

Coverage

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Articles

3

Trinity v. Cowan: A Gloss on 'Occurrence'

by Jack M. McKinley

Trinity v. Cowan holds that duplicating and passing around a photo shop customer's revealing photographs is not an "accident." The broader, tougher question: When injury-producing conduct is deliberate, yet the injury is unintended both subjectively and objectively, is there coverage? The court, at least, implies the answer is yes.

23

Reserving Rights Rightly: The Romance and the Temptations

by Michael Sean Quinn

One of the most important steps in processing some liability claims occurs when an insurer reserves its right to deny a duty-to-pay claim at a later date, reserves its right to take back its tentative, preliminary agreement to defend its insured, or both. At the same time, there is some confusion about the legal duties of the insurer that wishes to reserve its rights. There is good reason why there is confusion. Industry practice is not without uncertainty and complexity. Moreover, the law simply is not univocal and clear.

41

Unreasonably Unclear— Bad Faith Set-Back

by Michael W. Huddleston

The Texas Supreme Court, divided and splintered almost to the point of complete confusion, appears to have drastically altered the standards for determining whether an insurer has breached the duty of good faith and fair dealing in *Universal Life Ins. Co. v. Giles*.

46

Casenote—*Energex Systems v.* *Fireman's Fund*

by David A. Gauntlett

Insurance Coverage For Intentional Tort Liability

by Terry Budd and John K. Baillie

The ongoing and well-publicized legal travails of President Clinton in Paula Jones's sexual harassment suit have given rise to what is, within the realm of insurance coverage, a "sexy" issue (if you will pardon the pun). *Jones v. Clinton* has drawn a great deal of media attention to the breadth and availability of insurance for conduct one might not ordinarily think of as covered by insurance; some of the nation's most prominent newspapers have asked the question: "is insurance coverage available for 'intentional torts'?"¹ This article explains why, in many instances, insurance coverage is indeed available for intentional tort liability, even under standard insurance industry policy wordings, and even for insureds who do not wield political power.

Jones v. Clinton is particularly instructive in this regard. Jones's complaint includes allegations that might support claims for such potentially insured causes of action as violations of civil rights statutes, sexual harassment and discrimination, assault and battery, false imprisonment, and defamation under the standard form general liability policy's personal injury coverages.² Moreover, Jones's claim that she suffered such injuries as mental distress and humiliation as a result of the President's alleged misconduct would support coverage under the standard form policy's "bodily injury" coverage in a number of states.³ Indeed, President Clinton's personal umbrella liability insurer has seemingly acknowledged the potential for coverage, because it has agreed to defend the President against Jones's claims.⁴

(Continued on page 7)

Reserving Rights Rightly: The Romance and the Temptations

by Michael Sean Quinn

One of the most important steps in processing some liability claims occurs when an insurer reserves its right to deny a duty-to-pay claim at a later date, reserves its right to take back its tentative, preliminary agreement to defend its insured, or both. At the same time, there is some confusion about the legal duties of the insurer that wishes to reserve its rights. There is good reason why there is confusion. Industry practice is not without uncertainty and complexity. Moreover, the law simply is not univocal and clear.

Why Reserve Rights?

The duty to defend is broader than the duty to pay. Hence, a liability insurer may have a legal obligation to defend claims it does not ultimately owe. The duty to defend is broader than the duty to pay for two reasons. First, in many states the duty to defend is determined solely from the face of the pleadings,¹ whereas the duty to pay is determined from the actual facts of a case. Second, if an insurer has a duty to defend against part of a plaintiff's claim, it must defend the entire claim.

Here is a way the relationship between an insurer and its insured might be conceived. In a purely arm's length relationship, an entity may consider its own interests first, and it may place them ahead of those of the entity with which it is dealing. Of course, there are many things that an entity in an arm's length relationship may not do to the entity with which it is dealing. They are all articulated and regulated by specific legal rules. In a fiduciary relationship, the fiduciary must place the interests of its charge ahead of its own interests. In a fiduciary relationship, this required subordination is perfectly general. An insurance company must treat its own interests and those of its insured equally. An insurer


may not place its own interests ahead of those of its insured; at the same time it need not place the interests of its insured ahead of its own.

If a liability insurer has a duty to defend, it also has the right to defend. If it has a right to defend, it has a right to control the defense of the case. Therefore, by definition, when an insurance company has the right to defend, it is an independent contractor with respect to running the defense, and not an agent of the insured. Few doubt this proposition, once they hear it. It implies, however, that a liability insurer managing the defense of its insured is *not* a fiduciary with respect to the insured, in virtue of being an agent.

The insured's right to a defense is frequently a valuable asset of the insured. Insurers tend to have more experience, more knowledge, and more skill in supervising defense counsel, than insureds have. Frequently, monitoring defense counsel and making decisions about defending a case, take time, and, as they say, time is money.

When an insurance company has the right to defend, it is an independent contractor with respect to running the defense, and not an agent of the insured.

At the same time, if there is no duty to pay at all, if the duty to pay is limited to only some aspects of the plaintiff's claim, or if there is exposure to the insured in excess of policy limits, then the insurance carrier is controlling a process where non-insurance assets of the policyholder may be exposed to judgment and execution. When one person controls aspects of the financial destiny of another, the controlling person is often said to have higher duties than one contracting party normally has to another. Occasionally, courts say that these duties are akin to those a fiduciary has. (Trustees, agents, and lawyers are the fiduciaries of their clients). Most courts reject the view that liability insurance carriers defending their insureds are fiduciaries of

 Michael Sean Quinn became of counsel in the Austin, Texas, office of Sheinfeld, Maley, and Kay, in July 1997 after serving two years as visiting professor in the Law School of the University of Texas-Austin. Mr. Quinn devotes much of his time to insurance problems and their adjudication. He also serves frequently as an expert witness.

their insureds.² Nevertheless, the carrier-policyholder relationship, when the carrier is providing the policyholder a defense, is closer than an arms-length relationship, and courts subject it to higher scrutiny than they do ordinary contract relationships.

Therefore, if an insurer undertakes the defense of its insured, subject to the condition that it may later reject the proposition that it has a duty to pay, so that the insurer thereby leaves the insured subject to substantial liability, the insurer must give the insured adequate notice of what may happen and why. When such notice is given, the insurer is said to have reserved its rights. As a general rule, the notice is given formally and in writing. This communiqué is called a reservation of rights letter. The general idea is that an insured must be able to take action to protect itself.³

Occasionally, a court says that an insurance company does not need to issue a reservation of rights letter where the adversity between the insurer and the insured is otherwise quite clear. This is a very sensible view, since the fundamental function of a reservation of rights letter is to give the insured notice of adversity. On the other hand, an insurer should not count on contextual adversity relieving of it the duty to issue a reservation of rights letter.⁴ First, the existence of adversity in the atmosphere does not entail that the insured will have detailed knowledge of the points upon which there is adversity. Second, most states have never articulated this view.

Legal Theory of Reserving Rights

There are two principal theories which courts utilize in discussing reservations of rights. These theories are waiver and estoppel. They are often mentioned in the same breath. Lawyers frequently refer to them as if they were the same theory.⁵ Of course, such is not the case.⁶

Waiver

Sometimes, courts say that if an insurer fails to reserve its rights, then (at some point) it has waived any right it might have to deny coverage later.⁷ And, of course, an insurer can waive any right it has under an insurance contract to deny coverage. (It could do so, in an enforceable way, for example, by stating explicitly that it waives its right to deny coverage, in exchange for consideration.)

Nevertheless, carriers hardly ever create an impediment to subsequent denials of coverage through waiver. Under the law of most jurisdictions, a person waives a right he has when he voluntarily, and therefore intentionally, surrenders a known legal right which belongs to him.⁸ In order for there to be a waiver, the insurer must knowingly, intentionally, and voluntarily relinquish that right. Waiver requires that the insurer know it has the right. It requires that the insurer mean to give the right up. Waiver requires that this intention be communicated to the insured. Courts are generally unsympathetic to the idea that there can be such a thing as a constructive waiver. Consequently, an insurer's not sending a reservation of rights letter is never, in and of itself, a waiver of the insurer's right to deny duty-to-pay coverage. An omission—even a negligently erroneous one—is not by itself a waiver.

Under Louisiana law the concept of waiver is broader. When the law applies an insurer waives its right to deny coverage when its conduct is so inconsistent with its having a right to deny coverage that it must have intended to give up this right.⁹ Hence, if an insurer defends with knowledge facts indicating non coverage, then it has waived its right to deny coverage. This idea is really nothing but the anathema of constructive intent, and it is really much more like estoppel than waiver.

