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Good News, Bad News:
Responding to Reservation of Rights Letters

Mark Garbowski

Policyholders who receive reservations of rights letters from their liability insurance companies might feel a lot like the patient in this very old joke:

> A doctor calls up a dying patient and says "I've got good news and I've got bad news." The patient says "Let me have it." "The good news is, I've found a cure and I'm sending you my bill." "What's the bad news?" "The bad news is, I've found a cure and I'm sending you my bill."

Often, the good news in a reservation of rights letter is that the insurance company will pay your defense costs under a reservation of rights; the bad news is that the insurance company will pay your defense costs under a reservation of rights. It is understandable if a policyholder feels a bit befuddled by this equivocal response from its insurance company.

Good News: The Duty To Defend

Insurance companies often send a reservation of rights letter because the duty to defend is broader than the duty to indemnify. It is possible that an insurance company can be required to pay for the policyholder's defense even if it is not required to pay for any eventual liability. For this reason, insurance companies often agree to provide a defense while reserving their rights to deny liability insurance coverage at a later date.

An insurance company may also believe that it needs to send a reservation of rights letter in order to avoid being precluded from asserting defenses to insurance coverage at some later date. To avoid waiving defenses, the reservation of rights letter will specifically identify every conceivable defense to coverage. A sweeping, generalized assertion of reserved rights should not be allowed to preserve the insurance company's rights, although it sometimes does. An insurance company should be precluded from asserting any defense which it did not specifically set forth in its reservation of rights letter.

Bad News: Conflict of Interest
Good News: Independent Coverage Counsel

An insurance company is required to reserve its rights on a timely basis because delay can hurt the policyholder. For example, the insurance company's delay would prejudice the policyholder when the policyholder decides whether to use the insurance company's counsel or to hire its own, independent attorneys. The policyholder needs to know early on whether there is a real or potential conflict of interest between it and its insurance company.

The reservation of rights letter is, in itself, an indication that there is a conflict of interest, which would indicate that the policyholder should hire an independent law firm, not an attorney appointed by the insurance company, to provide a defense. Counsel hired by the insurance company are often dependent upon the insurance company for much of their work. Even this semblance of a conflict is enough reason for a policyholder who receives a reservation of rights letter to retain its own, independent counsel.

Cooperation with Insurance Company. Insurance companies often request a significant amount of information from policyholders in order to evaluate the claim and to provide a defense. After receiving both a request for information and a reservation of rights letter, many policyholders are not sure how to proceed. There are limits to the information insurance compa-

nies may request. Most importantly, the policyholder's duties under the cooperation clause usually contained in an insurance policy are conditioned upon the insurance company's performance of its policy obligations.

At the very least, a reservation of rights shows a divergence of interests between the insurance company and its policyholder. The policyholder's duty to cooperate should run only to the defense firm which the insurance company is funding and to the defense issues with which that firm is grappling, and not to the insurance company and to any insurance coverage issues.

Conflict of Interest and Privilege Issues. If the insurance company requests information concerning the underlying claim, a policyholder should not turn over privileged materials. Because the interests of the policyholder and the insurance company are not identical, doing so may waive a policyholder's right to assert attorney-client privilege or work product protection against the insurance company, or even against third-parties.

The insurance company may argue that it shares a "common interest" with its policyholder in defending the underlying claim, regardless of the reservation of rights. The insurance company will then assert that the policyholder should turn over privileged materials. This is not correct. The majority of courts to address the issue have held that the common interest doctrine is applicable to insurance coverage cases only when the insurance company pays for defense of underlying claims without reserving its rights.

Under the majority rule, if a policyholder shares privileged information with insurance companies that have reserved their rights, third parties could assert that the policyholder waived the privilege as to those materials. Thus, these documents could be subject to discovery by an underlying claimant. Therefore, a policyholder should resist giving its insurance company access to privileged documents when the insurance company has reserved its rights.

Non-Privileged Documents. A policyholder should, however, provide its insurance company with all non-privileged documents which could help the insurance company to provide a defense, especially if the insurance company is taking an active role in the defense of the underlying claim. If the number of non-privileged documents is huge, the policyholder may invite the insurance company to view the documents at its offices and to copy those documents it chooses.

If the insurance company requests documents before it commits to paying for the policyholder's defense, the policyholder should try to get the commitment before turning over its documents from the underlying claims. Often, this commitment will have already been in the reservation of rights letter. In most jurisdictions, the insurance company can determine whether it has a duty to defend simply by reading the complaint served against its policyholder. Therefore, the insurance company does not need additional information before it makes the decision of whether to defend.

If a policyholder does provide its insurance company with non-privileged records, and the insurance company refuses to provide a defense, then the policyholder may have no recourse other than to initiate coverage litigation, with an early motion for summary judgment on the issue of defense costs.

While policyholders might wish to avoid this step, especially while they are already in litigation with the underlying claimants, the only alternative is to fund their own defense and then seek reimbursement from the insurance company at a later date. The good news here for policyholders is that an insurance company refuses to defend at its own peril, and risks forfeiting rights under the policy if it wrongfully refuses to defend.

Where the insurance company is defending the policyholder without a reservation of rights, a policyholder freely may disclose otherwise-privileged information to the insurance company without fear of losing the protection of the privilege vis-a-vis third parties. In that situation, the element of confidentiality is not sacrificed because the insurance company's interest and the policyholder's interests are identical.

Very Bad News: Insurance Company Recovery of Defense Costs.

Insurance companies often attempt to insert a provision in reservation of rights letters allowing them to recover defense costs if it later turns out that there was no coverage. This provision is often contrary to the parties' rights and duties under the insurance policy, because, as noted above, an insurance company is generally required to pay

for the policyholder's defense as long as the underlying claim is potentially covered under the applicable insurance policies.

Absent some agreement to the contrary, if it later turns out that the underlying claim was not covered, the insurance company cannot recover what it has already spent on the defense. Accordingly, some courts will only enforce defense-cost recovery provisions if the policyholder signs an agreement, supported by additional consideration, giving the insurance company this right. This is a strong reason not to sign non-waiver agreements and to respond, in writing, to reservation of rights letters. Create a paper trail.

If an insurance company refuses to pay for defense unless the policyholder agrees to a provision allowing the insurance company to recoup its defense payments, check the policy and the law in your jurisdiction to be certain that the duty to defend is broader than the duty to indemnify. Send another letter notifying the insurance company of its duties and its obligation to deal in good faith. If the policyholder absolutely must sign a non-waiver agreement in order to get the insurance company to finance its defense, it should set forth its disagreement in writing and explain that it signed the agreement under economic duress.

Conclusion

Like the patient in the joke (who does, after all, survive), policyholders can come out ahead when they receive reservation of rights letters. The key is to take control of the defense of the underlying claim, challenge the insurance company's self-serving statements, and to be aware of the policyholder's strong rights under the policies it purchased. ■

MARK GARBOWSKI IS AN ATTORNEY IN AKO'S NEW YORK OFFICE. MARK CAN BE REACHED AT (212) 278-1169 OR **mgarbowski@andersonkill.com.**