, 265 Cal.Rptr. 372 (4th Dist.1989). A liability insurer that defends an action against its insured while reserving the right to deny coverage is not required to assign separate adjusters to the coverage and liability issues. Employers Ins. of Wausau v. Albert D. Seeno Const. Co., 945 F.2d 284 (9th Cir.1991).

GROWTH OF THE NON-WAIVER AGREEMENT

A Pennsylvania court in 1929 was one of the early courts to express the concept of preserving a coverage defense when it held that:

> When an insurance company or its representative is notified of loss occurring under an indemnity policy, it becomes its duty immediately to investigate all the facts in connection with the supposed loss as well as any possible defense on the policy. It cannot play fast and loose, taking a chance in the hope of winning, and, if the results are adverse, take advantage of a defect in the policy. The insured loses substantial rights when he surrenders, as he must, to the insurance carrier the conduct

of the case. *Malley v. American Indemnity Corporation,* 146 A. 571, (Pa. 1929).

Recognizing that some claims fall outside of policy coverage, courts permitted the use and enforced bilateral Non-Waiver Agreements. These agreements were separate contracts drafted by the insurer and signed by the insured. If the insured failed to sign, the insurer would refuse to provide a defense.

Typically, non-waiver agreements were entered before a defense was provided. The insured would reserve its rights during its investigation and then make a determination on coverage before providing a defense. In Commercial Standard Ins. Co. v. Harper, 103 S.W.2d 143 (Tex.App. 1937) the court reviewed a non-waiver agreement that stated as follows:

> It is hereby agreed by the assured and clearly understood by him that in conducting an investigation of the loss the said Commercial Standard Insurance Company is not in any way waiving any of their rights under the said policy, particularly in regard to the policy provision that a prompt notice of all losses shall be immediately reported to the company and it is further understood that the said Insurance Company does not waive any rights that they may have under the policy provisions.
>
> In undertaking the investigation of the said loss the assured, J. W. Harper, clearly understands that the Insurance Company does not admit any liability whatsoever for the loss but is conducting the investigation for the purpose of obtaining the circumstances and conditions surrounding the occurrence of the loss.

The court held that "under the nonwaiver agreement above set out there was no waiver by the company of the notice requirement of the policy." Non-waiver agreements executed by the insured and insurer, before an investigation occurred,

by which the parties may proceed without waiving their rights, were binding on the parties. City of Wichita Falls v. Travelers Ins. Co., 137 So.2d 170 (Tex. App. 1940). These agreements were sufficient for a time but, soon coverage issues arose that could not be conclusively determined before litigation. In these situations, a new mechanism was required during the tort action in order to defend without waiving the right to deny coverage later on.

EMERGENCE OF THE RESERVATION OF RIGHTS LETTER

The use of a bilateral agreement quietly faded from insurance law during the 1940's. From what can be implied from general case law, is that insurers' repeated requests for the execution and return of non-waiver agreements was tiring. Soon the insurers merely sent out a letter stating the substance of the non-waiver agreement. In the evolution of the present view, courts found that companies should have the opportunity to investigate the question of coverage before the trial takes place. The facts may be inconclusive; the company is then faced with the problem of whether to refuse to take part in the defense and risk a large judgment which they may be forced to pay if coverage is later proved, or to defend the lawsuit and be met later with an allegation that it has waived a coverage defense. Where the carrier sends its insured a notice that it is reserving its rights to contest liability for any judgment, and then goes ahead and defends the action, it is almost uniformly held that by this notice the company may defend and use its best efforts to prevent an excessive verdict, without thereby waiving its right to raise the question of liability under the terms of the policy at a later date. Damron v. Sledge, 460 P.2d 997 (Ariz. 1969).

By issuing a reservation of rights to the insured, the insurer is putting the insured on notice that there may not be insurance coverage for a judgment entered in the action. In addition, the insurer may take the position that if it is determined that there is no coverage under the policy during the course of litigation, it may reserve the right to withdraw defense counsel which it has provided. Such is the purpose of a reservation of rights: to allow the insurer to fulfill the broad duty to defend while at the same time investigating and pursuing the narrower issue of whether indemnification will result. Gallant Ins. Co. v. Oswalt, 762 N.E.2d 1254 (Ind.App. 2002).

BASIC REQUIREMENTS WITHIN A RESERVATION OF RIGHTS LETTER

A Reservation Of Rights Letter Must Be Issued Timely

Within most jurisdictions, a reservation of rights letter must provide the policyholder with reasonable notice of the reservation within a reasonable time. Delays such as 13 months or as little as 90 days have been held to be unreasonable. U.S. Liability Ins. Co. v. Staten Island Hospital, 162 A.D.2d 445, 556 N.Y.S. 2d 153 (NYSUP. Ct. App. Div. 1990); Mohawk Miden Ins. Co. v. Ferry, et al., 251 A.D.2d 846, 764 N.Y.S.2d 512 (Sup. Ct. App. Div. 1998). A delay of 10 ½ months is not timely. Insurance Co. of North America v. Kyla, Inc., 388 S.E.2d 530 (Ga.App.,1989).