Estoppel

In the law, there are legal principles which sometimes override rights. Under some circumstances, if I treat you badly, and hurt you in the process, there are legal principles which will stop me from asserting rights I might antecedently have against you. For example, if I have left you with the impression that I would do things, and then I don't do them, I may not be able to demand of you that you do things you said you would do. In general, this is called the doctrine of estoppel. If *A* treats *B* inequitably, and hurts *B*, then *A* may be prevented, by operation of law, from asserting (at least some) rights against *B*.

Every case of estoppel involves three elements. First, the person to be estopped must engage in conduct which the legal system recognizes is unacceptable. Second, the person to be estopped must either know that he should act otherwise, or his lack of knowledge must be negligent. Third, the iniquitous conduct of the person to be estopped must injure the other person in some way. If that person is prevented from

doing something which he otherwise would have done (or something that he surely should have done), then the type of injury sustained is called *prejudice*.¹⁰

In the duty-to-defend context some jurisdictions will presume prejudice, if an insurer fails to send a reservation of rights letter.¹¹ A fraction of those jurisdictions treat presumed prejudice as conclusive; others of those jurisdictions treat the presumption of prejudice as defeasible.¹² (There is little agreement among the latter type of jurisdiction as to how strong the rebuttable presumption is.) Still other jurisdictions vary where they place the burden of proof as to prejudice. Some place the burden on the insured to prove prejudice, while some jurisdictions require the insurer to prove the lack of prejudice. Some jurisdictions even vary the placement of the burden on a case by case basis.

Texas law exemplifies the confusion. It's law is unsettled and confused. Texas does not conclusively presume prejudice from an insurer's omitting to send a reservation of rights letter. Texas jurisprudence will not rebuttably presume prejudice unless the harm is "clearly and unmistakable[.]"¹³ This is a very odd rule, of course. If the *harm* is clear, then no prejudice need be presumed, because it is already proved. Harm is, by definition, injury. The court must have meant that Texas jurisprudence presumes prejudice only when the insurer's inequitable conduct is egregious and known to everyone to be the sort of conduct which almost always causes harm. Despite these confusing remarks it seems perfectly clear that, in general, Texas requires an actual showing of prejudice before the insurer's omitting to send a reservation of rights letter creates estoppel. Estoppel is not automatic in Texas, across the board, although—sometimes, perhaps—an insured need not affirmatively show prejudice.

What constitutes prejudice? There is no way to construct a complete list of states of affairs which prejudice insureds, of course. Prejudice is too protean for that. Here are some examples, nevertheless: (1) If an insurer provides its insured a defense and deliberately utilizes defense counsel to help build a case that the insurer does not have a duty to pay, there is prejudice.¹⁴ (2) Indeed, this may be *the* paradigm case of prejudice. If the insurer's control of litigation puts the insured in harms way, then the insured has suffered prejudice. This could happen, if counsel

selected by the insurer fails to advise the insured of steps he might wish to take in his deposition (*e.g.* taking the Fifth Amendment). It could also happen if counsel selected by the insured elects to answer written discovery in such a way that the insured unnecessarily confesses to an uncovered claim. (3) Similarly, if the insurer conducted settlement negotiations in a way detrimental to the insured, when it could have conducted settlement negotiations differently, then the insured has suffered prejudice. (4) If an insured relies to his detriment upon the absence of a reservation of rights letter, that may be prejudice.¹⁵

If an insurer provides its insured a defense and deliberately utilizes defense counsel to help build a case that the insurer does not have a duty to pay, there is prejudice.

Obviously, if the insured must prove prejudice, the existence of a "potential" conflict of interest, an "apparent" conflict of interest, or even an out-an-out conflict of interest will not guarantee estoppel. There must be actual prejudice.¹⁶ If so, then the mere fact that an insured has lost the opportunity to control his own defense is not automatic prejudice. Similarly, the mere fact that an insured has lost the opportunity to hire counsel who reports only to him is not necessarily prejudice. Estoppel includes the element of causation.

Insurers may reserve just about any right that would constitute an impediment to the insured's recovering under the policy. Straightforwardly, insurers may reserve their rights pertaining to any procedural aspects of the insurance contract. Thus, an insurer may reserve its right to deny coverage on the basis of the fact that the insured provided late notice of the occurrence. It may reserve its right to deny coverage on the grounds that the insured provided late notice of the suit. And it may reserve its right to deny coverage on the basis of breaches of the duty to cooperate. (Of course, an insurer need not, at any given time, reserve its right to deny coverage on the basis of future breaches of the cooperation clause by the insured, with a possible exception of future breaches which are inherently and integrally connected to breaches that have already occurred.)

The insurer's rights with respect to what is often called "the defense of noncoverage," (or, "the defense of no coverage") is more interesting. The defense of non-coverage means one of two things: either the events being litigated do not fit into the insuring agreement, or they do fit into at least one of the exclusions. Thus, if the insured acted intentionally, and caused an obviously foreseeable injury, there would be no duty to pay, under most liability policies, because there will be no accident, and if there is no accident, the insuring agreement is not satisfied. Similarly, to the extent that the plaintiff pleads an intentional act, which obviously causes foreseeable injuries (e.g., a drive-by shooting), there is no duty to defend, because the pleadings do not allege facts which if proven to be true would satisfy the insuring agreement. If the facts are that the insured meant to injure the plaintiff, then the "expected or intended" exclusion is satisfied, and there is no duty-to-pay coverage. Similarly, if the complaint expressly alleges that the insured meant to injure the plaintiff and that is the only pleading, then there will be no duty to defend.

But how does estoppel work? It is axiomatic that contract rights cannot be created by estoppel.¹⁷ This rule applies to insurance law:

While waiver or estoppel may preclude insurer's policy defense arising out of a condition or forfeiture provision, these doctrines do not normally operate to prevent the assertion of a defense of noncoverage.¹⁸

There is an exception to this rule, however:

If an insurer assumes the insured's defense without obtaining a non-waiver agreement or a reservation of rights and with knowledge of the facts indicating noncoverage, all policy defenses including those of noncoverage are waived, or the insurer may be estopped from raising them.¹⁹

Sometimes it appears as if the exception has devoured the rule. Insureds sometimes brief cases as though the exception to the general rule were itself the fundamental rule. The combination is perfectly sound but the logic of the rule is not well understood. Consider the following:

It is well established, that whereas the doctrines of waiver and estoppel may operate to avoid conditions that would cause a forfeiture of an insurance policy, they will not operate to change, re-write or enlarge the risks covered by the policy. However, *it follows from these general principles* that, if an insurer assumes the insured's defense

without obtaining a reservation of rights or a non-waiver agreement, and with knowledge of the facts indicating noncoverage, all policy defenses, *including those of noncoverage* are waived or the insurer may be estopped from raising them.²⁰

Clearly, the first sentence of the quote from *Wilkinson* does not entail the second sentence, as the case asserts. Rather, the rule set forth in the second sentence is an exception to the rule set forth in the first. *Acel Delivery* understood this point perfectly; *Wilkinson* botched it badly.

In some jurisdictions an insurer may defend unconditionally without waiving coverage defenses, if the insurer has no reason to believe that there may be any coverage problems.²¹ In those jurisdictions, a liability insurer has a strong and immediate duty to investigate. This rule is sensible but marginal. Most coverage problems are indicated on the face of well-pleaded complaints, and such problems entail an immediate duty to reserve rights.

Mechanics of Reserving Rights

The mechanics of reserving rights consists of four important topics. First, when should the reservation of rights letter be sent? Second, what should be its general structure and content? Third, what should be its style? And fourth, how should it be dispatched? In other words: Who should write it?

Timing

If an insured does not know of a problem jeopardizing the insured's right to policy proceeds (or its right to a defense), then—obviously—the insurer cannot be required to dispatch a reservation of rights letter.²² As soon as the insurer does know of a problem, however, it should issue a reservation of rights letter. But, when is "as soon as"? In the context of planning, the phrase "as soon as" means just that: Do it now! From a retrospective point of view (i.e., from a litigation standpoint), an insurer probably has a couple of months to dispatch a reservation of rights letter after its claims people finds out about a problem.²³ The court's are sympathetic about how long it takes a bureaucracy to absorb information and to react, especially when there are several layers of review when there being several layers of review makes sense. The courts are also sympathetic to the fact that the insurer may wish to get an opinion from counsel and have counsel draft the reservation of rights letter.

