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**What to Do and Not to Do When Defending
Insureds Under Reservation of Rights:
Avoiding the Bad Faith Set Up**

PLAN Regional Meeting

February 25, 2010

Presented By: Ivan J. Dolowich

The Insurer's Options

- The liability Insurer has three (3) options when it is faced with a claim where the availability of coverage is in question:
 - (1) Commence a declaratory judgment action regarding its coverage obligations;
 - (2) Issue a disclaimer/denial of coverage letter;
 - (3) Defend the Insured under a **Reservation of Rights**; or
 - (4) Undertake the defense of the Insured without any formal coverage determination.



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Reservation of Rights: The Basics

- A Reservation of Rights letter places the Insured on notice that certain coverage defenses may apply which could limit or preclude coverage for the underlying claim.
- A Reservation of Rights letter enables the Insurer to continue its coverage investigation and in the interim, defend an Insured either in whole or in part, without waiving its right to later deny coverage based on information revealed by that investigation.



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Who it Protects

- The Insurer's interests are protected if they timely issue a Reservation of Rights letter, which places the Insured on notice of potential coverage defenses that can ultimately limit or preclude coverage.
- The Insured's interests are protected because timely receipt of the Reservation of Rights letter enables the Insured to take the appropriate steps to protect its potential uninsured interests.



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Conditioning Acceptance

- The Insurer can condition its acceptance of the defense on its right to later contest coverage or seek reimbursement of defense costs.



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Reserving Rights – When Should it Be Done?

- Once an Insurer is aware that there may be coverage issues, the Insurer must act quickly to preserve its rights under the policy.
- Certain states require an Insurer to issue a Reservation of Rights letter within a particular time frame or face the risk of waiving its right to rely on these coverage defenses and be estopped from later raising those coverage defenses.



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Reserving Rights – When Should it Be Done? – continued

- In **Florida**, the Insurer must comply with Fla. Stat. ch. 627.426(2)(a), which provides that the insurer is required to provide the Insured with a reservation of rights within 30 days of gaining knowledge of coverage defenses under the policy.
- Then, within 60 days after complying with the 30 day requirement or 60 days after receiving a copy of the summons and complaint, whichever is later, the Insurer must fully disclose the specific facts and policy provisions on which the defense is based, obtain a non-waiver agreement from the insured, and obtain independent defense counsel.
- The defenses not raised in the reservation of rights notice are waived.



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Reserving Rights – When Should it Be Done? – continued

- **New York** Insurance Law §3420(d) requires the Insurer to notify the Insured of any basis of denying coverage as soon as reasonably possible.
 - A New York court has previously held that 4 months was unreasonable, however, it is fact specific.



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Reserving Rights – When Should it Be Done? – continued

- “An insurance company that assumes control of its policyholder’s defense in a lawsuit without issuing a proper reservation of rights may be estopped from later contesting coverage.” See, e.g., *Founders Ins. Co. v. Olivares*, 894 N.E.2d 586 (Ind. Ct. App. 2008).



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Reserving Rights – When Should it Be Done? – continued

- Generally, a non-waiver clause aims to preserve the Insurer’s rights and remedies if it fails, whether intentionally or by oversight, to take action in respect to properly reserving its rights.



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***Harleysville Lake States Ins. Co. v. Granite
Ridge Builders, Inc.,***

2009 WL 857412 (N.D. Ind. March 31, 2009)

- Courts have established certain requirements for a proper reservation of rights.
- Blanket statements that attempt to reserve all rights an insurer might have under its policy are generally inadequate.
- In Harleysville, the court held that the insurance company's reservation of rights letter was inadequate in the following particulars:



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***Harleysville Lake States Ins. Co. v. Granite
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- It failed to describe the claims or allegations in the complaint, including details of the facts known to the Insurer at the time;
- It failed to quote or reference the specific policy provisions that the insurance company contended precluded coverage or formed the basis of the coverage defenses and to explain their applicability;



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Harleysville Lake States Ins. Co. v. Granite Ridge Builders, Inc.,

2009 WL 857412 (N.D. Ind. March 31, 2009)

- It failed to provide a detailed explanation of the claim investigation that would be undertaken by the insurance company to reach a final coverage decision and a timeline for that decision; and
- It failed to advise regarding any issues that would actually or potentially give rise to a conflict of interest between the insurance company and its Insured.



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Harleysville Lake States Ins. Co. v. Granite Ridge Builders, Inc.,

2009 WL 857412 (N.D. Ind. March 31, 2009)

- The Harleysville court also held that a proper reservation of rights must be in writing, noting that an oral reservation of rights is “at odds with the purposes for a reservation of rights letter, which is to provide the Insureds with specific reasons for a reservation of rights and a non-coverage decision and to enable Insureds to make informed decisions.”



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Independent/CUMIS Counsel

- Sometimes reserving rights under certain coverage defenses can create a conflict of interest between the Insurer and Insured.
 - Fraudulent-Act Exclusion
 - Illegal Profit Exclusion
 - Other Exclusions requiring final adjudication
- In certain circumstances the Insurer may have a greater interest in establishing the application of an Exclusion rather than providing the Insured with a strong defense.