Failure to issue a reservation within 12 months has given rise to estoppel against an insurer. First United Bank of Bellevue v. First American Title Ins. Co., 496 N.W.2d 474 (Neb.,1993). Absent a specific statute of restrictive court decision, courts generally appear willing to allow 60 - 90 days for the issuance of a reservation of rights letter provided, no prejudice has resulted to the insured.

Several Jurisdictions Have Enacted Specific Statutes Regarding Reservation Of Rights Letters

New York Statute Addressing Reservation Of Rights

New York has enacted Insurance Law §3420(d) which requires that the insurer notify the insured of any basis for denying coverage "as soon as reasonably possible." This statute provides in part as follows:

> (d) If under a liability policy delivered or issued for delivery in this state, an insurer shall disclaim liability or deny coverage for death or bodily injury arising out of a motor vehicle accident or any other type of accident occurring within this state, it shall give written notice as soon as is reasonably possible of such disclaimer of liability or denial of coverage to the insured and the injured person or any other claimant.

A 1935 decision applied a portion of the former statute regarding direct actions against an insurer to a casualty policy issued to a business. Materazzi v. Commercial

Cas. Ins. Co., 283 N.Y.S. 942 (N.Y.Supp. 1935). A 2000 decision applied this statute to a commercial general liability policy and an attempted disclaimer based on the pollution exclusion. The court held that a delay of four months was unreasonable as a matter of law. American Ref-Fuel Co. of Hempstead v. Employers Ins. Co. of Wausau, 705 N.Y.S.2d 67 (N.Y.A.D. 2 Dept.,2000). In Hartford Insurance Co. v. County of Nassau, 46 N.Y.2d 1028, 416 N.Y.S.2d 539, 389 N.E.2d 1061, reconsideration denied 47 N.Y.2d 951, 419 N.Y.S.2d 1028, 393 N.E.2d 1051, an unexplained delay of two months was found to be unreasonable in disclaiming coverage but then reverse based on factual issues. Under the reasonableness standard, 7 months has been held unreasonable under a personal automobile policy. Progressive Cas. Ins. Co. v. Conklin, 510 N.Y.S.2d 246 (N.Y.A.D. 3 Dept.,1986.)

In one of the most dramatic decisions, a court held that a 30-day delay was unreasonable as a matter of law. The court found that a plaintiff's delay in notifying its insurer of the occurrence giving rise to the claim was the sole ground on which the insurer disclaimed coverage. This basis for denial was obvious from the face of the notice of claim and the accompanying complaint, and the insurer had no need to conduct an investigation before determining whether to disclaim. The insurer's 30-day delay in disclaiming coverage was therefore unreasonable as a matter of law under Section 3420. West 16th Street Tenants Corp. v. Public Service Mut. Ins. Co. 736 N.Y.S.2d 34 (N.Y.A.D. 1 Dept.,2002).

The Court of Appeals has held that "although an insurer may disclaim coverage for a valid reason ... the notice of disclaimer must promptly apprize the claimant with a high degree of specificity of the ground or grounds on which the disclaimer is predicated. Absent such specific notice, a claimant might have difficulty assessing whether the insurer will be able to disclaim successfully. This uncertainty could prejudice the claimant's ability to ultimately obtain recovery." General Accident Ins. Group v. Cirucci, 46 N.Y.2d 862, 864, 414 N.Y.S.2d 512, 387 N.E.2d 223 (1979).

However, the statute only applies to bodily injury claims, the statute only applies to claims made pursuant to New York policies. The question arise of whether the estoppel principles of New York Insurance Law Section 3420(d) apply to bodily injury claims arising out of mold exposure? Courts applying New York law would likely find that Section 3420(d) applies to these claims. Despite the fact that New York is one of the few states in which an insurer has an excellent chance of successfully defending a claim on the basis of late notice and/or the pollution exclusion, an insurer can quickly lose the right to rely on these defenses if it does not immediately deny coverage. It is anticipated that courts applying New York law would find that bodily injury claims arising from exposure to mold trigger an insurer's duty to disclaim under New York Insurance Law Section 3420(d). As such, every insurance practitioner may wish to maintain a heightened awareness for bodily injury claims, arising from exposure to mold or otherwise, that may fall within the parameters of this statute.

California Code Of Regulations, Title 10. Chapter 5

Section 2695.7.

Standards for Prompt, Fair and Equitable Settlements

(a) No insurer shall discriminate in its claims settlement practices based upon the claimant's race, gender, income, religion, language, sexual orientation, ancestry, national origin, or physical disability, or upon the territory of the property or person insured.

(b) Upon receiving proof of claim, every insurer, except as specified in subsection 2695.7(b)(4) below, shall immediately, but in no event more than forty (40) calendar days later, accept or deny the claim, in whole or in part.

(1) Where an insurer denies or rejects a first party claim, in whole or in part, it shall do so in writing and shall provide to the claimant a statement listing all bases for such rejection or denial and the factual and legal bases for each reason given for such rejection or denial which is then within the insurer's knowledge. Where an insurer's denial of a first party claim, in whole or in part, is based on a specific policy provision, condition or exclusion, the written denial shall include reference thereto and provide an explanation of the application of the provision, condition or exclusion to the

claim. Every insurer that denies or rejects a third party claim, in whole or in part, or disputes liability or damages shall do so in writing.