Still everything must probably move with dispatch. If the insurer takes longer than a couple of months, estoppel becomes a danger. It takes as long as six months, estoppel is likely. If it takes a couple of years, estoppel is a virtual (but defeasible) certainty.²⁴ The closer the time of trial, the less time the insurer has to issue reservation of rights. The more activity there is in the lawsuit, the less time the insurer has to issue a reservation of rights. Under some circumstances, an insurer should consider using phased reservation of rights letters. When an insurance company receives fragmentary information—information which is too skimpy to use in a full fledged reservation of rights letter—it might consider sending the letter saying it has received preliminary indications that there may be a problem, state what the preliminary indications are, state what the problem may be, and state that there may be a full-fledged reservation of rights letter following as the insurance company's investigation develops. Such phasing would have the effect of putting the insured on notice as soon as possible that there may be some sort of problem. On the other hand, if the preliminary letter were not followed by a full-fledged reservation of rights letter, or by a letter withdrawing the insurers preliminary concerns, things wouldn't look right.

Structure and Content

The law imposes few specific requirements on reservation of rights letters. In general, the law merely requires that reservations of rights communicate to the insurer the specific nature of the insurers concerns. Thus, perfectly general reservations are ineffective, because they do not convey specific information. A "notice of a reservation of rights must make specific reference to the policy defense which the insurer may assert."²⁵ The Sixth Circuit put it this way: "Tennessee law demands a high level of clarity in documents prepared by an insurer which purport to give notice to an insured of an insurer's reservation of rights. To be effective, the notice must be 'clearly and fairly communicated to the insured.'"²⁶ One court has even remarked that reservation of rights letters lacking specific references to pleadings and clauses of the policy smacked of bad faith.²⁷ Reservations of rights must "fairly and adequately inform the insured of the insurer's position so that the insured may make an intelligent choice as to the course to pursue in defending himself."²⁸ At least one court has held that reservations of rights letters will be

held to the same standards as insurance policies.²⁹

So much for legal requirements. Courts are not in the business of providing recipes for how to do things. They merely sit in judgment. Perhaps it might be well to provide some how-to advice on the preparation of reservation of rights letters. Much of this advice is in excess of minimum legal requirements. At the same time, it is probably prudent.

Reservations of rights must 'fairly and adequately inform the insured of the insurer's position so that the insured may make an intelligent choice as to the course to pursue in defending himself.'

In general, reservation of rights letters should have the same fundamental structure. Of course, all sorts of variations, deviations, and embellishments make sense. Specialized letters sometimes need specialized structures. Nevertheless, the courts are accustomed to seeing reservation of rights letters with a certain format. Consequently, most reservation of rights letters should break into the following parts.

- First, the insurance company sending the letter should be identified. Since insurance companies travel in fleets, insureds will not always be aware of the precise identity of their insurer. A mistake, in this regard, will probably not negate the effect of the letter or create estoppel.³⁰ Nevertheless, this sort of mistake creates the wrong impression. In some graceful manner, both the fleet name and the legal name should be mentioned.
- Second, the correct policy number should be recited. If more than one policy is at stake, some consideration should be given to sending one letter per policy. That is not a legal requirement, but it sometimes simplifies the letters.
- Third, the claim number should be correctly stated. All of this is probably done before the reader has reached "Dear Policyholder." (Of course, reservations of rights letters should address the policyholder or the policyholder's representative by name.) The letters should be somewhat formal, however. After all, they may be blown up and presented in court.

➤ Fourth, immediately—or, at least, soon—after the greetings, the letter should announce itself as a reservation of rights letter. The insurer should consider stating explicitly the insurer is sending a “full” reservation of rights letter. Sometimes the insurer will require strict compliance with the insurance contract. The word “full” is not a magic formula. On the other hand, it tells the insured that the insurer is seeking fully to reserve its rights. The demand for strict compliance may or may not be a good idea, depending on the context. If the insurance company has itself not been in strict compliance with the insurance policy, such a sentence would be very unwise. It is unclear what the use of the words “strict” and “full” add to the letter when it is otherwise well drafted. Then again, probably, it can’t hurt much.

➤ Fifth, the letter should immediately announce that the insurer will provide a defense, but subject to a reservation of rights. It is becoming fashionable for carriers to state that they will seek reimbursement of defense costs if there is no duty to defend. This is a difficult and controversial gambit which will be discussed later. (See p.31, “A New Trend: Recoupment & Restitution”)

➤ Sixth, the fact that the insurer may withdraw the defense and some circumstances under which it may withdraw the defense should be stated. If, for example, the plaintiff’s petition states two causes of action, one of which is covered and one of which is not, the insurer should consider stating that if the uncovered cause of action is dismissed, the defense will be withdrawn. (Of course, it is not—strictly speaking—causes of action which are covered or not covered. Nevertheless, this way of speaking is common enough and hence, not really misleading in this context.)

➤ Seventh, the history of the transaction should be recited. This history should include when the claim was received, how it was reported, perhaps who reported it, certainly the nature of the report, and so forth. In addition, there should be a recitation of whatever investigation the insurance company has done. This recitation should include the activities, who has been interviewed, and perhaps a brief discussion of what they have said.³¹ Next, there should be a notation that the insured has been sued. The central body of the letter, thereafter, will concern the suit itself.

➤ Eighth, the basic gist of the lawsuit should be discussed. This part of the letter need not be lengthy. Three topics should be covered, however. (1) The drift of the facts should be recounted. (2) The legal theories relied upon should be mentioned. (Clearly the letter must allude to the theories expressly relied upon. If there is a theory not named in the complaint but obviously implicit, that too should be discussed.) (3) The letter should focus upon the facts and pleaded facts which are especially pertinent to the reservation.

➤ Ninth, the letter should indicate that there may not be indemnity coverage and why. Obviously, this part of the letter will have to be grounded to some degree on facts. Knowledge of those facts may have resulted from the insurance company’s investigation. They may arise from what the insured has told the insurer. Or, they may simply derive from what tends to be true about the pattern of facts alleged against the insured. This can be a tricky matter, especially if the plaintiff’s live substantive pleading is quite sketchy about the facts.

The letter should immediately announce that the insurer will provide a defense, but subject to a reservation of rights.

If the insurer is raising questions about whether there is duty-to-defend coverage, it should relate the facts pleaded to the provisions of the policy. The preferred method for displaying the connection between the insurance policy and the plaintiff’s factual pleadings is to quote the policy at length. When the policy defenses are defenses resting upon noncoverage, it is customary to quote the insuring agreement, the appropriate definitions, and the applicable exclusions. When the policy defenses pertain to late notice or a lack of cooperation those sections are quoted. It is not customary to quote from the plaintiff’s pleadings at length. If the insurance company’s position rests upon statements taken from employees, it is common to quote at length from those statements.

If the insurer is raising questions about whether there is duty-to-pay coverage, it should relate the true facts to the provision of the policy. (The facts-as-pleaded—or, the factual pleadings—while relevant to the duty to defend, are irrelevant to the duty to indemnify.) The preferred method for displaying the connection

between the insurance policy and the true facts is similar to the preferred method for connecting pleadings in policy. It is customary to quote the relevant sections of the insurance policy at length. It is also customary to delineate the essence of the true facts, as the insurer understands them. When the insurer's policy defense is pertained to procedural matters such as late notice or lack of cooperation, those sections are quoted, and the facts amounting to a breach of one of the policy conditions are recounted. Procedural policy defenses are the same in both the context of the duty to defend and the context of the duty to pay.

Many reservation of rights letters simply juxtapose the two sets of information and then straight away conclude that a reservation of rights is appropriate. The philosophy behind this approach will be apparent in a moment. Another approach is to link the insurance policy with the other material (whether it is pleading materials or factual materials) through argumentation. I'm inclined towards the second view. The philosophy underlying the first view is that if the writer of the reservation of rights letter misses a linkage, it will be waived. For reasons which will become apparent in a moment, I believe that is a risk that should be run. The best reservation of rights letters constitute an argument for a conclusion. Of course, this observation does not imply that such letters should be polemical or argumentative. Restraint and rationality are the order of the day.

➤ Tenth, the insurer should identify the lawyer with whom the case will be referred, and request that the insured meet with the lawyer at an early date. The insurer should not only provide its insured with the name of the lawyer, but per firm name, her business street address, business postal address, and her telephone number. Under some circumstances, the insurer might consider sending the insured the appropriate pages out of Martindale-Hubbell. At the same time, the insurance company should request that the lawyer contact the insured to get the ball rolling.

➤ Eleventh, it is advisable to include a paragraph stating that the insurance company reserves the right to amend or supplement its reservation of rights as facts are developed and as the plaintiff changes his pleadings.³²

➤ Twelfth, the insurance company should request that the insured send it any revised pleadings it receives. The insurer should emphasize how important it is that it receive successor pleadings.

