



# 2023 Insurance Roundtable

May 31 – June 2, 2023

## Reservation of Rights 101

Lawrence Dunn

*Moderator*

MCCANDLISH HOLTON, PC

Richmond, VA

[Ldunn@lawmh.com](mailto:Ldunn@lawmh.com)

Glenn Fencil

JOHNSON & BELL, LTD

Chicago, IL

[Fencilg@jbltd.com](mailto:Fencilg@jbltd.com)

### What is a Reservation of Rights Letter?

A Reservation of Rights ("ROR") letter is a written communication to policyholders notifying them of the carrier's coverage position and setting forth a company's assumption of defense, subject to coverage reservations. The ROR letter mainly affords the insurer an opportunity to undertake a more thorough factual investigation into the claim without waiving its rights to deny or limit coverage at a later date. In many jurisdictions, the ROR may allow the insurer to withdraw from the defense when there is no potential for coverage under the policy. The ROR letters allow insurers to decline indemnifying the insured for any portion of a judgment not covered under the policy. ROR letters, or non-waiver agreements, should be used when an insurer identifies either coverage or policy defenses.

#### *1. What is the Difference Between a ROR and a Non-Waiver Agreement?*

A ROR letter is generally a unilateral letter from the insurer to the insured. By contrast, the term "non-waiver agreement" is sometimes used to refer to a bilateral agreement (signed by both parties) between the insurer and the insured stating that the insurer's defense of the action against the insured will not result in a waiver of any rights by the insurer to later assert some defense to coverage. Other insurers use the term "non-waiver agreement" when referring to a letter sent to the insured immediately after the claim is tendered but before the insurer assumes the defense, to advise that any acts taken by the insurer in investigating the claim will not result in a waiver of coverage or policy defenses.

#### *2. What are Coverage Defenses?*

A coverage defense is one by which the liability insurer asserts that a given claim is or may not be covered by its policy.

#### *3. What are Policy Defenses?*

A policy defense is one by which the liability insurer admits coverage of the claim but asserts that the policy is not enforceable due to the breach of a policy condition by the insured. An example would be a breach of a policy condition such as late notice or voluntary payments.

#### *4. What is a Right to Reimbursement for Defense Fees?*

The ROR 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. Whether such a provision is enforceable depends on the jurisdiction.

In some jurisdictions, a ROR to recoup defense costs is only enforceable if it is later determined that there was no duty to defend; courts in those jurisdictions will not allow apportionment of defense costs between covered and non-covered claims.

#### *5. What is the Right to Reimbursement of Amounts Paid to Settle?*

In certain jurisdictions, an insurer that settles an action against its insured may be entitled to reimbursement of that portion of the settlement payment that is attributable to noncovered claims. It should be noted that to be entitled to reimbursement, the insurer must specifically reserve its right to do so. While the insured's agreement to reimbursement – and to the settlement – is generally not required, the insurer will need to establish that the amount paid to settle the noncovered claims was reasonable. In some jurisdictions, the insurer is required to notify the insured before entering into a settlement and allow the insured to assume its own defense if it is opposed to settlement.

### How to Draft a Reservation of Rights Letter

The ROR letter must contain certain information. Some of the specific information that should be included is listed below. But remember to always review your jurisdiction's applicable statutes, case law, and rules. Generally, timeliness, specificity, and clarity should be utmost in consideration of preparing a ROR letter. A well-drafted ROR letter should address the following:

#### *1. Timeliness*

Whenever it becomes evident to the insurer that a coverage defense or policy defense may exist, a ROR **must** be sent. Timeliness is vital, though there is generally no specific deadline for sending a ROR letter. Much depends on the issue of prejudice. If there is a justifiable reason for a delay in sending a ROR letter, that reason should be documented in the claim file and in the ROR letter itself. Ultimately, whether a ROR is timely or untimely will be dependent on the jurisdiction, venue, and facts surrounding the ROR.

#### *2. Necessary Matters*

##### *a. Identify Policy and Purpose of the Letter*

The ROR letter should be specific and concise so as to avoid confusion where the insured has multiple policies. To that end, the ROR letter should identify the policy under which the defense, and reservation, is provided. It should also include the date of loss and claim number for the sake of clarity. At, or very near, the beginning of the letter the insurer should state the purpose of the correspondence – to reserve the insurer's rights. This statement should be made in simple and easy to understand language. The statement should use the specific phrase "reservation of rights" to avoid any argument the insured did not understand the letter's purpose.

##### *b. Summarize the Pleadings and the Facts*

The ROR letter should contain a summary of the complaint, other pleadings related to the coverage or policy defense, and any facts relied on from sources outside the pleadings. Note-facts from outside the pleadings will only be allowed in a jurisdiction where extrinsic evidence may be considered in determining whether an insurer has a duty to defend.

##### *c. Policy Language*

The ROR letter should quote verbatim the specific policy provisions relied upon. The letter should not quote policy provisions that are clearly not implicated, but if there is some basis to believe that a policy provision may apply, the letter should quote the provision and state that it may also apply to preclude or limit coverage. When quoting a policy exclusion, any exception or qualification to that exclusion should also be quoted, unless clearly inapplicable.