* * *

3) Written notification pursuant to this subsection shall include a statement that, if the claimant believes the claim has been wrongfully denied or rejected, he or she may have the matter reviewed by the California Department of Insurance, and shall include the address and telephone number of the unit of the Department which reviews claims practices.

* * *

(c)

(1) If more time is required than is allotted in subsection 2695.7(b) to determine whether a claim should be accepted and/or denied in whole or in part, then, every insurer shall provide the claimant, within the time frame specified in subsection 2695.7(b), with written notice of the need for additional time. This written notice shall specify any additional information the insurer requires in order

to make a determination and state any continuing reasons for the insurer's inability to make a determination. Thereafter, the written notice shall be provided every thirty (30) calendar days until a determination is made or notice of legal action is served. If the determination cannot be made until some future event occurs, then the insurer shall comply with this continuing notice requirement by advising the claimant of the situation and providing an estimate as to when the determination can be made.

* * *

(f) Except where a claim has been settled by payment, every insurer shall provide written notice of any statute of limitation or other time period requirement upon which the insurer may rely to deny a timely claim. Such notice shall be given to the claimant not less than sixty (60) days prior to the expiration date; except, if notice of claim is first received by the insurer within that sixty days, then notice of the expiration date must be given to the claimant immediately. With respect to a first party claimant in a matter involving

an uninsured motorist, this notice shall be given at least thirty (30) days prior to the expiration date; except, if notice of claim is first received by the insurer within that thirty days, then notice of the expiration date must be given to the claimant immediately. This subsection shall not apply to a claimant represented by counsel on the claim matter.

Florida Statute Addressing Reservation Of Rights

Florida has a particularly insured oriented statute that requires the insurer to

SAMPLE NOTICE - Not part of the statute

Under the Unfair Claims Practices Acts Regulations, you have the right to have the Department of Insurance review any questions you may have. Their telephone number is 1-800-927 HELP, or 213-987-5061. Their address is:

California Department of Insurance
Claims Services Bureau, 11th Floor
300 South Spring Street
Los Angeles, CA 90013

provide a reservation of rights notice to the insured within 30 days of gaining knowledge of coverage defenses under the policy. Fla. Stat. ch. 627.426(2)(a). Within 60 days after complying with the 30 day requirement or receiving a copy of the summons and complaint against the insured, whichever is later, the insurer must fully disclose the specific facts and policy provisions on which its defense is based and obtain a nonwaiver agreement from the insured and obtain independent counsel. Fla. Stat. ch. 627.426(2)(b)(2) (West 1996). The statute provides in part as follows:

(2) 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 defense 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.

Virginia Statute Addressing Reservation Of Rights

Virginia requires notice within 45 days of the insurer's discovery of coverage defenses. Va. Code §38.2-2226. This statute provides in part that:

> Whenever any insurer on a policy of liability insurance discovers a breach of the terms or conditions of the insurance contract by the insured, the insurer shall notify the claimant or the claimant's counsel of the breach. **Notification shall be given within forty-five days after discovery** by the insurer of the breach or of the claim, whichever is later. Whenever, on account of such breach, a nonwaiver of rights agreement is executed by the insurer and the insured, or a reservation of rights letter is sent by the insurer to the insured, **notice of such action shall be given to the claimant or the claimant's counsel within forty-five days** after that agreement is executed or the letter is sent, or after notice of the claim is received, whichever is later. Failure to give the notice within forty-five days will result in a waiver of the defense based on such breach to the extent of the claim by operation of law. (Emphasis added).

Va. Code Ann. §§ 38.2-2226 (2003) further states that "insurer shall give notice of reservation of rights in writing to the claimant, ... not less than thirty days prior to the date set for trial of the matter. ... Failure to give the notice within thirty days of the trial date, or such shorter period as the court may have allowed, shall result in a waiver of the defense based on such breach to the extent of the claim by operation of law."

Montana Statute Addressing Reservation Of Rights

Montana has enacted M.C.A. § 33-18-201 that states that: "No person may, with such frequency as to indicate a general business practice, do any of the following… fail to promptly provide 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." This provision does not impose a specific time but, it does provide a statutory basis for an insured to claim unfair claims handling if a reservation of rights or denial is not issued within a reasonable time.

In Safeco Insurance Company v. Ellinghouse 725 P.2d 217 (1986), the court interpreted this statute and held that "where an insurer, without reservation and with actual or presumed knowledge, assumes the exclusive control of the defense of claims against the insured, it cannot thereafter withdraw and deny liability under the policy on the ground of noncoverage, prejudice to the insured by virtue of the insurer's assumption of the defense being, in this situation, conclusively presumed ... the loss of the right of the insured to control and manage the case is itself prejudicial." This suggests that any reservation must be issued prior to an appearance by counsel retained by the insurer. Under the Montana statute, a denial after 18 months would likely be unreasonable. Safeco Ins. Co. v. Ellinghouse, 725 P.2d 217 (Mont.,1986).