➤ Thirteenth, it is customary for insurers to state that by dispatching this reservation of rights letter, the insurer does not waive its right to reserve (nor should it be deemed to be estopped from reserving) its rights based upon any other grounds whatsoever. This standard paragraph is sometimes thought to make the reservation of rights letter a "full" reservation of rights communiqué, and sometimes insurers say in the letter that it is a "full" reservation of rights. The intent behind this paragraph, is to try to make it possible for the insurer to reserve its rights with respect to things its knew before it dispatched to first letter but hadn't properly understood it. It is unclear what the legal effect of the such paragraphs is.³³ One would be well advised not to be too sanguine about them. At the same time, its inclusion probably does not have any adverse affect on the remainder of the letter.

➤ Fourteenth, I recommend that the reservation of rights letter contain a paragraph inviting the insured to comment upon anything in the letter with which it disagrees. The insurance company might even be well advised to emphasize how important dialogue is in the insurer-insured context, when there are disagreements. From a trial lawyer's point of view, if a succession of reservation of rights letters contains such a paragraph, and if the insured, or its counsel, has done nothing to respond to material which they subsequently say is anathema, their position at trial looks implausible.

➤ Lastly, at some point, the insurer should advise the insured of its right to obtain independent counsel. This is especially true when the insurer is relying upon defenses of no coverage, where the insurer may defend the case but is not likely to contribute to settlement. It is also important where the insured faces excess exposure, exposure for events which are not covered, or exposure for a type of damages which are not covered. (Many states do not permit liability coverage for punitive damages.³⁴)

Wise Omissions

Behind closed doors, insurance lawyers argue about whether reservation of rights letters should contain explanatory material. Should a reservations of rights letter should contain explanatory material? Should a reservation of rights letter explain what its legal effect is? Should a reservation of rights letter explain to policyholders what their options are? Should it explain to policyholders the various ways the policyholder

might react to the reservation of rights letter? The law, so far forth, seems clear. An insurer does not have a legal obligation to explain to its policyholder the legal significance of a reservation of rights. In this general area, the insurer will have discharged its obligation, if it advises the policyholder to seek personal counsel.

There is something to be said for the notion that insurance companies ought to warn ignorant insureds regarding the legal significance of a reservation of rights letter. Many such insureds acquiesce in a reservation of rights, when completely independent counsel acting only on their behalf might advise them to take a different course. Since an insurer is not a fiduciary of its insured, it does not have to advise the insured solely from the point of view of the insured's interest. At the same time, there is an air of inconsistency about requiring insurance companies to dispatch complex legal instruments like reservations of rights without at the same time making sure that the insured understands what he's getting.

In the previous section, I discussed reservation of rights letters which linked policy provisions to facts. Some lawyers are concerned about writing such reservation of rights letters, since they may have to be given up in discovery. (It is not uncommon in underlying tort cases for plaintiff's lawyers to seek insurance policies and reservation of rights letters. The rules of civil procedure in most jurisdictions give plaintiffs access to these documents so that they can evaluate the settlement value of their cases.) Obviously, a reservation of rights letter which contains a discussion of the facts of the underlying tort case as understood by the insurance company should not be turned over to the plaintiff. As the very least, all of the fact-related observations in any such letter should be redacted before the letter is produced.³⁵ Any quotations from witness interviews should likewise be blocked out.

Style

What should be the style of a reservation of rights letter? The answer to this question is determined by the purposes of such a letter. It has at least three purposes. First, it should succeed in having the legal effect of reserving the insurer's right. Second, it should communicate important information to the insured. Third, it should be drafted in such a way that it can play a significant role in any trial which arises out of the coverage dispute. When a document is likely

to play a role in a trial, it should be drafted in such a way—most importantly—that it won't hurt the insurer in the trial. Thereafter, it should be drafted in such as to be helpful to the insurer's position.

**Many reservation of rights
letters are laced with citations
to numerous reported cases.
This is a bad idea.**

All three of these purposes suggest that the style of the reservation of rights letter should be as simple as possible. Reservations of rights are complex legal instruments. If there are a number of rights to be reserved, and if those rights pertain both to the duty to pay and to the duty to defend, not only will the reservation be conceptually complex, it will be lengthy; it will talk about a number of different things; and it may be complicated. Nevertheless, the style should be as simple as possible. The court might say, after all, that an unintelligible reservations of rights letter was unsuccessful in reserving rights. An obscure reservation of rights letter will not communicate information to the insured, and communication is one of the functions of such a letter. Finally, if a reservation of rights letter is filled with arcane terminology, opaque wording, and convoluted grammar, the letter will do the insurer a good deal of harm when it comes to trial. Probably, authors of reservation of rights letters should strive not only for simplicity but for grace. These properties are the hallmark of convincing prose, which is often associated with careful thought. They are the marks of careful thought.

Many reservation of rights letters are laced with citations to numerous reported cases. This is a bad idea. If the letter contains a paragraph reciting of black letter law controlling, say, the duty to defend, the prose in that paragraph does not need explicit legal support in the context of a reservation of rights letter. Statements of the law need to be absolutely accurate. Citation is mostly unnecessary. I recall seeing a reservation of rights letter not long ago which had 67 case cites in it. The underlying tort case was a defamation case. Many of the citations pertained to various aspects of the law of defamation, which the insurer thought it needed to explain at length. I thought that many of the citations were pointless and unnecessary.

If a reservation of rights letter turns on some recent case, it is probably wise to cite and discuss the case. It may even be wise to include a copy for the edification of the insured. Such situations are relatively rare, however, although one sees them in the environmental area, from time to time.

Signatory

Who should sign the insurer's reservation of rights letter? The general practice is for the claims person handling the file to sign the reservation of rights letter. Sometimes the line adjuster and her supervisor will sign it. Sometimes several claims people sign it. I have never understood the theory behind the reservations of rights letter carrying two, three, and sometimes more signatures. I surmise it is to make the document official and thought-through. In fact, it does nothing more than subject people to deposition. Often those people profess not to remember signing the letter and not to remember discussions which led up to the signing of the letter. This just makes everybody look silly. Often, the reser-

vation of rights letter is actually written by an attorney retained by the insurer. Frequently, when attorneys provide liability insurers with coverage opinions, they attach reservation of rights letters.

The fact that a draft of the reservation of rights letter is prepared by an attorney—usually a young lawyer—is one explanation for why citations are frequently included in reservation of rights letters. Some young lawyers like to wear their learning on their sleeves. Sometimes whole law firms are insecure about their status and so want to prove everything, right here—right now. At the same time, the fact that a claims person is signing the reservation of rights letters is one good reason why such letters should not contain numerous citations to reported cases. Furthermore, in the trial of the coverage case, if a claims person who signs the letter does not know the cases cited in the letter and does not so much as have the cases in his adjustment file, the insurer will look foolish.

There is nothing fixed in the law which requires that reservation of rights letter be signed by the claims person for the company. Indeed, sometimes, it is signed by a claims person for a firm of independent adjusters. Sometimes, it is appropriate that counsel for the insurer sign the letter. This is particularly true once the insured has hired counsel and the locus of dialogue, discussion, and argument has become lawyer-to-lawyer rather than claims person-to-risk manager (or, claims person-to-insured).

An Interesting Puzzle

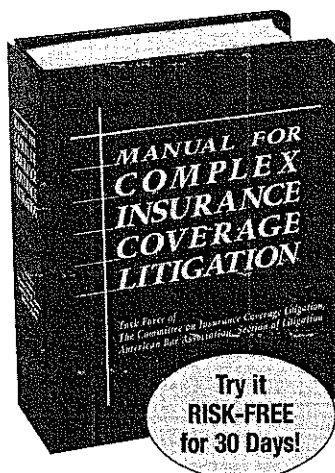
One recent case with which I have some familiarity involved a rather puzzling issue. A liability insurer had insured an industrial enterprise for a couple of decades. During that period of time, the insurer had exercised its right to defend many cases and lots of them had been settled.

The insurer and the insured worked closely together, and—over the years—they developed a mode of dealing with each other. There would be oral discussions as to whether there was coverage for a certain case, and the policyholder and the carrier could be trusted to remember when the insurer had doubts about a duty to pay.

As luck would have it, the risk management staff of the policyholder and the adjustment staff of the carrier changed substantially at approximately the same time. The insurance company was, at that time, was defending a rather large environmental case—just the type of case in

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which one would expect to find a reservation of rights letter having been issued. As events developed, the insured dispatched a reservation of right letter—ostensibly, quite late—and the insured took the position that it relied upon carrier's not having issued a reservation of rights letter at the "appropriate" time.

