BY RYAN A. HISS & ERIN E. KREJCI

Reservation of Rights Letters: Take Control of Your Legal Defense

When a contractor is forced to defend against a claim for construction defects, breach of warranties, or personal injuries, whether in arbitration or court, one would look to vigorously defend its company against liability. One would gather documents to support the claim, including a "smoking gun" e-mail or letter, a signed change order, meeting minutes, an executed sworn statement, daily reports, project schedules, and an unequivocal lien waiver.

Also, one would obtain and document statements from key employees involved in the project and other supporting testimony, as well as assemble a legal team that knows a contractor's business practices and understands the construction and development industry.

Armed with information and shielded by its legal team, a contractor would feel confident in doing everything possible to protect the company.

Why, then, would a contractor allow its or a third-party's liability insurance company to takeover complete control of its defense? Why would the insurance company be permitted to assign its own attorneys to the contractor's case – regardless of experience, familiarity with the business, or knowledge of the construction industry?

Perhaps this route might help one to feel insulated from potential financial exposure; after all, one would expect the insurance company to pay for the defense costs and any settlement or judgment rendered against the company.

But what if the insurance company said that after it investigates the claim it may *not* pay the cost of the legal defense or the judgment/settlement? Or, that it may require reimbursement from the contractor to the insurance company for any legal defense costs, judgments, or settlements that it pays out?

Unfortunately, insurance companies frequently tell insureds they might not cover a claim and the insureds continue to let these companies control their defense as if coverage were guaranteed.

Reservation of Rights Letters

A reservation of rights letter is a non-committal communication from an insurance company to an insured that states the insurance company may or may not be required to pay for the defense of the claim and any settlement or judgment.

This letter includes excerpts from the policy and is typically mailed and/or e-mailed by an insurance company within 30 days of receiving a claim.

In the letter, the insurance company acknowledges receipt of the claim and discusses its limited investigation to date. Here is an excerpt from a reservation of rights letter:

> "We have reviewed the allegations in the pleadings, and have determined that our company *may not provide coverage* for the lawsuit based upon the terms and conditions of the policy/policies and [state] law which govern the interpretation of such policies. Until such time as our investigation is complete and the coverage issues resolved, we will participate in the defense of the lawsuit under a complete reservation of rights." (emphasis added).

The insurance company usually advises that it is reserving its right to dispute paying anything on the contractor's behalf should its ongoing investigation reveal that any policy exclusions or exceptions apply.

The letter might then discuss potentially applicable policy exclusions and exceptions. After it outlines why it may or may not provide coverage, a full reservation of all rights follows, similar to the following:

> "The insurance company fully reserves its rights under its policy/policies, and nothing stated in this letter is intended as a waiver of any other portion of the policy/policies that may be found to apply upon further review or investigation of the incident that allegedly caused damages."

Considerations for When Insurance Companies Provide the Defense

Even when a reservation of rights letter has been issued, the insurance company typically hires a panel attorney to defend a company against the claim for, at least, the time being.

It is important to note that panel attorneys often handle all different types of lawsuits on the insurance company's behalf, so it is not guaranteed that their practice focuses solely on the construction and development industry.

The insurance company will pay for panel attorneys to defend a company unless their investigation reveals that any insurance policy exceptions or exclusions apply. The insurance company may even seek reimbursement for any legal fees and costs that it has paid its panel counsel to date.

Typically, the reservation letter will express this concept with language similar to the following:

> "The insurance company reserves its right to withdraw its participation in the defense of the lawsuit should it be determined that coverage does not apply and to file a declaratory judgment action to determine the parties' rights, and obligations under the policy/policies. The insurance company further reserves the right to seek reimbursement from the insured of any legal fees and costs incurred in its defense should it be determined that the insurance company has no duty or obligation to defend under the policy/policies."

Insurance Companies May Not Cover the Claim

Even though one might have paid substantial premiums for liability coverage, there could still be several policy exclusions or exceptions that excuse the insurance carrier from paying any judgment or settlement. Some exclusions include, but are not limited to:

- No damage to property other than the work performed
- No occurrence
- Contractual liability exclusion
- Late notice
- Occurrence did not take place during policy period

If any exceptions or exclusions apply, then the company would be left with no insurance coverage for the claim or lawsuit.

How Can One Protect Its Company?

