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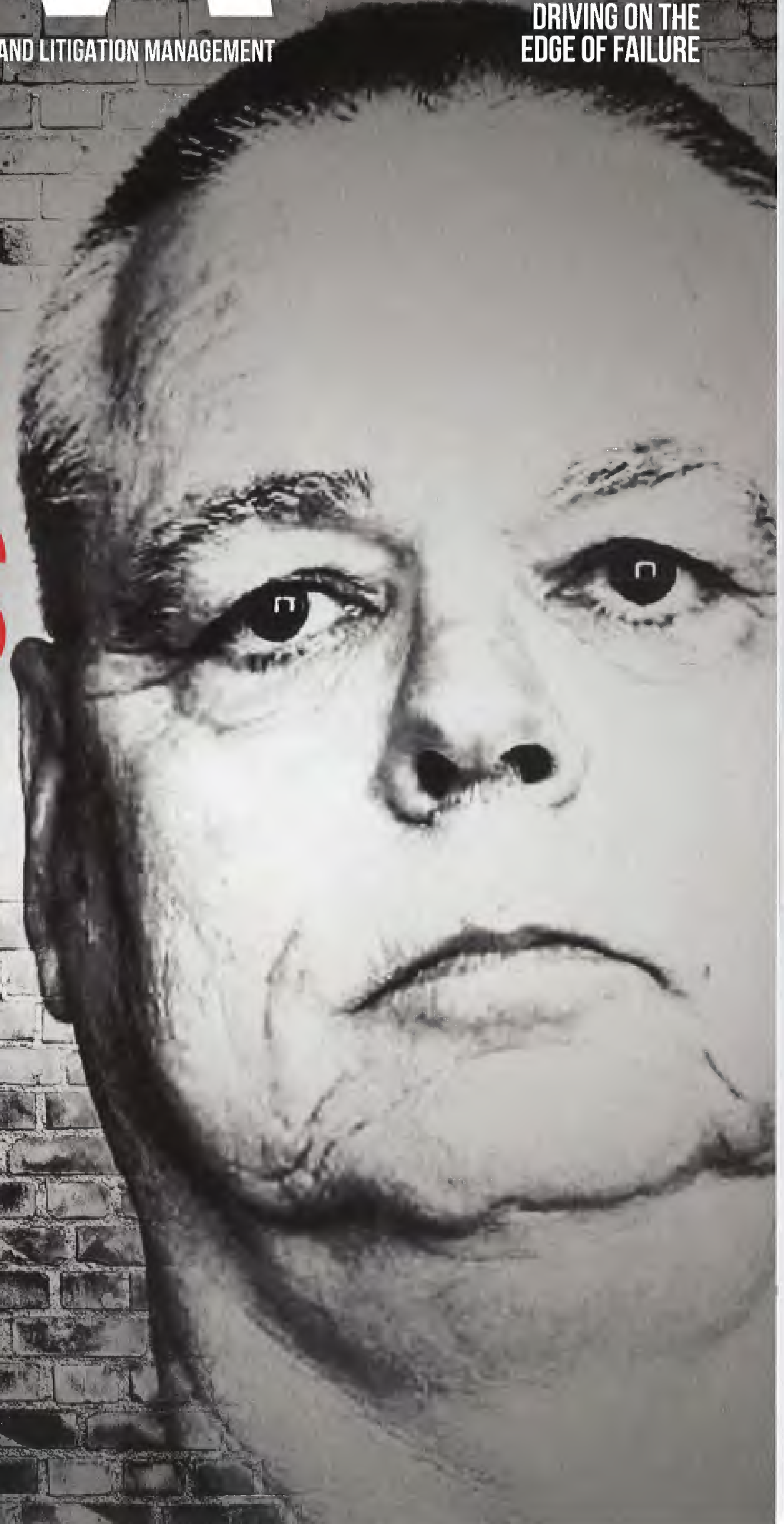

BEYOND THE TEMPLATE

Write an Effective Reservation of Rights Now and Avoid Trouble Later

By Martetta Thompson and Mark Mills

When an insurer is uncertain if its policy covers the liability alleged against an insured, a reservation of rights letter allows the insurer to protect its right to deny payment for the insured's liability. Many of us believe we know how to write an effective reservation of rights letter (thank you very much!). We may even have a handy template allowing us to efficiently draft a reservation of rights.

Recently, however, there have been cases and commentary about insurers losing coverage defenses because of shortcomings in their reservation of rights letters. How can you avoid this fate and comply with the most important requirements of reservation of rights letters? Here are some suggestions.

State the obvious. Using the words "reservation of rights" aids the letter's purpose. As its name implies, a reservation of rights protects, or reserves, the insurer's right to deny coverage for the insured's liability. Accordingly, and preferably more than once in the letter, use the words "reservation of rights."