How should this case come out? From a purely legal point of view, if the insurance company could prove the course of dealing, and could prove that the insured was aware of the specifics of its coverage doubts, the insured should be able to prevail on the estoppel issue. Theory and practice are not always the same, however. Proving that the insured had specific and detailed knowledge as to insurer's coverage doubts is extremely difficult, even when everybody can be counted on to tell the truth. Moreover, proving the details of a course of dealing is also very difficult for a variety of reasons. Some of the risk managers will have disappeared. Some of them will simply not remember. Some of the former risk managers will be retired, and they may be afraid for their pensions. And so on.

A New Trend: Recoupment and Restitution

A number of insurance companies are now seeking to obtain back from their insureds defense costs (including attorney's fees) spent, when there never was a duty to defend. The system works this way. An insured gets sued. It sends the suit papers to the insurance company. The insurance company dispatches a reservation of rights letter and files a declaratory judgment act. For an interval, the insurer defends its insured, but—eventually—obtains a declaration of no coverage and no duty to defend.

The insurer then amends the declaratory judgment action seeking restitution of the attorney's fees, based upon the proposition that it never owed them. The wise insurer will have included some sort of statement in its reservation of rights letter, to the effect that it will seek recoupment if it has no duty to defend. The reservation of rights letter will play a key role in the law suit, which was formerly a declaratory judgment action and which is now an action seeking restitution.

There are other ways that the issue of recoupment can be presented to tribunals. In all probability, it need not be part of the declaratory judgment action. However the issue is presented, the wise insurer will have included in the reserva-

tion of rights letter a warning to the insured that it will seek recoupment.³⁶

On July 24, 1997, the California Supreme Court weighed in on the side of permitting insurers which have properly reserved their rights to recoup certain defense costs. It did this in a mandamus case, *Buss v. Superior Court*.³⁷ The decision was not unanimous. Both sides have some wisdom inherent in their positions, as is characteristic of great debates.

If an insurer spends money defending claims, some of which are covered and some of which are not, and the insurer cannot separate the expenses, it cannot get reimbursement.

The case arose out of a business controversy. The complaint articulated 27 causes of action. All of the common law theories characteristic of business litigation has been rounded up and deployed. Defamation was included, and one of the 27 counts included wrongful eviction as a subsidiary. Unquestionably, the gist of the litigation concerned a broken business relationship. Transamerica, the real party in interest, defended pursuant to a reservation of rights in which it stated that it might seek recoupment of defense costs for uncovered claims. Two CGL policies were at issue.

Justice Mosk, writing for himself and five others, held that an insurer might obtain reimbursement for money expended upon defending causes of action which were not even potentially covered. The insurer bears the burden of proving all of the elements required for reimbursement, but it is held only to a preponderance of the evidence. Apparently, if an insurer spends money defending claims, some of which are covered and some of which are not, and the insurer cannot separate the expenses, it cannot get reimbursement.

The majority relies upon the following argument. (1) If all the claims in a complaint are potentially covered, then the insurer has a duty to defend the entire law suit. (2) If "none of the claims are potentially covered, the insurer does not have a duty to defend." (3) "It follows that, in a 'mixed' action, in which some of the claims are at least potentially covered and other are not,

the insurer has a duty to defend as to the claims that are at least potentially covered, having been paid premiums by the insured therefor, but does not have a duty to defend as to those that are not, having not been paid therefor." The conclusion does not, of course, follow from the premises. In fact the argument involves not one but two howling fallacies. First, the argument assumes that if *A* is true of one ingredient and *not-A* is true of another ingredient, then, when the two ingredients are mixed together, and characteristics of the mixed substances will remain separate and identifiable. In general, nothing of the sort need be true. One characteristic might trump the other, and extinguish it, or they might blend. Second, the court assumed—without any evidence at all having been presented!—that the underwriting function does not anticipate that there will be some lawsuits like *Buss* and charge appropriate premiums for anomalous defense costs. This assumption is almost certainly false.

The court is unwilling to say, however, that the insurer need not defend claims which are not even potentially covered when some claims

must be defended. "To defend meaningfully, the insurer must defend immediately. To defend immediately, it must defend entirely." However, the insurer may get some of its money back later based upon a theory of restitution. The majority regards this as a sensible view because it discourages insurers from denying legitimate claims where the insurer would have to spend more than it bargained for and the insured would end up being unjustly enriched. In effect the court places the risk of the insured's insolvency upon the insurer, while it creates substantially more work for insurance lawyers of all persuasions.

Justice Kennard dissented for himself alone. He points out that the insurance policy requires the insurer to defend "suits" not "claims." Thus, contrary to the express position of the majority, Justice Kennard thinks that a duty to defend some uncovered claims is a contractual—as opposed to purely legal—obligations. He has a powerful argument.

Policyholder's Response

In general, there are three ways in which a policyholder can respond to a reservation of rights. It can acquiesce. It can raise questions. It can reject the reservation.

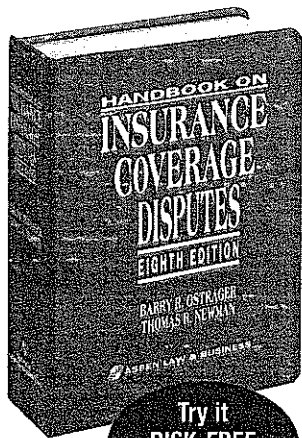
Acquiescence

In the overwhelming majority of cases, insureds simply go along with the reservation of rights. They permit the insurance company to run the case and either don't think about it or worry in silence.

In the vast majority of cases, the reservation of rights comes to nothing. Many times, the cases prove to be relatively worthless and the insurance company settles it for a nominal amount. On other occasions, it turns out the reservation of rights was ill-considered and the insurer resolves the case by way of settlement without ever withdrawing the reservation. In other cases, the reservation is well taken, the plaintiff comes to see that fact, and settles with the defendant for a small sum, which the insurance company pays. In a final category of case, the insured and the insurer combine together to negotiate a settlement, and both of them pay something.

Every once in a while, the reservation of rights is well taken, and the plaintiff presses its case to a conclusion. Sometimes, the defendant has the money to settle the case or pay the judgment.

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Sometimes, the insured-defendant and the plaintiff enter into some sort of an arrangement whereby the defendant pays off his obligation to the plaintiff by assigning rights he has against the insurance company. Sometimes, the insured tries to wiggle out of its acquiescence. I shall return to this topic later.

Questions

Sometimes, policyholders (and their lawyers) respond to a reservation of rights letter by asking a series of detailed questions: It is probably always best to try and place the ball in the other fellow's court. Hence, asking questions and seeking further information, as well as clarification, is a wise strategy—at least in general. Sometimes, it can be exquisitely interesting to ask an insurer what options the policyholder has in the face of the insurance company's reservation of rights. No insurer wants to try to answer this question. It doesn't really know the answer, partly, because the law is rather thin, and partly because all sorts of imaginative options are possible. Moreover, it doesn't want to hem itself in to fixed options, and it doesn't really want to educate its own insured. On the other hand, if the insurer fails to answer the insured's questions, it looks terrible.

It can be exquisitely interesting to ask an insurer what options the policyholder has in the face of the insurance company's reservation of rights. No insurer wants to try to answer this question.

Under most circumstances, a policyholder can count on the insurer taking substantial amount of time in answering its questions, if it answers them at all. A policyholder can make an insurance company look bad in subsequent litigation, if the insurer does not answer its questions promptly and comprehensively, or—at the very least—gently and politely suggest that the insured's questions are more appropriately discussed with the insured's personal counsel. (This gambit, while reasonable and appropriate, will not succeed at the level of rhetoric. The determined insured will simply re-ask all these questions, and more, through counsel.)

When faced with this gambit, therefore, an insurer should answer the policyholder's questions promptly, thoroughly, comprehensively, and in an open-ended way. This last point is of crucial significance. The insurance company need not box itself in. It can point out to the policyholder that all sorts of alternative options are available. It is also frequently appropriate for the insurance company to try to set up a meeting with the insured. Often, the insured will resist the suggestion. Meetings are seldom a bad idea from the insurer's point of view. Furthermore, if the insurer hypothesizes that the insured is setting it up, it can frequently get better confirmation or disconfirmation of this hypothesis from a meeting than it can from letters.