Fortunately, when insurance companies issue reservation of rights letters, the law – in many states – can provide protection. However, many contractors fail to take advantage of such protection.

Several courts throughout the country have recognized that attorneys appointed by insurance companies in question have conflicts of interest in reservation of rights situations. In Illinois, for example, the courts have ruled that when an insurance company issues a reservation of rights, the insurance company must allow the insured to select its own attorneys to address the claims in the lawsuit. The insurance company must pay those attorneys selected by the insured to defend against the claims for as long as the lawsuit is pending.[1]

Similarly, in California and New York, courts have held that when an insurer reserves rights on issues critical to the defense of the case, a conflict of interest arises for the attorney appointed by the insurer to defend and gives rise to the right of an insured to hire independent counsel at the insurer's expense.[2]

This conflict of interest allows a contractor to select an experienced construction and development attorney to represent its interests at the insurance company's expense. The contractor has control over its own defense at the insurance company's expense.

Though many states have recognized this conflict of interest and have outlined the protections afforded when such conflicts arise, such protections vary by state. As such, it is imperative to confirm governing law.

For example, under Hawaii law, no potential conflict arises due to counsel's representation of both the insurer and the insured that would give the insured the right to independent counsel.[3] Colorado remains uncertain as to whether independent counsel will be required in light of an insurer's reservation of rights.[4]

Controlling One's Own Defense Is Critical

Controlling one's defense is critical because the insurance company may ultimately decide not to cover a claim – exposing the company to liability.

Even if the insurance company ultimately covers the claim, it is vital to exert control over one's own defense because any loss that the insurance company pays on a contractor's behalf will impact its experience modifier and loss history.

Baseless claims must be defeated so they do not affect one's loss history, as any amount an insurance company pays in settlement or judgment will be assessed against the contractor's insurance rating – thereby increasing premiums.

Presenting the best defense, with attorneys who know the industry and your company's business, puts your company in the best position to defeat claims and control premiums.

Controlling the Defense as an Additional Insured

Controlling your company's defense is also critical when it has submitted the claim as an additional insured to a subcontractor's insurance company. If the subcontractor's insurance carrier does not cover the claim, or the claim exceeds the limits of that subcontractor's policy and the claim exceeds the financial wherewithal of the subcontractor, then your company will be financially responsible for the claim – even if the subcontractor is at fault.

Accordingly, when the subcontractor's insurance carrier issues a reservation of rights letter to your company as an additional insured, be sure to exercise the same right to independent counsel as if your company's own insurance carrier issued the letter.

How Should a Company Proceed?

If New York law does not apply, then it is unlikely that an insurance company will inform a contractor of its right to select independent counsel at the insurer's expense.

Instead, in its reservation of rights letter, the insurance company likely provide that it has assigned an attorney, making it appear as if one's legal defense is under control and there is nothing more to worry about. The insurance company may even lead one to believe that it will not allow independent counsel to be hired at the insurance company's expense. For example:

> "To protect the insured against the possibility of damages not covered by said policy/policies, for which insured may be liable, the insured may wish to engage its own counsel. Please note the cost for this counsel would not be covered by the policy/policies with the insurance company."

Such a statement could be misleading as it does not inform of one's right to hire independent counsel paid for by the insurance company when the insurance company reserves its rights.

Be proactive and protect your company's rights. When your company submits a claim to its insurance company, check with your broker on whether the insurance company has issued a response, and ask if the insurance company issued a reservation of rights letter or whether it is committing to cover your company without reserving any rights. Review closely any communications received from the insurance carrier to determine if it is a reservation of rights letter.

Once it has been confirmed that a reservation of rights letter has been issued, contact an experienced construction lawyer and request that he or she make arrangements to defend your company – at the insurance company's expense.

What If the Insurance Company Does Not Issue a Reservation of Rights Letter?

Even when a reservation of rights letter is not issued, your company may still be entitled to hire its own attorney at the insurance company's expense.

If the amount claimed in the complaint against your company could potentially exceed the insurance limits in its commercial general liability policy (not excess or umbrella policies), then, depending on controlling law, a conflict may exist and the insurance company may be required to pay your independent counsel to defend your company.

Protect your company by consulting an attorney to help determine the circumstances under which state law affords your company control over its own defense, even if the insurance company does not issue a reservation of rights letter.