Ensure proper receipt of the reservation of rights. Anyone who has dealt with contractors being sued for poor workmanship knows that their addresses can change frequently, so be sure to check the address on the declarations page. In addition, multiple parties could be named in a lawsuit, including the named insured, its employee, and an additional insured. It is important that the insurer identify all parties who could be insureds, correctly address the reservation of rights, and try to make sure the reservation of rights letter reaches all parties being defended.

If an insured can credibly argue that it never received the reservation of rights, the letter may be ineffective. Insurers sometimes must prove that they either delivered the reservation of rights to the insured, or made every reasonable effort to deliver it.

Because a sent email shows delivery to a valid email address, delivering the

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reservation of rights by email is usually sufficient if the insured is a viable and well-established business and the carrier and insured have been communicating by email. If the insured is an individual, the professional status of the insured is doubtful, the insured is expected to be hard to find, or, for whatever reason, the carrier believes the insured's receipt of the reservation of rights might become an issue, then the letter should be sent by certified mail.

Correctly identify the policy or policies, and get the language right. In the letter's "Re:" line, list all relevant policies and their dates. In another section of the letter, correctly quote all relevant language. Policy language may change from one period to the next. In construction-defect or environmental cases, multiple policy periods may be triggered. Endorsements amend language, and the endorsements may not apply to every policy period. An effective reservation of rights correctly quotes all relevant language for each applicable policy period.

Tell the insured how a reservation of rights works. Explain to the insured that the carrier is hiring a lawyer to defend the insured against the allegations. For the insured's convenience, provide the defense lawyer's contact information. The defense lawyer should be copied on the reservation of rights.

Depending on the state, explain potential conflicts between the insured and insurer. For example, using Washington as an example, the insured is defense counsel's only client, so the reservation of rights letter can say that, while the insurer pays for the service, defense counsel only represent the insured's interests in defending against the suit's allegations. If your state requires independent defense counsel in certain conflict situations—sometimes called *Cumis* counsel after the eponymous California case—insureds should be informed that they have the right to additional defense counsel paid for by the carrier.

Tell the insured why it is being sued. A separate section should summarize the allegations because some facts are more important than others. If the underlying suit alleges the insured contractor is liable for defective construction, the facts section of the reservation of rights should say that the plaintiff alleges the defendant's work was defective and caused property damage. If the insured is being sued for what may be uncovered economic damage, then the reservation of rights should say that the plaintiff alleges the defendant's conduct caused the plaintiff to lose profits.

After summarizing the facts alleged against the insured, the reservation of rights should list the legal theories (e.g., negligence or breach of contract), along with the facts alleged under each theory of recovery. If the letter mentions a fact while explaining why the insurer reserves its rights, then make sure this fact is mentioned earlier in the letter when the allegations are summarized.

Don't hide the ball. Courts most often prevent the insurer from denying indemnity or payment because the reservation of rights inadequately explains why the policy does not cover the allegations. Courts have stated, in different ways, that they expect reservation of rights letters to explain this.

Some courts require the reservation of rights to fairly inform the insured of the carrier's reasons for denying coverage. Others say a reservation of rights cannot be ambiguous. Courts often criticize reservations of rights letters that contain a laundry list of exclusions without explaining how the exclusions preclude coverage. Courts also dislike generic or cut-and-paste letters that do not explain how the policy language applies to the allegations. Courts condemn letters stating the insurer reserves its rights, and little else, without connecting policy language to the allegations.

To avoid these scenarios, after quoting applicable language and summarizing the allegations, explain in reasonably understandable language why the carrier may not have a duty to settle or satisfy the insured's liability. This is the most important requirement of a reservation of rights letter.

The following examples may assist in drafting reservations of rights:

- If the insured is sued for assault, then tell the insured that intentional conduct may not fall within the policy's coverage for an accidental "occurrence." The policy's intentional-conduct exclusion may also preclude coverage for intentional conduct.
- If the insured contractor is sued for shoddy workmanship, then be sure to state that allegations of poor workmanship, especially if alleged as breach of contract or warranty, may not constitute a covered "occurrence." Exclusions of "property damage" to where the insured was working, "property damage" to the insured's "product," and "property damage" to the insured's work may also preclude coverage for poor workmanship.
- If the insured is sued in a commercial dispute, then state that the policy covers "property damage," which the policy defines as "physical injury to tangible property," or "loss of use of tangible property that is not physically injured." Allegations of economic loss may not meet the policy's definition of "property damage."

Leave an escape route. At the conclusion of the reservation of rights, reserve the right to withdraw from defending the insured and the right to litigate coverage. The conclusion is also a good place to reserve the right to assert other defenses that may become apparent later. Depending on the state, use the final paragraphs to reserve recovery of defense expenses, withdrawal from the defense, and similar items. It is also prudent to include a general statement that the carrier reserves all of its rights and defenses and does not intend to give up any of them.

Explain to the insured what is being claimed or alleged and why the policy may not cover what is being claimed or alleged. Admittedly, this can be time consuming, but so is dealing with coverage litigation later—or worse, extracontractual litigation—that could have been avoided if a thoughtfully worded reservation of rights had been prepared and sent to the appropriate parties in the first place. ■