Rejection

Some courts in some states say that a policyholder has a right that insurers shall make a decision as to whether it has coverage or not. In some courts, in some states say that a policyholder has a right to a defense unburdened by a reservation of rights. Under these circumstances, the policyholder may demand that the insurance company make a decision and dispense of their reservation of rights.³⁸

This view cannot be the law of Texas. In Texas, insureds do not have a general right to an unburdened defense. The reason for this fact is quite simple. The insurer's duty to defend and the insurer's duty to pay have different sources, and—under current Texas law—the duty to pay cannot really be determined until the underlying case is resolved.³⁹

Nevertheless, in general, if an insured rejects a reservation of rights, then the insurer is put to an election. It may do one of four things. First, it may defend unconditionally. Second, it may deny coverage completely. Third, the insurer can ignore the insured's reaction to its reservation of rights letter and keep on defending as though nothing has ever happened. (Subsequently, the insurer will take the position that by not insisting in taking over the case, the insured acquiesced in the reservation.) Fourth, it can acquiesce in the insured's demand by permitting the insured to select personal counsel who will be the attorney for the insured only. This counsel will report only to the insured and will take no instructions from the insurer. The only responsibility of the insurer with respect to the insured's defense is to pay that lawyers reasonable attorney's fees.

Many people believe this last scenario to be firmly established as *the* legal obligation of the liability carrier when faced with a reservation of rights. It is amazing how little binding authority there is for this view. I have not located any cases from Texas state courts, for example, saying that this arrangement *must* be put into practice whenever the insurer and the insured cannot agree, although there is some Fifth Circuit authority to this effect, which purports to construe Texas law.⁴⁰ Nevertheless, many people believe that the scenario like the above one is required of insurers and the widely held belief may rise the level of industry practice.

Insurers and insureds can negotiate all sorts of individualized arrangements about how to handle the defense of the insured in the face of a reservation of rights letter.

In reality, insurers and insureds can negotiate all sorts of individualized arrangements about how to handle the defense of the insured in the face of a reservation of rights letter. It is seldom a good idea for the insurer to simply ignore the insured's rejection of the reservation and continue to defending the case. When the insurer keeps on defending, after ignoring the insured's rejection, it will try to take the position that the insured acquiesced in the reservation, after all. The insured will take the position that it didn't know quite what to do when the insurance company refused to relinquish its defense file. The outcome of such cases will turn on factual subtleties, since the bold positions of both sides are manifestly wrong. Consequently, the outcome of any such case is completely unpredictable. Obviously, therefore, the situation is one to be avoided.

It is seldom a good idea for an insurer to simply refuse to pay any of the fees of the insured's personal counsel, if personal counsel will not agree to the insurer's fee schedule. At the same time, an insurer is obligated to pay *reasonable* attorney's fees for necessary activities. It is *not* obligated to pay attorney's fees at an inflated rate. The fact that an insurer can get capable attorneys at lower fees is surely relevant to the reasonableness of the fee. Insurance companies surely have the right to audit legal bills which they are expected to pay. The position which

insureds frequently take opposing any such audit is surely lacking in legal foundation.

The insurers' responsibility for legal fees following its insured's rejection of the reservation of rights is one of the least tractable issues I know. The attorney's are defensive about their fees and most litigating lawyers believe that the best defense is a good offense. What counts as a necessary activity is, therefore, subject to substantial discretion. Perhaps no more than a smell test can be used to review whether an activity was necessary. The insured is put out with the insurer anyway, and so is ill-disposed to cooperate. If the insured is using its usual law firm, the insured is delighted for the law firm to make a little money. The insured may have an angry, resentful attitude towards the insurer, and wish to hurt it. The insurer knows that it needs to proceed gingerly. All of this is very unfortunate. From a legal point of view, the issue is relatively simple, and there are quite simple ways to handle the problem. Obviously, everyone needs to cooperate. Once the matter is approached in a cooperative spirit, an arbitrator can be selected who is a stranger to all sides, and who is sophisticated about attorney's fees. Such a person can generally be counted on to do the right thing.

Estoppel of the Insured

Suppose the insured declines in silence, the various invitations of the insurer to ask question, react, comment, and so forth. Might there not come a time when the insured is estopped from complaining about the insured's managing the defense? Case law on this is non-existent, as far as I can tell. Theoretically, of course, there is no reason why an insured could not be estopped from claiming that an insurer's management of its defense barred the insurer from denying coverage. On the other hand, there is something inelegant about claiming that an insured may be estopped from asserting estoppel.

Splitting the File

Can the same claims person process the defense of a case against an insurance company's insured, with a reservation of rights in place, and also work on the coverage issues? Obviously, the same lawyer may not perform both functions, because the lawyer's a fiduciary of her client. Neither the insurance company nor the claims person is a fiduciary, however, so there is no black-legal rule which requires that the file be split. At the same time, if defense counsel re-

ports fully on the development of the case, she might make disclosures to the claims person in charge of both files which the insurer would use to deny coverage or which would alert the insurer new dimensions of the already existing coverage problems. If defense counsel assists an insurer in developing policy defenses, the insurer may be estopped from asserting those policy defenses. As a general rule, the lawyer must *knowingly* assist the insurer in developing policy defenses, but the contours of the rule are not clear and the rule is not so fixed that the prudent insurer should rely on its narrow wording rather than its spirit and purpose.

Consequently, prudent insurers will split the file, when a reservation has been issued. This means that the prudent insurer will appoint one claims person to oversee the defense of the case and another claims person to conduct and oversee the coverage dispute. The prudent insurer will also screen off these two claims people from one another. Where possible, it is sensible to place them in geographically different offices. Such placement is easier said than done, however, except in large cities where an insurer will have several offices. Obviously, if an adjuster is expected to investigate a case for the purposes of determining coverage, the adjuster needs to be proximate to the scene where witnesses and documents can be found.

The prudent insurer will appoint one claims person to oversee the defense of the case and another claims person to conduct and oversee the coverage dispute.

There is a paradox not very deeply buried in the recommendation that the file be split. Claims departments of liability insurance companies are organized hierarchically. Line adjusters report to supervisors. Supervisors report to examiners. Examiners report to executives. If a file is to be split, the line of reporting should be kept as separate as possible for as long as possible. Nevertheless, since we are dealing with one insurance company, eventually, the channels of reporting and supervision will converge. Usually, it will be below the vice president for claims, but not very far. Hence, no file can be completely split. Nevertheless, insurance companies should keep

them split for as long as possible, and each file should be flagged so that the one senior person who is responsible for both files will be aware of the split and informed about the reason for the split. Does this convergence negate, in legal contemplation, splitting of the file? In strict legal theory, the answer is probably affirmative. As a practical matter, if a company tries to keep its activities from the defense file separate from its activities on the coverage file, and if there is no real prejudice, the mere fact of convergence will not create estoppel.

A Problematic Defensive Move

Suppose that an insured has been sued upon two theories, one which is covered and one which is not. Suppose further that the insurer has reserved its rights and is defending the insured. Is it ever proper for the liability insurer to move for summary judgment on the covered claim? If it does this, the insurer will be utilizing its position as the insured's litigation manager to place itself in a position to deny coverage completely and to withdraw the defense. On the other hand, if the insurance company does not move for summary judgment, it may be leaving its insured exposed.

One simple resolution of this conflict is to say when a liability insurer moves for summary judgment an uncovered claim, it thereby estops itself from withdrawing the defense. Some insurance companies already behave as though this is the rule and continue providing a defense to an insured, even after all coverage claims have been removed by summary judgment. This is certainly a safe and honorable course, if the insured is informed that the insurer will not be paying any damages if a judgment is returned against the insured. But is it legally required?

Here is my conjecture. (1) If the plaintiff might realistically obtain a jury verdict in the absence of a summary judgment, then the insurer may move for summary judgment on behalf of its insured. By doing so the insurer is protecting the insured from real danger. (This is true even though the jury verdict could be set aside upon a motion for judgment non *obstante verdicto*. As a practical matter some judges are more reluctant to disturb a jury verdict than they are to grant a summary judgment. The insurer should take all necessary measures to avoid subjecting an insured to the appeal of an adverse judgment.) (2) In contrast, if the covered claim is almost

pure make-weight, the insurer probably should not move for summary judgment. The only point in doing so is to avoid paying defense costs. When the insurer files a summary judgment in this situation, it is acting in its own interest only. It is not really defending the insured. This a defending insurer should not do. Of course, distinguishing between these two situations is not always easy. In fact, it may always be hard. When it is unclear whether (1) or (2) obtains, a prudent will always treat the situation as an instance of (1).