##### *d. Identify Coverage and Policy Defenses Reserved*

Depending on the jurisdiction, a general ROR letter that does not adequately specify the coverage defenses may be inadequate. It must adequately inform the insured of the rights the insurer intends to reserve so that the insured can intelligently choose between retaining their own counsel or accepting the tender of defense counsel from the insurer. The letter should specifically mention that the insurer reserves its right to withdraw from the defense if it later determines there is no coverage.

The letter should also specifically note whether the insurer is reserving its right to seek reimbursement of defense costs expended in defending claims that are not covered. Ensuring

this is in the letter will clearly show the insurer is not denying coverage by virtue of the letter. By maintaining clarity, the insured will be precluded from asserting the insurer is denying coverage through the ROR letter.

To reiterate the importance of clarity, the letter should be easy for the insured to comprehend and should be free from any ambiguities or overly convoluted language. Reservation rights could be unenforceable where the ROR is not clearly and fairly communicated to the insured.

Lastly, the letter should include an offer to the insured to review any additional information that they may be aware of and should include a catch-all provision for any other defenses that could become pertinent. This may enable the ROR to be supplemented.

### *e. Continued Cooperation of the Policyholder*

The ROR should request the continued cooperation of the policyholder, especially if any further facts come to light, or if new or amended pleadings are served on the policyholder. This will allow the insurer to continue to reevaluate coverage.

### *f. Insured's Right to Own Counsel*

The ROR letter should set forth the policyholder's right to retain personal counsel at the policyholder's own expense. Failure to do so could render the ROR, or non-waiver agreement, invalid.

### *g. Conflict Triggering Insured's Right to Independent Counsel*

Some jurisdictions, including California, have statutory provisions, mandating that if and when a potential conflict of interest arises between the insured and the insurer, the insurer must inform the insured of its right to independent counsel and must provide independent counsel to the insured, unless the insured expressly waives, in writing, its right to independent counsel. Be sure to see if you operate in one of these jurisdictions. If so, the insurer should advise the insured of its right to independent counsel if the reservation of rights gives rise to a conflict of interest between the insurer and the insured.

### *h. Insurer's Right to File Declaratory Relief Action*

The insured should be informed of the possibility that the insurer may file a declaratory relief action. This provides the insured with notice that it may be faced with a second, additional, action to determine coverage. Informing the insured of such ensures the insured is given the opportunity to assess its risk.

### *i. Insurer's Right to Assert Other Policy Defenses*

It behooves the insurer to reserve the right to assert other defenses as they become known. This alerts the insured that a defense is not waived solely because the insurer is not yet aware it exists.

### *j. What Not to Include in the ROR*

Extraneous information that is not relevant to the ROR should not be included. The inclusion of facts and policy provisions that are not relevant open the insurer to the accusation that the ROR are being buried in the coverage defense letter.

### *k. Never Advise an Insured to Refrain from Seeking Counsel*

An insurer should generally refrain from expressly waiving a policy or coverage defense unless there is a tactical reason for doing so. One such tactical reason for waiving a defense is to avoid a conflict of interest that will trigger an insured's right to independent counsel in states where applicable.

### *l. Who Should Author the ROR*

The ROR should be printed on the carrier's letterhead and signed by a company representative. The ROR signatory may be deposed in any litigation which ensues between the parties. Therefore, the person who signs the ROR letter should be familiar with the claim and coverage issues existing when they sign the letter. This helps protect the insurer from claims of bad faith.

Some insurers prefer ROR letters to be signed by members of a management-level employee. This practice is safe so long as those employees are familiar with the claim and coverage issues when they sign the letter.

Coverage counsel should not sign any ROR letter. To do otherwise invites the possible waiver of attorney-client privilege.

### *m. How to Send the ROR Letter and Who to Send It To*

The ROR letter should be sent by certified mail, return receipt requested, to the insured's address set forth on the policy. If there has been any change of address, send it to the new address as well. If there are multiple insureds, send each insured a separate copy of the ROR letter. Coverage counsel should be blind copied.

Remember to only copy those parties who must be informed of coverage defenses. Do not copy the plaintiff's attorney or the attorney retained by the insurer to defend the insured. However, if the insured has personal counsel, they should receive a copy. It should be noted that advising the defense counsel of the coverage issues may create the appearance of a conflict of interest.

## ***3. Failure to Provide Right of Reservation or Deficient Right of Reservation – Waiver/Estoppel***

An insurer generally does not have a duty to reserve its rights on coverage and policy defenses of which it is not aware, but a ROR letter should be sent as soon as the insurance carrier becomes aware of a coverage or policy defense. There is generally no specific time by which an insurer must provide a reservation of rights letter to the insured. But an insurer runs the risk of waiving, or being estopped from asserting, its coverage and policy defenses if its reservation of rights letter is untimely.

Generally, the rule is that the doctrines of waiver and estoppel cannot be used to create insurance coverage where none exists under the terms of the policy. But many jurisdictions recognize exceptions to this rule where an insurer conducts an insured's defense without timely reserving its right to deny coverage. In this situation, the insurer cannot later disclaim coverage based on a policy defense. Most jurisdictions require that the insured demonstrate prejudice, or detrimental reliance, in order to defeat a reservation of rights.