New Hampshire Statute Addressing Reservation Of Rights

New Hampshire has a particularly strict statute. New Hampshire's Declaratory Judgment Statute, Section 491:22 provides in part as follows:

> No petition shall be maintained under this section to determine coverage of an insurance policy unless it is filed within 6 months after the filing of the writ, complaint, or other pleading initiating the action which gives rise to the question; provided, however, that the foregoing prohibition shall not apply where the facts giving rise to such coverage dispute are

> not known to, or reasonably discoverable by, the insurer until after expiration of such 6-month period; and provided, further, that the superior court may permit the filing of such a petition after such period upon a finding that the failure to file such petition was the result of accident, mistake or misfortune and not due to neglect. A petition for declaratory judgment to determine coverage of an insurance policy may be instituted as long as the court has personal jurisdiction over the parties to the matter, even though the action giving rise to the coverage question is brought in a federal court or another state court.

Pursuant to this statute, the declaratory judgment must be initiated within 6 months of the underlying complaint unless one of the exceptions is satisfied. This statute "does not set forth a discovery rule such that the six-month period begins to run from the date of the discovery of the facts giving rise to the dispute over insurance coverage." Hartford Ins. Co. v. Bird, 124 N.H. 784, 786, 480 A.2d 4, 5 (1984). Rather, the six-month period runs from the date the underlying writ is filed. Quincy Mutual Fire Ins. Co. v. Croteau, 127 N.H. 676, 678, 506 A.2d 303, 305 (1986). If, however, the facts giving rise to a coverage dispute are not known or reasonably discoverable until after the expiration of the six-month period, then a declaratory judgment petition may still be filed within a reasonable time frame (late discovery exception). Hartford Ins. Co., 124 N.H. at 786, 480 A.2d at 5.

An Insurer May Issue A Reservation Of Rights Letter Based Upon Known Extrinsic Facts

During its initial investigation, the insurer will typically review the complaint and policy to determine if there is a potential for coverage under the policy. In most jurisdictions, the insurer is permitted to conduct additional investigation regarding the facts in the underlying case. If the insurer discovers facts which remove the potential for coverage, it may use those extrinsic facts to deny coverage under the policy. For example, if the underlying complaint alleges battery and negligent bodily injury, and the insurer discovers that the defendant was convicted of an aggravated

assault in a criminal proceeding, the insurer may be permitted use that extrinsic evidence to deny coverage under intentional acts exclusion.

For the insured to establish a duty to defend, he or she "must prove the existence of a potential for coverage," while for the insurer to negate the existence of such a duty, it "must establish the absence of any such potential. In other words, the insured need only show that the underlying claim may fall within policy coverage; the insurer must prove it cannot. Swain et Al. V. California Casualty Insurance Co., 99 Cal.App.4th 1, 120 Cal.Rptr.2d 808, 811 (Cal.App. 1st Dist. 2002).

Facts extrinsic to the allegations of the complaint may give rise to a duty to defend when they reveal a possibility that the claim may be covered by the terms of the insurance policy. (Gunderson v. Fire Ins. Exchange (1995) 37 Cal.App.4th 1106, 1113-1114, 44 Cal.Rptr.2d 272; Horace Mann Ins. Co. v. Barbara B., supra, 4 Cal.4th at p. 1081, 17 Cal.Rptr.2d 210, 846 P.2d 792.) To trigger such a duty, however, "the extrinsic facts ... must be known by the insurer," if not "at the inception of the third party lawsuit," then "at the time of tender. Swain, Cal.Rptr.2d at 811.

Even if the face of the complaint does not suggest a potential for liability under the policy, the extrinsic facts known to the insurer can generate a duty to defend, because current pleading rules liberally allow amendment and the third party cannot be the arbiter of coverage. El-Com Hardware, Inc., et Al., v. Fireman's Fund Ins., 92 Cal.App.4th 205, 111 Cal.Rptr.2d 670 (Cal.App. 1st Dist. 2001).

If An Insurer Discovers Extrinsic Facts During The Course Of Litigation, It May Issue A Revised Reservation Of Rights Letter Or Deny Coverage

If an insurer initially defended an insured without a reservation of rights letter but then subsequently discovers through testimony or otherwise that a basis exists upon which to deny indemnification, the insurer may use those extrinsic facts and issue a new reservation of rights letter. Likewise, if the insurer discovers an additional basis upon which it may deny indemnification, the insurer may issue a revised reservation of rights letter.

Merely by conducting the defense of the insured, the insurer does not generally waive the right to issue a reservation of rights upon the discovery of extrinsic facts.

Once a duty to defend has arisen, it can be extinguished but, that requires very clear evidence. "[E]vidence extrinsic to the underlying complaint can defeat as well as generate a defense duty...." Montrose Chemical Corp. v. Superior Court, 6 Cal.4th 287, 291, 24 Cal.Rptr.2d 467, 861 P.2d 1153 (1993). In Waller v. Truck Ins. Exchange, Inc, the California Supreme Court stated: "[W]here the extrinsic facts eliminate the potential for coverage, the insurer may decline to defend even when the bare allegations in the complaint suggest potential liability. This is because the duty to defend, although broad, is not unlimited; it is measured by the nature and kinds of risks covered by the Policy. Peerless Lighting Corporation, v. American Motorists Ins. Co., 82 Cal.App.4th 995, 98 Cal.Rptr.2d 753 (Cal.App. 1st Dist. 2001).

Facts extrinsic to the complaint give rise to a duty to defend when they reveal the possibility the claim may be covered by the policy. Conversely, where such facts

eliminate the potential for coverage, the insurer may decline to defend even where the bare allegations of the complaint suggest potential liability. Pardee Const. Co. v. Ins. Co. of the West, 77 Cal.App.4th 1340, 92 Cal.Rptr.2d 443 (Cal.App. 4th Dist. 2000).