The Minnesota Supreme Court recently shed some light on this general area in *Meadowbrook, Inc. v. Tower Insurance Company*. The underlying case was an employment dispute based mostly on various kinds of discrimination and sexual harassment, but with defamation claims thrown in. The trial court granted summary judgment as to the defamation claim, and it was subsequently settled. One question on appeal was whether the insurer could stop paying defense costs when the only covered claim was eliminated. The underlying suit was filed in Year-1; the trial court granted summary judgment on the defamation claim in Year-2; and the defamation claim was settled in Year-3. The court held that the insurer owed its insured a defense for any potentially covered claim until it was eliminated with finality. Hence, a mere partial summary judgment was not sufficient to terminate the insurer's duty to defend. (One wonders if a severed followed by a final judgment in the severed action is sufficient, if an appeal is pending.) But the insurer settled the already defeated claim with the plaintiffs and obtained a release of the insured. At this point, said the court, the duty to defend ended, since no potentially covered was—or even had ever been pleaded. The insured complained that an insurer should not be able to settle a covered claim (as opposed to the entire suit) when such a settlement would expose the insured to litigation costs. The court disagreed. It pointed to the language of the insurance contract which permits insurer to settle tort cases as they “deem expedient.”⁴¹ It is unclear how influential this decision and opinion will be. Not every liability policy contains the “deem expedient” clause. Many policies contain language which suggests that insurers may settle suits against their insureds at their discretion.

Withdrawing the Defense

Suppose everything has been done right. The insurer has issued a proper and timely reservation of right letter. It has split the file. And the insured has acquiesced in the reservation. Now let us suppose that the plaintiff has amended his pleadings several times, and that the insurer has issued a new reservation of rights letter every time.

Now let us suppose that something goes wrong. Suppose, the plaintiff files another amended pleading, but the insurer fails to issue a new reservation of rights letter, or issues a reservation of rights letter but fails to realize that the latest amended pleading has extinguished the insurer's duty to defend. Suppose that this state of affairs lasts for two years or more, at which point the insurance company wakes up and withdraws from the defense of the case.

Not only may an insurance company be estopped for failing to issue a reservation of rights letter in the first place, it can be estopped if it does not withdraw it in a timely way.

Can an insurer do this? The *Acel Delivery* case considered pretty much this issue, and it concluded that the insurer could not withdraw under these circumstances and could not claim that it had no duty to pay. The position of the court seems well taken, at least when trial is drawing near, or when the insured would never have hired or kept the lawyers retained by the insurance company. Short delays are unproblematic, but long delays are never permitted. Within those parameters, the length of a permissible delay is probably inversely proportional to the proximity of the trial date.

Of course, no insurer should ever “jerk” a defense. Groundwork must be properly laid. Explanations must be given. The insured should be given the opportunity to comment. Perhaps there must be a period of dialogue. Things should go smoothly. At the same time, insurers should keep the model of due process in mind: insureds should get notice of a hearing.

There is a second kind of estoppel at work in these cases. Not only may an insurance company be estopped for failing to issue a reservation of rights letter in the first place, it can be estopped if it does not withdraw it in a timely

way. In the "hypo" set up above, the estoppel working against the insurer is still linked to the reservation of rights. But one could just as easily imagine an insurer properly issuing a letter saying that the duty to defend had been distinguished and indicating to the insured that it would withdraw in the near future in an orderly way, and yet—as the result of a bureaucratic blunder—the insurer never withdraws. Estoppel would function just as forcefully in this new "hypo" and the estoppel here would be divorced from any error in the reservation of rights.

Reserving Rights and Declaratory Judgment Acts

When should a liability insurer which has reserved its right file a declaratory judgment against its insured? This question has legal, strategic, and economic significance.

In many jurisdictions, and in all federal courts, an insurer's duty to pay may be determined in a declaratory judgment action before the underlying case is resolved. Sometimes, if the duty to pay is extinguished in a declaratory judgment action, the courts say that the duty to defend is extinguished as well. In contrast, other courts say that liability carriers continue to have a duty to defend, even though they have no duty to pay. (Obviously, this latter situation creates difficult anomalies. The principal difficulty is that the insurer will have a duty to defend, but no duty to settle. This means that the insurer cannot completely control the defense.)

Heretofore, this situation could not arise in Texas. Under the *Burch* case, there was no case or controversy pertaining to the duty to pay until after the underlying tort case was resolved.⁴² Consequently, there could be no declaratory judgment action regarding the duty to pay, although there could be declaratory judgment action regarding the duty to defend, before the resolution of the underlying tort case. Recently, the Texas court may have eroded this doctrine to some degree. In the *Gandy* case in 1996, the Texas Supreme Court held that one of the crucial components in defeating "sweetheart deals," by which plaintiffs and defendants entered into collusive arrangements to siphon money out of insurance companies, was for the insurance company to file and pursue a declaratory judgment action.⁴³ This doctrine would make sense only if an insurance company could obtain an immediate declaration as to the duty to pay. Moreover, in the *Griffin* case,⁴⁴ the Supreme Court per-

mitted the insurer, the insured, and the tort victim to proceed with a declaratory judgment action which eventuated in a finding of no duty to pay.

So, when should a liability insurer carrier file and pursue a declaratory judgment action. Obviously, there are competing considerations to be balanced here. Such actions are not overwhelmingly expensive, but they're not cheap either. On the other hand, liability insurers should be haunted by the specter of the "sweetheart deal." Here's how they work. The plaintiff pleads his tort case in a somewhat ambiguous way. The plaintiff hopes to establish a duty to defend, but trap the carrier into defending only pursuant to a reservation. Once the carrier defends pursuant to a reservation, the plaintiff and the insured cooperate in trying to get rid of the insured. One way to do this is to reject the carrier's reservation, and require the carriers to either defend unconditionally or to stand aside. If the carrier elects to stand aside, the plaintiff and the defendant-insured see to it that the court enters a huge judgment with respect with which there is a covenant not to execute. In the process, the insured assigns any case it has against the insurance company to the tort victim, including all contract rights, as well as all statutory and common law bad faith rights. The tort victim then proceeds directly against the insurance company.

Hundreds of millions of dollars changed hands in Texas over the last decade as the result of these "sweetheart deals." In *Gandy*, the Supreme Court stepped in and made these deals vastly more difficult. One key barrier the court has created to "sweetheart deals" is the declaratory judgment action. According to the court, if a liability insurer files and pursues a declaratory judgment action, then it has a complete defense to a "sweetheart deal." Therefore, whenever a liability insurer faces a situation in which there may be a "sweetheart deal," it behooves the insurer to file and pursue a declaratory judgment action. "Sweetheart deals" were all the rage several years ago. Their significance has now declined precipitously.⁴⁵ Many lawyers no longer have any confidence that they will work, and insurers have been heartened considerably. Nevertheless, liability insurers should be careful. They can still be set up. The key to diffusing any such stratagem is the declaratory judgment action. Hence, if there is any realistic possibility of a "sweetheart deal," the insurer should pursue a declaratory judgment action. Obviously, the insurer's reservation of rights letter will play a pivotal role in the development and presentation of the declaratory judgment act.

Conclusion

Opinions in various jurisdictions link estoppel to conflicts of interest experienced by the insured. Some relate them to apparent conflicts. Some speak of potential conflicts. Others speak simply of conflicts. Estoppel should not be generated by the appearance of evil. It should only be generated by evil itself. The possibility that harmful conduct may emerge, which is what a potential conflict is, is also not sufficient to create estoppel. Even in an actual, out-and-out conflict of interest should not be taken to be sufficient to generate estoppel. Conduct may be un-

acceptable, but the conduct must also cause injury, at least in the form of prejudice.

As a matter of legal theory, estoppel should be difficult to prove. On the other hand, insurers know that they are not favored by juries. In some venues, they are even despised. From a practical point of view, therefore, estoppel is easier to prove than it should be in legal theory. Insurance companies manage their affairs in the real world, and make their plans based on practicality, and not simply upon legal theory. The prudent insurance company, therefore, will give situations which might generate estoppel a wide berth.

NOTES

1. *Trinity Universal Ins. Co. v. Cowan*, 40 Tex. S. Ct. J. 583 (1997), *National Union Fire Ins. Co. of Pgh, Pa. v. Merchants Fast Motor Lines*, 40 Tex. S. Ct. J. 353 (Feb. 21, 1997), and *Farmers Texas Mut. Co. v. Griffin*, 40 Tex. S. Ct. J. 362 (Feb. 21, 1997).

There has been a motion for rehearing in *Griffin*. In response the Texas Supreme Court has asked the parties to brief whether or not the insured right to indemnity under the policy was ripe for decision under Texas constitutional law. This is an extremely important and much debated issue in Texas, although not much elsewhere. See *Firemen's Ins. Co. v. Burch*, 442 S.W.2d 331 (Tex. 1968) and *State Farm Fire & Cas. Co. v. Gandy*, 925 S.W.2d 696 (Tex. 1996).

2. Jeffrey W. Stempel, *INTERPRETATION OF INSURANCE CONTRACTS*, § 19.2 at 458 n.1 (1994).

3. *Continental Ins. Co. v. Bayless and Roberts, Inc.*, 608 P.2d 281 (Alaska 1980) (comparing variations on the general rule). It should be obvious from this discussion that first party carriers (such as property insurers, health insurers, life insurers, and so forth) need not issue letters reserving their rights when the insurance company is simply investigating a claim made under a policy. Nevertheless, the issuance of reservation of rights letter in that context is quite common.