Note that in some jurisdictions, an insurer's delay in or failure to promptly reserve its rights gives rise to a presumption of prejudice to the insured.

### ***4. Factors for Determining Waiver/Estoppel.***

In determining whether the insured has detrimentally relied on the absence of a reservation of rights by the insurer, courts look at many factors, including:

- Length of time before tender
- Length of time between tender and reservation
- Whether it was made with reservation or without reservation
- The stage of litigation when the insurer issues the reservation
- The insurer's diligence giving rise to coverage and policy defenses
- Whether the insured is represented by counsel
- Whether the insured exercised control over their defense

### ***5. Other Factors Arising from a ROR***

A ROR letter may create a potential conflict of interest between the insurer and insured, depending upon the nature of the reservation. For example, when the complaint against the insured alleges that property damage or bodily injury was both negligently and intentionally caused, an insurer may reserve its rights to deny coverage for any intentionally caused damage or injury. This creates a potential conflict of interest because the insurer-retained defense counsel may be able to control the insured's defense in such a way as to affect the outcome of the coverage issue.

In certain jurisdictions, such as California and Illinois, when a ROR creates a potential conflict of interest, insurers are required to notify the insured of the potential conflict and offer to provide the insured with independent counsel, paid for by the insurer.

The insured is not obligated to accept the offer of independent counsel. In some jurisdictions, the insured will be entitled to select independent counsel. But in other jurisdictions, the insurer retains this right. Make sure to review the rules in your jurisdiction to see duties.

Remember, not every ROR will create a potential conflict of interest. The key question is whether counsel retained by the insured has the ability to manipulate the outcome of the issues upon which coverage depends. For instance, in jurisdictions that do not permit insurance coverage for punitive damages, the mere existence of a punitive damage claim does not create a conflict of interest. This is because the interests of both the insurer and the insured are aligned: both want to minimize any award against the insured. In some jurisdictions, the key is whether the ROR creates a situation where the insurer will provide less than a vigorous defense.

### ***6. Filing a Declaratory Judgment Action.***

A dispute between the insurer and insured over coverage or the duty to defend may be resolved in a separate declaratory judgment action. Problems may arise, however, where the resolution of the coverage issue involves a determination of issues that are disputed in the underlying action against the insured – for instance, whether the insured intentionally harmed the third-party plaintiff. Additionally, an insured – especially one with limited financial means – may be prejudiced by having to defend two lawsuits simultaneously. Where such a conflict or prejudice exists, the court may stay the declaratory judgment action pending the resolution of the underlying third-party action.

### ***7. What to do when Insured Rejects***

In many jurisdictions, the insurer's unilateral ROR is enforceable. In some, however, the insurer must

## Reservation of Rights 101

---

obtain the agreement of the insured to the ROR. Where the insured's consent is required, it will usually be deemed granted if the insured tacitly acquiesces through silence, failure to object, or accepting money or the defense after being notified of the reservations.

If consent to the ROR is required – but rejected – by the insured, the insurer is then faced with the following options:

### *a. Offer an Unqualified Defense*

This is a business decision the insurer may choose to make after weighing the likelihood of success in litigating the coverage issues, the possibility of extracontractual damages, and the likelihood of a successful resolution of the underlying litigation. An unqualified offer to defend generally results in a waiver by the insurer of all policy and coverage defenses, but the insurer will have control of the defense, including control of settlement. This helps prevent against collusion between the insured and claimants.

### *b. Continue to Defend*

If the insurer continues to defend after the rejection of an offer of a defense subject to a reservation of rights, the insurer will be found to have waived all coverage defenses.

### *c. Withdraw from Defense*

If the insurer decides to stand by its offer to defend subject to a ROR, the insurer must immediately withdraw from the defense after the insured's rejection to avoid waiver of its coverage defenses. This is the best – and only – option to preserve an insurer's coverage defenses. In a case where there are both covered and non-covered claims, most jurisdictions hold that the withdrawal allows the insurer to apportion any judgment in the underlying case, so it is only required to pay for the covered claims.

### *d. Offer an Independent Defense*

The final option is to offer to defend the insured under a ROR letter but provide the insured independent counsel who will not be controlled by the insurance company. This eliminates the potential conflict of interest presented when the insured controls the defense while reserving coverage defenses that may be manipulated by the defense of the action.

## Conclusion

The most important thing to do when offering to defend under a ROR is to remember what the letter is accomplishing for you: the letter is preserving your right to assert coverage defenses and, possibly, seek reimbursement. Thus, it is important to do what you say you will do in the letter, and to follow up with all promises, actions, etc. If new pleadings are filed against the insured, always analyze whether the current reservation of rights letter adequately addresses the new allegations. If not, then you must issue a supplemental reservation of rights letter or else risk waiving that policy defense. Likewise, in jurisdictions in which evidence extrinsic to the complaint may be considered, you should regularly monitor the information provided by counsel and, if new information gives rise to additional policy or coverage defenses, supplement your reservation of rights letter accordingly.