The duty to defend is a continuing one, arising upon tender and lasting until the underlying litigation is resolved, or until the insurer has established there is no potential for coverage. Horace Mann Ins. Co. v. Barbara B. (1993) 4 Cal.4th 1076, 1081, 17 Cal.Rptr.2d 210, 846 P.2d 792; Gray v. Zurich Insurance Co. (1966) 65 Cal.2d 263, 274, 276, 54 Cal.Rptr. 104, 419 P.2d 168; Waller v. Truck Ins. Exchange, Inc. (1995) 11 Cal.4th 1, 19, 44 Cal.Rptr.2d 370, 900 P.2d 619; Borg v. Transamerica Ins. Co. (1996) 47 Cal.App.4th 448, 454-455, 54 Cal.Rptr.2d 811.)

If a potential for coverage is created by the face of the complaint or through facts known to the insurer at the time of the tender, the insurer must defend the insured. If it is later discovered through extrinsic facts that there is no possibility of coverage under the policy, the insurer may issue a new reservation of rights or deny coverage. If a denial is made, the facts should be so clear that there is not even a potential, however small, of coverage under the policy. If an insurer wrongfully refuses to defend or denies after providing a defense, the insured may normally proceed as it wishes and seek all expenses back from the insurer and bring a tort action of bad faith against the insurer.

The Contents Of A Reservation Of Rights Letter

A typical reservation of rights letter will normally include the following provisions:

1) The letter should identify the insurance carrier, claim number and specific lawsuit at issue. The letter should clearly state that it is a reservation of rights letter.

2) The letter should acknowledge that the carrier has received notice of the suit from the insured.

3) The letter should provide specific facts regarding the claim to demonstrate that the insurer has conducted an initial investigation which factually supports the reservation of rights letter. Within the

discussion of the initial investigation, the lawsuit should be discussed in sufficient detail to identify the bases upon which the reservation of rights letter is being issued. This discussion should include the factual assertions, legal theories and relevant matter pertaining to the reservation of rights.

4) The reservation of rights letter should request additional information from the insured regarding any other applicable policies or facts which should be considered by the insurer in its coverage analysis.

5) The letter should sufficiently identify the policy upon which the reservation of rights is being issued. In the case of multiple policies, if the provisions are not sufficiently similar, the insurer may wish to issue several reservation of rights letter in order to avoid any argument that the letter was confusing or ambiguous to the insured. Similarly, if multiple suits are tendered, an insurer will want to issue separate letters for each suit to avoid the allegation of confusion.

6) If the request for defense did not come directly from the insured or if there were any unusual circumstances surrounding the request for coverage the letter should include a brief recitation of how the claim was presented to the insurer if the tender gives rise to a coverage issue.

7) Following the explanation of facts, the letter should set forth the policy provisions which may limit or preclude coverage. Each potential basis upon which coverage may be denied should be stated within the letter.

If there are bases that seem remote at the time the letter is drafted, the insurer can include language such as "in the event it is determined" or "If it is later found that …." in order to include every reasonable bases which coverage may later be denied.

8) The letter should state that it does not constitute a denial of insurance coverage and that the insurer is providing a defense to the insured subject to the reservation of rights. The letter should provide notice that the insurers actions do not constitute an admission of liability or an admission of coverage under the policy.

9) Within the situations requiring it, or the jurisdictions that require it, the insured should be informed of their right to independent counsel.

10) The letter should reserve a right to the insurer to amend or modify its position upon the discovery of additional extrinsic facts or information. In addition, the letter should retain the right to withdraw from the insured's defense and seek reimbursement if it is determined that there is no potential for coverage under the policy.

ESTOPPEL AND WAIVER

The Failure To Issue A Reservation Of Rights May Result In The Carrier Being Estopped From Asserting Coverage Defenses

If an insurer has knowledge of a basis upon which it may deny insurance coverage and it fails to issue a reservation of rights, it will likely be estopped from raising that defense. McKay v. Healthcare Underwriters Mutt. Ins. Co., 295 A.D.2d 686, 743 N.Y.S.2d 593 (Sup. Ct. App. Div. 2002).

An insurer contesting coverage "may defend the action with a reservation of rights, it may file a separate declaratory relief action, ... or it may simply deny the request and take its chance that the trier of fact in an action alleging bad faith breach of the contractual duty to defend will agree that no defense was owed." Amato v. Mercury Casualty Co., 18 Cal.App.4th 1784, 1792, 23 Cal.Rptr.2d 73 (1993) fn. omitted, overruled on another ground in Amato v. Mercury Casualty Co., 53 Cal.App.4th 825, 834-835, 61 Cal.Rptr.2d 909 (1997) When an insurer wrongfully refuses to defend, the insured is relieved of his or her obligation to allow the insurer to manage the litigation and may proceed in whatever manner is deemed appropriate. Drinnon v. Oliver, 24 Cal.App.3d 571, 580, 101 Cal.Rptr. 120 (1972) disapproved of on another ground in Johnson & Johnson v. Superior Court, 38 Cal.3d 243, 244, fn. 7, 211 Cal.Rptr. 517, 695 P.2d 1058 (1985).

