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RECENT TRENDS CONCERNING RESERVATION OF RIGHTS IN NEW JERSEY

A reservation of rights letter creates difficult choices for both the insurance company and the policyholder. As such, this election by the insurance company can result in issues other than coverage or policy limits. Recent trends in New Jersey law deal with some of the issues that may arise.

Right to Control Defense of an Insured Under a Reservation of Rights

Under New Jersey law, insurers wishing to control the defense of an insured while simultaneously reserving the right to dispute liability can do so only with the consent of the insured. *Merchants Indemnity Corp. v. Eggleston*, 27 N.J. 114, 127 (1962) The insured's consent can be inferred from the insured's failure to reject an offer to defend, but if the insured consents by silence, the reservation of rights letter "must fairly inform the insured that the offer may be accepted or rejected." Id. at 127-128. When an insurer fails to inform an insured of the ability to accept or reject the terms of the defense, the insurer is estopped from later denying coverage.

In *Nazario v. The Lobster House*, et al., Docket No. A-3025-07T1 (App. Div. May 5, 2009) (unpublished decision), the Appellate Division expounded on that doctrine and held that two insurers were estopped from denying coverage because their reservation of rights letters were inadequate.

The *Nazario* case involved a bodily injury claim by a contractor's employee against Cold Spring Fish & Supply Co., d/b/a The Lobster House. Cold Spring had two primary policies that could potentially provide coverage: one from Essex Insurance Company and one from Sirius America Insurance Company. Both insurers responded to the notice of claim by Cold Spring with reservation of rights letters. Neither insurer advised the insured that their offers to defend may be accepted or rejected. Several months later, Cold Spring, Essex and Sirius all moved for summary judgment on the issue of coverage. The court found that Essex and Sirius were both right and that Cold Spring did not have coverage under either policy. However, the court held that both insurers were estopped from withdrawing coverage because both reservation of rights letters failed "to inform [Cold Spring] that the offer[s] (to defend) may be accepted or rejected."

The Appellate Division affirmed. Like the trial court, the Appellate Division relied on the simple rule that unless a reservation of rights letter specifically stated that the insured had the right to accept or reject the defense under those terms, it was inadequate. The court relied principally on the New Jersey Supreme Court's decision in *Merchants Indem. Corp. v. Eggleston*, 37 N.J. 114 (1962). The court found that since the insurers did not inform the insured that it had the right to reject the defense that they offered, the court found that the insured was in the same position as though the insurers had assumed the defense without a reservation of rights.

In *Gomez v. First Jersey Cas. Ins. Co.*, No. A-3928-08T1 (N.J. Super. Ct. App. Div. April 1,

2010)(unpublished decision), the insurer provided a defense to the insured under a reservation of rights to deny coverage based on late notice and the intentional act exclusion. The reservation of rights letter informed the insured of the coverage issues and advised that the insured may want to retain personal counsel, as coverage may be disclaimed in the future. The letter did not inform the insured that the offer of defense could be accepted or rejected. The insured did not respond to the letter.

After a verdict was entered against the insured, the insurer advised that it would not indemnify him because the intentional act provision of the policy excluded coverage. A declaratory judgment action was brought to challenge the denial. The Appellate Division held that the insured's silence in response to the reservation of rights letter could not be deemed consent to the defense under *Eggleston* because the insurer failed to inform the insured that he could reject the offer. Thus, the insurer was precluded from disclaiming coverage for a claim that could have been excluded under the policy.

The implications of these holdings could be damaging to an insurer defending a case under a reservation of rights, if an insurer fails to advise an insured that the insured has the right to accept or deny a defense offered under a reservation of rights.

Reservation of Rights Triggers Right to Independent Counsel

A reservation of rights letter will effectively inform the insured of potential conflicts with its insurer. In some jurisdictions, such potential conflicts may give the insured the right to independent counsel. The leading national case addressing the rights of policyholders with the respect to the right to independent counsel in “conflicts” cases is *San Diego Federal Credit Union v. Cumis Ins. Society*, 162 Cal. App.2d 358 (1984). Under the Cumis doctrine, when an insurer agrees to defend its insured under a reservation of rights, a conflict exists between the insurer and insured. In those instances, the insured has a right to retain independent counsel to be paid for by the insurer, commonly referred to as “*cumis* counsel."

New Jersey addressed the selection of counsel scenario long before the California court’s opinion in Cumis. See *Burd v. Sussex Mut. Ins. Co.*, 267 A.2d 7 (N.J. 1970). New Jersey does not recognize the insured’s right to unilaterally select defense counsel to be paid concurrently by the carrier when a carrier issues a reservation of rights letter. If the carrier desires to defend under a reservation of rights, the carrier cannot assume control of the defense absent the specific agreement by the insured to the reservation of rights after being informed of the conflict. In New Jersey, in the event the insured does not accept a defense or reservation of rights the insured is allowed to select its own defense counsel, *with a right of reimbursement from the carrier*, if it is later found in the underlying lawsuit that the claim falls within the ambit of coverage under the policy. *Burd*, 267 A.2d at 10-13; *Hartford Accident & Indemnity Co. v. Aetna Life & Casualty Insurance Co.*, 483 A.2d 402 (N.J. 1984).

Insurer’s Ability to Reserve Rights to Seek Reimbursement of Defense Costs

The California Supreme Court’s decision in *Buss v. Superior Court*, 16 Cal. 4th 35 (CA) (1997) is one example of the “majority” position on reimbursement under reservation of rights. Even though the California Supreme Court was not the first to hold that insurers could recoup defense fees for a defense provided under reservation of rights once it determined no coverage existed, its decision in *Buss* remains the most well-known case to so hold. Though widely considered the majority position, only seven states have actually permitted such reimbursement. New Jersey is one of those states. New Jersey permits reimbursement. See *Hebela v. Healthcare Ins. Co.*, 851 A.2d 75, 86 (N.J. App. Div. 2004) (applying equitable principle of “unjust enrichment,” court allowed recoupment of defense costs). The New Jersey Supreme Court held in *SL Indus., Inc. v. America Motorists Ins. Co.*, 607A.2d 1266, 1280 (N.J. 1992) that an insurer can seek reimbursement if it can

carry the burden to show defense costs that are allocable to non-covered claims. However, it has been argued that Buss's duty to reimburse rule is inconsistent with New Jersey's broad duty to defend.

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