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Independent/CUMIS Counsel - continued

- Such conflicts may entitle the Insured to retain independent/CUMIS counsel at the Insurer's expense.
 - This right is recognized in many jurisdictions (including New York and California), on occasion by statute but mostly by case law.
- Generally, the underlying litigation must implicate an issue that is dispositive on coverage.



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Independent/CUMIS Counsel - continued

- However, not every reserved coverage defense creates a conflict.
 - Public Serv. Mut. Ins. Co. v. Goldfarb, et al., 53 N.Y. 2d 392,401 provides that a conflict of interest requiring retention of separate counsel will not arise in every case where multiple claims are made.
 - “Independent counsel is only necessary in cases where the defense attorney’s duty to the insured would require that we defeat liability on any ground and his duty to the insurer would require that he defeat liability only upon grounds which would render the insurer liable...[w]hen such a conflict is apparent, the insured must be free to choose his own counsel whose reasonable fee is paid by the insurer.”



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Independent/CUMIS Counsel - continued

- Many jurisdictions require an actual conflict.
 - *i.e.*, the Insurer must reserve rights to disclaim coverage and defense counsel must appear to have the ability to influence the outcome of the coverage issues.
- Some courts use a higher standard.
 - *E.g.*, requiring the Insured to first refuse the Insurer’s offer to provide a defense under a reservation of rights



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Independent/CUMIS Counsel - continued

- Other Circumstances Triggering Independent/Cumis Counsel
 - When multiple Insured defendants have conflicting interests.
 - When the Insurer's misconduct causes a conflict.
 - *E.g.*, If an Insurer wrongly refuses to authorize settlement and the Insured retains separate counsel to do so, the Insurer may be obligated to reimburse defense costs in addition to covering the settlement.



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Independent/CUMIS Counsel - continued

- While ethical duties may require defense counsel to identify the conflict and either obtain consent or withdraw as counsel, the Insurer may also have obligations to identify the conflict and right to Independent/Cumis counsel.
- In California, when issuing a Reservation of Rights letter, it is best practices to include a paragraph advising the Insured of its right to elect Independent/CUMIS Counsel.



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Independent/CUMIS Counsel - continued

- It is possible that failure to identify the conflict constitutes bad faith.
- However, this issue remains undeveloped by the courts.
 - Given this uncertainty, Insurers may want to err on the side of informing the Insured.
- Insureds may also contend that the failure to inform waives a Insurer's Independent/Cumis right to challenge the cost of counsel.



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Avoiding Bad Faith – Settlement Offers

- An Insurer can mitigate its exposure by reserving its right to dispute coverage but then accepting the settlement offer, thereby protecting it from exposure to an excess judgment.
 - If non-coverage is later determined, Insurer could then seek reimbursement of its settlement contribution from the Insured.
 - Of course, for practical purposes, the Insurer may prefer not to limit its recourse to subsequent recoupment.



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Avoiding Bad Faith - continued

- New York Standard
 - “Gross Disregard” of the Insured’s Interests
 - *i.e.*, deliberate or reckless failure to place on equal footing the Insured’s interests with the Insurer’s own interests.



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Avoiding Bad Faith – continued

- Factors Indicative of Gross Disregard
 - Likelihood of success of the underlying action
 - Potential exposure from failure to settle
 - Insurer’s failure to properly investigate the claim and potential defenses
 - Information available to an Insurer at time of demand
 - Other evidence tending to establish or negate bad faith

- New York permits an Insurer’s reasonable denial of coverage as a viable defense to a bad-faith action.



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Best Practices

- Timely send a Reservation of Rights Letter to the Insured alerting it to the multiple provisions of the Policy that may serve to limit or preclude coverage;
 - **The Letter Form**
 - Write out the dates;
 - February 25, 2010 instead of 2/25/10
 - Indent, in the “Re” line, both the category names and the information within the category;



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Best Practices - continued

- Eliminate unnecessary passive language;
- Instead of “We were advised by the adjuster...” write “The adjuster told us...”
- Avoid stuffy, old fashion language;
 - » - “please contact the undersigned...”
- Lead readers in and out of the policy language smoothly;



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Best Practices - continued

- Watch your tone
 - Guard against emotional language that shows your state of mind
 - Instead of “We cant proceed with your claim file until this information arrives...” use “Once this information arrives, we can proceed with the investigation.”
- Indent policy language and indent its subcategories
 - The eye will immediately recognize you are quoting the policy.



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Best Practices - continued

- Humanize the closing
 - Many judges are urging insurance companies to have their professionals write more conversational plain English.
- Close with “Sincerely” or “Regards” instead of “Respectfully” or “Very truly yours” or “Sincerely yours”



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Best Practices - continued

- Investigate the claim in order to determine if coverage applies;
- Notify the Insured of its right to seek Independent/Cumis counsel, if a conflict of interest between the Insurer and Insured is present.



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Questions and Answers



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