In The Event An Insurer Issues A Reservation Of Rights But Fails To Identify A Policy Provision, The Insurer Will Likely Be Estopped From Relying Upon That Policy Provision

When an insurer fails to cite a policy provision within its reservation of rights letter, the insured will likely argue that the insurer is estopped from relying upon that provision. In many jurisdictions, prejudice on the part of the insured is required in order for the insurer to be estopped from asserting its coverage position.

In Some Jurisdictions, An Insurer May Seek Reimbursement Of Amounts Paid In Defense Of Its Insured Where It Is Later Determined That No Coverage Potentially Existed

If an insurer has appropriately reserved its rights, it may assert a right to recover defense or indemnification costs in may jurisdictions.

In one Florida case, the insurer specified the rights it reserved in a second letter as follows:

> This letter is to serve as a reservation of Colony's rights to deny coverage and/or defense under the Policy and/or applicable law and further, with respect to defense costs incurred or to be incurred in the future, to be reimbursed and/or obtain an allocation of attorney's fees and expenses if it is determined that there is no coverage.

In accepting the defense provided by Colony, G & E necessarily agreed to the terms on which Colony extended the offer. Colony Ins. Co. v. G & E Tires & Service, Inc., 777 So.2d 1034 (Fla.App. 1 Dist.,2000).

In contrast to the insurer's right to seek reimbursement, many states permit attorney fees for the insured if they prevail in a declaratory judgment coverage actions. Maine permits the insured to recover from a wrongful denial. Gibson v. Farm Family Mut. Ins. Co., 673 A.2d 1350 (Me. 1996).

In General Agents, the City of Chicago and Cook County sued Midwest Sporting Goods for creating a public nuisance by selling guns to inappropriate purchasers. Midwest tendered its defense to its liability insurer, General Agents Insurance Company of America ("Gainsco"). Gainsco denied coverage but defended under a reservation of rights. Within its reservation of rights letter, Gainsco stated that it was reserving the right "to recoup any defense costs paid in the event that it is determined that the Company does not owe Insured a defense in this matter." Gainsco also filed a declaratory judgment action against Midwest.

The trial court found in favor of Gainsco on the coverage issue and Gainsco then sought to recoup the amounts it paid for Midwest's defense. The trial court found in favor of Gainsco and ordered the reimbursement by Midwest to its insurer of Midwest's defense costs.

On appeal, Midwest argued that Gainsco paid defense costs pursuant to the insurance contract and the contract contained no provision allowing Gainsco to recover these defense costs.

The court in General Agents relied upon a 1903 decision wherein the parties entered into an express agreement to dispute payment under a contract while continuing to perform certain obligations under the contract. In City of Chicago v. McKechney, 205 Ill. 372 (1903), the parties to a contract made a new arrangement for resumption of work pending a final determination of the parties' rights in a lawsuit. The court in General Agents found that Gainsco offered a similar accommodation pending litigation to determine whether Gainsco owed Midwest the cost of defending the underlying lawsuit. The court in General Agents also reviewed the California decision of Buss v. Superior Court, 16 Cal. 4th 35, 939 P. 2d 766, 65 Cal. Rptr. 2d 366 (1997). In Buss, a dispute arose over the payment of defense costs following a tender. The insured and insurer entered into a formalized written agreement regarding the dispute of defense costs. After a finding of no coverage, the court in Buss ordered the insured to reimburse the insurer for the defense costs.

Midwest argued that this would place too much power in the hands of the insurer and that an insured would not have any finality as to defense costs. The court in General Agents stated that an insured may refuse to accept the funds on the conditions imposed by the insurer. The insurer would then be forced to choose whether to defend without a reservation of rights or to deny a defense and risk losing policy defenses if a court found it in breach of the insurance contract. Significantly, the court also found that Gainsco did not make the payments to the insured's counsel pursuant to the insurance contract. Instead, the court found that

Gainsco made the payments "as an accommodation pending litigation to determine whether Gainsco owed Midwest" a defense. By accepting payment of defense counsel, Midwest accepted the conditions Gainsco placed on the accommodation despite the non-existence of a formal or written agreement.

In General Agents Ins. Co. of Am., Inc. v. Midwest Sporting Goods, 812 N.E.2d 620 (Ill. App. 2004), a case of first impression and a split decision, a majority of the Illinois Appellate Court ordered an insured (Midwest) to reimburse its liability insurer (Gainsco) for costs paid to defend Midwest for claims not covered by Gainsco's policy. The majority's holding is expressly based upon the circumstances presented, where Midwest accepted defense payments knowing Gainsco intended to seek recovery of such costs if the underlying claims were ultimately found to fall outside of coverage.

Facts

The underlying nuisance suit was filed against Midwest in connection with gun sales to inappropriate purchasers. Gainsco denied coverage, but agreed to defend Midwest under a reservation of rights, including the right to recoup any defense costs paid if it was determined that Gainsco did not owe a defense in the matter. Gainsco filed a declaratory judgment action claiming it owed no duty to defend or indemnify Midwest.

A summary judgment ruling in favor of Gainsco was affirmed on appeal. Gainsco then sought to recoup the defense costs it previously paid to Midwest's counsel. The trial court awarded the costs to Gainsco and Midwest appealed. The decision was affirmed.