4. *Sussex Mutual Ins. Co. v. Hala Cleaners, Inc.*, 320 A.2d 693 (N.J. 1977).

5. *J.E.M. v. Fidelity & Casualty Co. of N.Y.*, 928 S.W.2d 668 (Tex. App.—Houston [14th Dist.] 1996, no writ).

6. *K. Bell & Associates, Inc. v. Lloyd's Underwriters*, 827 F. Supp. 985 (S.D. N.Y. 1993).

7. *American Home Insurance Co. v. Ozburn-Hessey Storage Co.*, 817 S.W.2d 672 (Tenn. 1991).

8. *State Farm Lloyds Inc. v. Williams*, 791 S.W.2d 542 (Tex. App.—Dallas 1990, no writ). See *Utilities Ins. Co. v. Montgomery*, 138 S.W.2d 1062 (Tex. Comm'n App.

1940, opinion adopted). See also *Pacific Indem. Co. v. Acel Delivery Service, Inc.* 485 F.2d 1169 (5th Cir. 1973) cert denied 415 U.S. 921 (1974) (Texas law) ("If an insured is to prove that the insurer is barred from asserting that it has no duty to pay based upon a theory of waiver, the insured must "demonstrate a voluntary relinquishment of a known legal right." *Id.* at 1173.).

9. *Steptone v. Masco Construction Co., Inc.*, 643 So. 2d 1213 (La. 1994).

10. Generally speaking, "[e]stoppel requires a showing that the insured was prejudiced by the conduct of the insurer." *Williams*, 791 S.W.2d at 552. See *Employers Casualty Co. v. Tilley* 496 S.W.2d 552 (Tex. 1973).

11. *Braun v. Bradley*, 936 F.2d 1105 (10th Cir. 1991)(Oklahoma law) and *Underwriters at Lloyds v. Denali Seafoods, Inc.*, 927 F.2d 458 (9th Cir. 1991)(Washington law).

12. *Safeco Ins. Co. v. Ellinghouse*, 725 P.2d 217 (Mont. 1986) (prejudice conclusively presumed).

13. *Williams*, 791 S.W.2d at 553.

14. *Employers Casualty Co. v. Tilley*, 496 S.W.2d 552 (Tex. 1973).

15. *Merrimack Mutual Fire Ins. Co. v. Nomaka*, 606 N.E.2d 904 (Mass. 1993). (5 month delay not necessarily too long.)

16. *Pacific Indem. Co. v. Acel Delivery Service, Inc.*, 485 F.2d 1161 (5th Cir. 1973). ("The theory underlying [some parts of estoppel] is based on the apparent conflict of interest that might arise when the insurer represents the insured in a law suit against the insured and simultaneously formulates its defense against the insured for noncoverage. For estoppel to prevent the assertion of a defense of noncoverage . . . , there must be a showing of prejudice." *Id.* at 1173.) For a very tough minded view of prejudice, see *St. Paul School District Mo. 625 v. Columbia Transit Corp.*, 321 N.W.2d 41 (Minn. 1982). See also *State Farm Mutual Auto Ins. Co.*

- v. Kay, 487 P.2d 852 (Utah 1971) and National Mutual Ins. Co. v. McMahon & Sons., Inc., 356 S.E.2d 488 (W. Pa. 1987).
17. Arthur L. Corbin, CORBIN ON CONTRACTS, § 752ff (1960).
 18. Acel Delivery, 485 F.2d at 1173.
 19. *Id.*
 20. Farmers Texas County Mut. Ins. Co. v. Wilkinson, 601 S.W.2d 520, 521-22 (Tex App.—El Paso 1980, writ ref'd n.r.e.). (Citations omitted. First emphasis added. Second emphasis in original).
 21. AIG Hawaii Ins. Co. v. Smith, 891 P.2d 261 (Hawaii 1995).
 22. Williams, 791 S.W.2d at 552.
 23. In Florida, insurers may have only 30 days. Doe v. Allstate Ins. Co., 653 So.2d 371 (1995). This rule results from a statute. The prudent adjuster will always check the statutes of the relevant state.
 24. Acel Delivery, 485 F.2d 1173-4. Notice that the timetable here was two years after the lawsuit was filed, not two years after the occurrence. Ideal Mut. Ins. Co. v. Meyers, 789 S.W.2d 1196, 1201 (5th Cir. 1986).
 25. Doctor's Co. v. Ins. Corp. of Am., 864 P.2d 1018 (Wyo. 1993).
 26. Knox-Tenn Rental Co. v. Home Ins. Co., 2 F.3d 678 (6th Cir. 1993).
 27. Meirthew v. Last, 135 N.W. 2d 353 (Mich. 1965).
 28. This means that reservations of rights letters may not be vague or ambiguous. Bogel v. Conway, 433 P.2d 407 (Kan. 1967).
 29. Knox-Tenn., 2 F. 3rd at 683.
 30. Rodriguez v. Texas Farmers Ins. Co., 903 S.W.2d 499, 510 (Tex App.—Amarillo 1995, no writ).
 31. Some issues of privilege may come up here. (1) If reference is made to interviews, will any privileges be waived in the underlying tort case? (2) If reference to some matters is made, will the insurer's privileges be waived in the coverage litigation? The approach and wording of the letter should keep these problems in mind. (I owe this point—and several others—to Beth D. Bradley of the firm of Thompson, Coe, Cousins, and Irons in Dallas.)
 32. Alan D. Windt, INSURANCE CLAIMS & DISPUTES, § 2.16 at 65-66 (3d Ed. 1995).
 33. *Id.* at § 2.14 at 60.
 34. Michael Sean Quinn, "Punitive Damages and Liability Insurance: Whither Texas?" 18 Ins. Litg. Rptr. 121 (March 1996).
 35. It should be remembered that, as a practical matter, it may be difficult to get this done. The insurer should consider having coverage counsel do it. Under no circumstances should defense counsel in the underlying tort case be asked to do this.
 36. Reimbursement was the topic of a moot court conducted at a February 20-22, 1997 ABA meeting on insurance coverage. The meeting was co-sponsored by the Insurance Coverage Litigation Committee of Torts and Insurance Practice Section and by the Appellate Advocacy Committee held in San Antonio, Texas. William Barker of Chicago briefed one point of view while Michael Quinn briefed the other position. The "briefs" cite the then available case law, and discuss the best of it at some length. Copies of the "briefs" can be obtained from the A.B.A. or from the authors. Barker's "brief" is included in the printed proceedings of the meeting. Quinn's got there too late for inclusion.
 37. ___ P.2d ___ (Cal. 1997) [1997 WL 412086].
 38. State Farm Mut. Auto. Ins. Co. v. Baumer, 889 S.W.2d 523 (Mo. banc 1995).
 39. Fireman's Ins. Co. of Newark, N.J. v. Burch, 442 S.W.2d 331 (Tex. 1968). See Note 1, *supra*.
 40. Acel Delivery, 485 F.2d at 1169. There is one very confused Texas Case, Steel Erection Co. v. Travelers Indem. Co., 392 S.W.2d 713 (Tex. Civ. App.—San Antonio 1965, writ ref'd n.r.e.), which speaks to the matter. That case says that if an insurer denied indemnity coverage, it does not have a right to defend the underlying tort suit, even if there are factual allegations which are potentially covered. This situation is a very odd one of course, and not at all identical to the reservation-of-rights situation. If this case implies anything for the reservation-of-rights situation, it implies that when the insurer has a temptation to "throw" the defense in such a way as to favor itself, then the insured may have a right to independent counsel. In any case, Steel Erection has not been an influential case in Texas jurisprudence.
 41. 559 N.W.2d 411 (Minn. 1997). This court cites and purports to rely upon Comm. and Indus. Ins. Co. 832 P.2d 733 (Hawaii 1992).
 42. Fireman's Ins. Co. v. Burch, 442 S.W.2d at 333.
 43. State Farm Fire and Casualty Co. v. Gandy, 925 S.W.2d 696 (Tex. 1996).
 44. See 1, *supra*.
 45. Careful coverage counsel will still advise insurers in many states that "sweetheart deals" may lead to litigation. Here is one pattern. P and D have done a sweetheart deal; they have procured the entry of a judgment; and they arrange an assignment of D's rights against I to P. P now intervenes in the dec action and asserts a right to be paid under the policy. A judge could say this: "I will honor the judgment, and I will now try the tort case in the context of the dec action." One would not want this gambit to come as a surprise to one's insurer-client.