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NATIONAL TRENDS AND IMPLICATIONS CONCERNING RESERVATION OF RIGHTS: WHAT EVERY INSURANCE PROFESSIONAL MUST KNOW

Insurance carriers and coverage professionals are often confronted with a variety of issues related to the duty to defend and the duty to indemnify. The duty to defend is generally broader than the duty to indemnify. The duty to defend is based upon allegations and potential coverage. A suit that triggers the duty to defend does not necessarily mean there is coverage.

A situation arises when the claims alleged include both covered and uncovered claims or where there appears to be a question as to whether the claims alleged fall within the scope of coverage. Under these circumstances, the insurer will often agree to defend its insured through a reservation of rights letter. 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.

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.”

Several jurisdictions have adopted the position set forth in *Cumis* that the issuance of a reservation of rights constitutes a per se conflict of interest. These jurisdictions have determined that a policyholder is entitled to representation by independent counsel whenever the insurer issues a reservation of rights. Those states include: Florida, Kentucky, Louisiana, Massachusetts, Missouri, Texas, and Washington.

Three years after *Cumis* was decided, the California State Legislature enacted Civil Code section 2860 modifying Cumis and limiting the duty of an insurer to provide independent counsel. Where the *Cumis* court required an insurer to provide independent counsel merely because of a potential conflict of interest, the statute imposes a duty only where “a conflict of interest arises” and states that a conflict does not necessarily arise simply because the insurer has reserved its rights.

Similar to California, several other jurisdictions have held that the existence of a reservation of rights letter does not automatically give rise to a conflict of interest between the insurer and the insured with regard to the conduct of the insured's defense and instead determine whether independent counsel is necessary based on (1) whether the insurer would be able to direct the policyholder’s defense in a manner adverse to the insured on the disputed

December 2010
November 2010
October 2010
September 2010
August 2010
July 2010
June 2010
May 2010
April 2010
March 2010
February 2010
January 2010

coverage issue and/or (2) which party (insurer or insured) bears the greater financial stake in the underlying litigation

The jurisdictions that require an actual or potential conflict include: Alabama, Alaska, Arizona, Arkansas, California, Hawaii, Illinois, Kansas, Maine, Maryland, Minnesota, Nebraska, New Hampshire, New Jersey, New York, North Carolina, New Mexico, North Dakota, Ohio, Oklahoma, Pennsylvania, South Carolina, South Dakota, Utah, and Vermont.

Almost all courts find a conflict of interest where the underlying complaint alleges mutually exclusive covered and non-covered theories of recovery, such as negligence and intentional torts, because of the danger that an insurer might deliberately defend the policyholder in a manner that would result in a finding of liability only on non-covered claims.

Issues Related To Control of Defense

Once it is decided that the insured is entitled to independent counsel and that the insurer is responsible to reimburse this counsel, issues frequently arise as to the conduct of the defense. These issues include (1) the reasonableness of the attorney's fees and expenses and attempts by an insurer to manage litigation costs; (2) whether the insurer or the policyholder controls the defense; and (3) whether the insurer or policyholder controls settlement.

Reasonableness of Defense Costs

Carriers argue that they should only be required to pay independent counsel the rates that they normally pay their defense counsel. Some carriers now include provisions in their policies stating this position. Similarly, Alaska and California have enacted statutes declaring that in independent counsel situations, the reasonableness of defense costs must be measured from the carrier's perspective based upon what the carrier typically pays defense counsel.

However, courts generally hold that the insurer's obligation extends to reimbursing counsel for its "reasonable" fees and expenses incurred in conducting the defense. See *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc.*, Inc., 208 Cal. Rptr. 494 (Ct. App. 1984). There is a vast amount of case law from each jurisdiction that defines what constitutes a reasonable fee for independent counsel.

Control of Defense Under Reservation of Rights

Courts addressing this issue have concluded that where a conflict arises, the insurer's contractual right to control the defense must give way to its contractual obligation to defend the insured. These courts hold that, in conflict situations, the insurer must surrender control of the litigation to the policyholder's independent counsel. Even those jurisdictions that permit the insurer to select independent counsel hold that the control of the defense must be surrendered to the policyholder. See *Penn Aluminum v. Aetna Cas. & Sur. Co.*, 402 N.Y.S.2d 877 (App. Div. 1978); *Handy v. First Interstate Bank*, 16 Cal. Rptr. 770 (Ct. App. 1993); see also, *Previews, Inc. v. California Ins. Co.*, 640 F.2d 1026 (9th Cir. 1981); *Union Ins. Co. v. The Knife Co.*, 902 F. Supp. 877 (W.D. Ark. 1995); *Federal Ins. Co. v. X-Rite Inc.*, 748 F. Supp. 1223 (W.D. Mich. 1990).

However, some courts have concluded that while the policyholder's independent counsel maintains control over the litigation, the insurer's own counsel may also participate in the underlying litigation. See *Maryland Cas. Co. v. Peppers*, 355 N.E.2d 24 (Ill. 1976); *Prahm v. Rupp. Constr. Co.*, 277 N.W.2d 389 (Minn. 1979). Statutes enacted in California and Alaska suggest the same.

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)

Control of Settlement Under Reservation of Rights

Issues can arise regarding an insured's ability to control litigation when represented by insurer appointed counsel. One such issue is the control of settlement. There are three approaches as to how defending under a reservation of rights may impact an insurer's right to control the settlement:

Approach 1: The majority rule is exemplified by the decision of the Arizona Supreme Court in *United Services Auto Ass'n v. Morris* , 741 P.2d 246 (1987). In Morris the court held that the solution to the conflict created by a defense under a reservation of rights is to permit the insured to reject a defense offered under a reservation, thereby forcing the insurer to either defend unconditionally (thus accepting coverage) or to refuse to defend at all. In sum, the Morris court held that the consent to settle clause prevents an insured from settling claims only where the insurer unconditionally assumes liability under the policy. However, where the insurer reserves the privilege to deny the duty to pay, it relinquishes control of the litigation to the insured.

Approach 2: The second line of cases identified by the Superior Court is exemplified by the Eighth Circuits opinion in *Vincent Soybean & Grain Co, Inc. v. Lloyd's Underwriters of London*, 246 F. 3d 1129 (8th Cir. 2001). These decisions hold, generally, that when an insurer tenders a defense subject to a reservation of rights it retains full authority under a consent to settle provision. The insured's rights are protected by its ability to sue the insurer for bad faith in the event that the insurer fails to settle and a verdict in excess of policy limits ensues. In that scenario, the insured can recover the excess judgment if it is determined that the insurer's failure to settle within policy limits was unreasonable.

Approach 3: When an insurer offers to defend under a reservation of rights, the insured can choose to: 1) accept the defense, in which case the insurer has exclusive control over defense and settlement, including the consent to settle provision, or 2) reject the insurer's qualified defense and then retain its own counsel and control its own defense at the insured's expense. Under the second option, the insured is not bound by the consent to settle provision of the policy. The insured retains full control of its defense, including the option of settling the underlying claim under terms it believes is best. So long as the settlement is fair, reasonable and non-collusive, the insurer will be obligated to reimburse its insured. This approach was derived from the Florida case, *Taylor v. Safeco Ins. Co.*, 361 SO.2d 743 (Fla.Ct.App. 1978), as well as a line of Missouri cases. The Pennsylvania Superior Court in *Babcock & Wilcox Co. v. American Nuclear Insurers*, 2013 Pa. Super. 174 (2013) adopted this approach.

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