Analysis

The majority found Gainsco's payments of defense costs were not made pursuant to its insurance policy, but rather as an accommodation pending litigation to determine whether Gainsco actually owed Midwest a defense. Midwest accepted the conditions placed on the accommodation by accepting the checks it received. The majority found this arrangement similar to an accommodation upheld in City of Chicago v. McKechney, 68 N.E. 954 (1903), an Illinois Supreme Court case involving a construction contract. The majority also cited several out-of-state decisions and Grinnell Mut. Re. v. Shierk, 996 F.Supp. 836 (S.D. Ill. 1998), a case which predicted Illinois would follow California decisions which have allowed insurers to recoup defense costs after reserving the right to do so.

The majority suggested that if Midwest had refused to accept a defense on the conditions imposed by Gainsco, it could have forced Gainsco to either defend without a right of reimbursement, or to deny coverage entirely and risk a loss of policy defenses if a court later found it in breach of its insurance contract.

The dissent opined that the majority's decision was not supported by Illinois case law and pointed to various cases from other jurisdictions which supported the opposite conclusion. The dissent also disagreed with the majority's suggestion that

Midwest could have refused the defense under the terms offered as "wrong," and opined that the burden instead was on Gainsco to file a declaratory action before agreeing to defend.

Learning Point: When preparing reservation of rights letters for liability carriers, counsel should include a reservation of the right to seek reimbursement of any defense costs paid for uncovered claims. If an insured agrees to the arrangement, the carrier may be able to obtain reimbursement if a court finds it owed no duty to defend the underlying claims. If an insured refuses to accept a defense under such a reservation of rights, the insurer should consider filing a declaratory judgment action, so as to avoid any claim of estoppel as to its coverage defenses.

THE ETHICAL ISSUES CREATING AN INSURED'S RIGHT TO INDEPENDENT COUNSEL UNDER A RESERVATION OF RIGHTS LETTER AND POTENTIAL CONFLICTS OF INTEREST

The Right to Independent Counsel

Common Law Right to Independent Counsel

There is a contractual right of an insurer to select counsel for the insured in the tender of a defense under reservation of rights, it is well settled that the insured must have the right to reject this tender. Rhodes v. Chicago Ins. Co., 719 F.2d 116, 120 (5th Cir.1983) "When a reservation of rights is made, however, the insured may properly refuse the tender of defense and pursue his own defense." Where the insured refuses to enter into an agreement permitting insurer to defend with reservations, and communicates to the insurer a denial of the latter's right to so defend with reservation... and thereafter the insurer fails to withdraw and continues to represent the insured in defense of the suit, the law is clear that the insurer has waived its right to withdraw, and will be estopped to later assert such right when sued by the insured for failure to properly defend. Yuen Shee v. London Guar. & Accident Co., 40 Haw. 213, 232 (1953)

In many jurisdictions, the insured retains the right to refuse to accept a defense under a reservation of rights. In Safeco Ins. Co. of America v. Rogers, 968 S.W.2d 256 (Mo.App. W.D.,1998), the insured retained the right to reject defense counsel supplied by the insurer. The court stated that the Missouri rule provides that the insurer forfeits the right to participate in the defense if it wishes to reserve its rights.

Statutory Right to Independent Counsel

Pursuant to the decisions in San Diego Navy Fed. Credit Union v. Cumis Ins. Soc. Inc., 162 Cal.App.3d 358, 208 Cal.Rptr. 494 (Ca. App. 1985) superceded by CA Civil Code Section 2860, an insured has a right to select its own counsel when a conflict with the insurer arises. The California legislature has codified the Cumis decision in the California Civil Code Section 2860.

In summary, the statute requires that the insurer offer the right to the insured to select its own counsel when a conflict arises. The insured can waive this right and continue with the counsel selected by the insurer. The conflict addressed by the statute can arise in many forms. Circumstances that may create a conflict of interest requiring a liability insurer to provide independent counsel to the insured include the following:

(1) the insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by the insurer's retained counsel;

(2) the insurer insures both the plaintiff and the defendant;

(3) the insurer has filed suit against the insured, whether or not the suit is related to the lawsuit the insurer is obligated to defend;

(4) the insurer pursues settlement in excess of policy limits without the insured's consent and leaving the insured exposed to claims by third parties; and

(5) any other situation where an attorney who represents the interests of both the insurer and the insured finds that his or her representation of the one is rendered less effective by reason of his or her representation of the other. *James 3 Corp. v. Truck Ins. Exchange,* 111 Cal.Rptr.2d 181, 91 Cal.App.4th 1093 (Cal.App. 2001). A sample Cumis letter is attached as Appendix 3.

CONCLUSION

The general purpose behind a reservation of rights letter is to place the insured on timely notice of coverage issues so that it can make an informed decision in its defense. When reviewing whether an action is permitted within or during the issuance of a reservation of rights, general notice rules and the duty of good faith overshadow the court decisions regarding these notices. Actions taken within a reservation of rights letter should be thought of in these terms. As a starting point in any letter, consider how a reviewing court may view the language used, the timeliness of the letter and the bases asserted within the letter. If your review of the letter leaves you with the conclusion that it provides fair notice of bona fide coverage issues, it is possible that it meets most requirements in most jurisdictions. As always, you should review the specific law within the jurisdiction to confirm this.