For example, in Delaware, in situations where a settlement may exceed policy limits, counsel retained by the insurer has a duty to communicate to the insured the conflicting interests involved and inform the insured of its right to consult with independent counsel.[5] In Illinois, the courts have held that a potential conflict of interest arises when it becomes known that there is a likelihood of settlement or verdict in excess of the policy limits.[6]

In addition, some courts have determined that if there are multiple parties in the lawsuit insured by the same insurance company, a conflict of interest is present, entitling a party to hire independent counsel to protect its interests at the insurance company's cost[7] (holding that insurer could not appoint counsel to defend insureds with "diametrically opposed" interests). This could very well exist when a subcontractor's insurance carrier is defending your company's interests, as well as those of the subcontractor.

In some lawsuits, claimants seek particular types of damages that are not covered by the policy. For example, punitive damages typically are not covered by one's general liability policy. If the claimant is seeking punitive damages in the lawsuit against your company, depending on the applicable state law, there may be a conflict of interest compelling the insurance company to pay for independent counsel to represent your company at the insurance company's expense[8] (under Illinois law, an actual conflict may exist if the insurer disclaims coverage for punitive damages).

Understanding reservation of rights letters and their language helps a company make more informed decisions as to how its defense will be handled, and who should represent its interests.

However, other states have determined that no such conflict exists[9] (holding, under Pennsylvania law, that a claim for punitive damages did not create a conflict of interest because any award of punitive damages would necessarily occasion a large compensatory award, and both parties shared an interest in defending against a large award).

Even in those instances where the insurance company does not issue a reservation of rights letter, but instead, commits to pay defense costs and any judgment or settlement, it's possible to hire an attorney to participate in the lawsuit and protect one's interests.

However, if the insurance company has not reserved its rights to withdraw coverage, and none of the exceptions previously listed apply, then your company is responsible to pay for the counsel it hires. This expense may be worthwhile as your attorney can oversee the defense. Since one's own attorney does not need to attend court conferences, draft discovery, prepare pleadings, etc., those expenses will not be incurred.

However, he or she can keep an eye on the case, the strategies being implemented by the insurance company's defense counsel, and ensure that your company's best interests are being properly handled throughout the litigation.

Depending on the size of the claim, this may save your company much more in a settlement or judgment than what it costs, thereby minimizing its loss history as much as possible.

Conclusion

Understanding reservation of rights letters and their language helps a company make more informed decisions as to how its defense will be handled, and who should represent its interests.

Take proactive control over your company's defense to provide the best opportunity to defeat any claim against it and minimize its loss history. ■

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Endnotes

1. *Maryland Cas. Co. v. Peppers*, 355 N.E.2d 24 (1976); *Ill. Mun. League Risk Mgmt. Ass'n v. Seibert*, 585 N.E.2d 1130 (1st Dist. 1992).
2. *Diego Federal Credit Union v. Cumis Ins. Soc'y, Inc.*, 162 Cal. App. 3d 358 (1984); California Civil Code § 286; *Pub. Serv. Mut. Ins. Co. v. Goldfarb*, 425 N.E.2d 810, 815 (N.Y. 1981).
3. *Finley v. Home Ins. Co.*, 975 P.2d 1145 (Haw. 1998).
4. *Hecla Mining Co. v. New Hampshire Ins. Co.*, 811 P.2d 1083, 1098 n.7 (Colo. 1991).
5. *Corrado Bros., Inc. v. Twin City Fire Ins. Co.*, 562 A.2d 1188, 1193 (Del. 1989).
6. *R.G. Wegman Constr. Co. v. Admiral Ins. Co.*, 629 F.3d 724 (7th Cir. 2011); *Perma-Pipe, Inc. v. Liberty Surplus Insurance Corporation*, 38 F.Supp.3d 890 (N.D. Ill. 2014) (Laurie & Brennan, LLP represented the victorious Perma-Pipe in this case).
7. *Murphy v. Urso*, 430 N.E.2d 1079 (1981).
8. *Nandorf, Inc. v. CAN Ins. Co.*, 479 N.E.2d 988 (1st Dist. 1985).
9. *Pennbank v. St. Paul Fire & Marine Ins. Co.*, 669 F. Supp. 122, 127 (W.D. Pa. 1987).

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