Appendix 1

Florida Statute § 627.426

(1) Without limitation of any right or defense of an insurer otherwise, none of the following acts by or on behalf of an insurer shall be deemed to constitute a waiver of any provision of a policy or of any defense of the insurer thereunder:

(a) Acknowledgment of the receipt of notice of loss or claim under the policy.

(b) Furnishing forms for reporting a loss or claim, for giving information relative thereto, or for making proof of loss, or receiving or acknowledging receipt of any such forms or proofs completed or uncompleted.

(c) Investigating any loss or claim under any policy or engaging in negotiations looking toward a possible settlement of any such loss or claim.

(2) 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 defense 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.

Florida Statute § 627.426

Appendix 2

California “Cumis” Statute

Civil Code Section 2860

(a) If the provisions of a policy of insurance impose a duty to defend upon an insurer and a conflict of interest arises which creates a duty on the part of the insurer to provide independent counsel to the insured, the insurer shall provide independent counsel to represent the insured unless, at the time the insured is informed that a possible conflict may arise or does exist, the insured expressly waives, in writing, the right to independent counsel. An insurance contract may contain a provision which sets forth the method of selecting that counsel consistent with this section.

(b) For purposes of this section, a conflict of interest does not exist as to allegations or facts in the litigation for which the insurer denies coverage; however, when an insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim, a conflict of interest may exist. No conflict of interest shall be deemed to exist as to allegations of punitive damages or be deemed to exist solely because an insured is sued for an amount in excess of the insurance policy limits.

(c) When the insured has selected independent counsel to represent him or her, the insurer may exercise its right to require that the counsel selected by the insured possess certain minimum qualifications which may include that the selected counsel have (1) at least five years of civil litigation practice which includes substantial defense experience in the subject at issue in the litigation, and (2) errors and omissions coverage. The insurer's obligation to pay fees to the independent counsel selected by the insured is limited to the rates which are actually paid by the insurer to attorneys retained by it in the ordinary course of business in the defense of similar actions in the community where the claim arose or is being defended. This subdivision does not invalidate other different or additional policy provisions pertaining to attorney's fees or providing for methods of settlement of disputes concerning those fees. Any dispute concerning attorney's fees not resolved by these methods shall be resolved by final and binding arbitration by a single neutral arbitrator selected by the parties to the dispute.

(d) When independent counsel has been selected by the insured, it shall be the duty of that counsel and the insured to disclose to the insurer all information concerning the action except privileged materials

relevant to coverage disputes, and timely to inform and consult with the insurer on all matters relating to the action. Any claim of privilege asserted is subject to in camera review in the appropriate law and motion department of the superior court. Any information disclosed by the insured or by independent counsel is not a waiver of the privilege as to any other party.

(e) The insured may waive its right to select independent counsel by signing the following statement: "I have been advised and informed of my right to select independent counsel to represent me in this lawsuit. I have considered this matter fully and freely waive my right to select independent counsel at this time. I authorize my insurer to select a defense attorney to represent me in this lawsuit."

(f) Where the insured selects independent counsel pursuant to the provisions of this section, both the counsel provided by the insurer and independent counsel selected by the insured shall be allowed to participate in all aspects of the litigation. Counsel shall cooperate fully in the exchange of information that is consistent with each counsel's ethical and legal obligation to the insured. Nothing in this section shall relieve the insured of his or her duty to cooperate with the insurer under the terms of the insurance contract.

Appendix 3

Sample Cumis Letter

CERTIFIED MAIL - RETURN RECEIPT

Re: Case Name:
Claimant:
Insured:
Policy No.:
Date of Loss:
Dear :

Insurance Company issued policy No. 7654321 to Insured, effective from January 1, 2021 through January 1, 2022 with liability limits of $2 million per occurrence and $2 million in the aggregate. Defendant Insured is an insured under the policy. We have had an opportunity to review the Complaint filed in *Plaintiff v. Defendant Insured.,* Superior Court, San Diego, California, Case No.1234567, (the "*Plaintiff*" suit), as well as the applicable law.

Insurance Company has issued a reservation of rights pursuant to the terms and conditions within the policy. Insurance Company has agreed to participate in the defense of Defendant Insured subject to a full and complete reservation of its rights under the policy identified above. Pursuant to *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc. Inc*., 162 Cal.App.3d 358, 208 Cal.Rptr. 494 (Ca. App. 1985) superceded by CA Civil Code Section 2860, you have the right to select defense counsel of your own choosing. Insurance Company has selected Defense Firm as your defense counsel. You have the right to continue with this selection or select counsel of your choice.

If you elect to continue with the counsel currently selected by Insurance Company, please sign this letter in the space below and return it to the address stated above. If you elect to have different counsel represent you, please provide us with the name, address and phone number of that attorney at your earliest opportunity. Please also have that attorney contact the undersigned at their earliest opportunity. If you have any questions regarding this matter, please contact the undersigned

Very Truly Yours,

Insurance Company Representative

I have been advised and informed of my right to select independent counsel to represent me in this lawsuit. I have considered this matter fully and freely waive my right to select independent counsel at this time. I authorize my insurer to select a defense attorney to represent me in this lawsuit.

_____

On Behalf of