

# Defending Under A Reservation of Rights: A Potential Minefield of Conflicts

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A reservation of rights (“ROR”) is a means by which an insurer agrees to defend an insured against a claim or suit while simultaneously retaining its ability to evaluate, or even disclaim, coverage for some or all of the claims alleged by the plaintiff.



This discussion will examine typical ROR scenarios and the minefield of challenges presented to defense counsel and clients in claims involving RORs.

Examples of common situations where insurers may issue RORs include the following: 1) some of the allegations in the complaint do not fall within the scope of the policy’s coverage, 2) there is an applicable policy exclusion, 3) some of the damages are not covered by the policy, 4) the damages alleged exceed the policy limits, 5) the coverage has been exhausted under an “aggregate” limit of liability, and 6) the policyholder breached a condition of the policy.

ROR letters typically recite a laundry list of reasons the insurer could have for denying coverage and often frighten policyholders who had of course purchased policies thinking that they would be covered in the event of a loss. The insurer is obligated to notify the insured that it may not cover a particular claim, so as to enable the insured to prepare an adequate defense.

The ROR letter must explain to the policyholder why a particular provision of the policy, as applied to the facts of the case, could result in the denial of coverage. The letter should quote the relevant policy language that is to be the basis of a possible future denial of coverage.

An insurer’s indemnity obligation often cannot be determined until after a suit against the insured is concluded. For example, where the insured is charged with both negligent and intentional conduct, the insured may have coverage for the former but not the latter. Where the insurer’s coverage obligations are unclear, it beneficial for the carrier to defend the insured subject to a ROR and, if appropriate, seek a declaratory judgment determining the obligations of the insurer.<sup>1</sup>

The issuance of a ROR allows the insurer the flexibility to fulfill its obligation under the policy to provide a defense while protecting itself by carrying on an investigation which could allow it to raise eventual defenses to coverage and, at the same, alerting the insured as to what actions it needs to take to protect its own interests.

Typically, when an insurer issues a ROR, it retains defense counsel for the insured while simultaneously monitoring the case and coverage issues related thereto either itself or with the help of coverage counsel. However, ROR’s may also give rise to a

policyholder's right to independent counsel paid for at the carriers' expense.<sup>2</sup>

ROR letters should be sent as soon as questions of coverage are recognized. Pursuant to Insurance Law § 3420(d), an insurer wishing to disclaim coverage for death or bodily injury must give "written notice as soon as is reasonably possible." The Court of Appeals has held that a 48 day delay in disclaiming is unreasonable, late and renders the disclaimer void.<sup>3</sup> Recently, the Appellate Division recognized that the duty to timely disclaim extends to property damage claims as well.<sup>4</sup>

Such letters should contain, at a minimum:

- The relevant policy language.
- Every potential applicable defense to coverage; i.e., that claims for punitive damages are not covered; that intentional claims (fraud, assault, intentional infliction of emotional distress) are not covered; that a complaint seeking damages in excess of the policy limit is covered only to the limit of the policy.
- If further investigation is required to ascertain whether coverage is available, the Reservation of Rights Letter should state that the insurer reserves the right to disclaim coverage based upon further factual developments (and the investigation must in fact be promptly pursued).
- References to the allegations in underlying complaint.
- Identification of the claims that are covered and those which are not covered.
- Identification of each and every policy exclusion, coverage provision, general condition which may bar coverage.
- The insurer's position regarding coverage.
- Notification to the policyholder that it has the right to independent counsel in the underlying suit. (The value of advising the policyholder of this fact, of course, is if the insured raises a question as to the viability of the defense provided by the insurer at a later time.)
- An insurer will be estopped from raising any defenses known or which should have been known if not included in the letter.<sup>5</sup>
- If new grounds surface during discovery, the insurer should supplement the Reservation of Rights Letter as soon as it learns of the information.

Insurance defense attorneys must be extremely cautious because an insurance company's reservation of rights often presents a classic conflict of interest. Since the insurer may eventually prevail on a coverage issue, it could be perceived to have less initiative to

defend a policyholder's claim. Since some of the claims asserted against the policyholder might be covered by insurance and others might not be, an insurer could appear to have more incentive to direct or steer counsel to more vigorously defend those claims not covered by the policy.

Since a defense attorney is often on a carrier's designated panel of litigation firms, and wants to remain there so as to obtain more business, there is a natural inclination for the attorney to want to satisfy the wishes of that insurer. In fact, the Eighth Circuit stated in United States Fidelity & Guar. Co. v. Louis A. Roser Co.,<sup>6</sup> that "the most optimistic view of human nature requires us to realize that an attorney employed by an insurance company will slant his efforts, perhaps unconsciously, in the interests of his real client -- the one who is paying his fee and from whom he hopes to receive future business -- the insurance company."

A Texas high court similarly stated, "[h]e who pays the piper, calls the tune."<sup>7</sup>

Whether a ROR is issued or not, defense counsel assigned by the insurer, of course, owes primary allegiance to the policyholder. Occasionally, however, a conflict may arise when an attorney finds himself caught in the financial and fiduciary tensions between him, his client, and the insurance company which hired him to represent his client.

These entities have what is known in industry parlance as a tripartite relationship, a creature unique to the insurance defense world, in which an insurer assigns counsel to a policyholder, and pays for the defense of that policyholder, although the interests of the policyholder and insurer could be divergent. Carriers who refer cases to defense counsel have an interest in controlling every aspect of the defense in order to minimize their costs and efforts by insurers to do so could interfere with an attorney's supreme duty to his client.

It is important to appreciate and avoid the potential ethical conflicts presented by this relationship in order to preserve the rights and interests of the client. An attorney who does not properly assess and address the ethical constraints of the tripartite relationship could be figuratively staring into the barrel of a gun, facing potential sanctions or even the loss of a client.

The most common scenario in which a defense attorney faces a potential conflict after a ROR is where he learns of information regarding potential coverage defenses.

For example, an attorney may learn that the insured acted intentionally or fraudulently, thereby vitiating coverage under its policy. Ethical opinions in New York provide that a lawyer retained by an

insurance company to represent an insured may not, unless the client consents, give the insurance company information the insurer can use to deny coverage to the client. Any request for information implicating coverage should be passed on to the client, with an explanation of the possible ramifications of responding to the request.

Under the recently enacted New York Rules of Professional Conduct, the requirement of the supreme allegiance to the insured client remains intact. Specifically, 22 NYCRR Part 1200, Rule 5.4 (c) states a “lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal service for another to direct or regulate the lawyer’s professional judgment in rendering such legal services or to cause the lawyer to compromise the lawyer’s duty to maintain confidential information of the client under Rule 1.6.”

Based on an attorney’s ethical obligations, he or she should not report matters that will harm the client by jeopardizing insurance coverage, and the insurer should not require such disclosures as a condition of representing the insured client. 22 NYCRR Part 1200, Rule 2.3 (b).

The attorney’s duty to preserve the confidentiality of information under 22 NYCRR part 1200, Rule 1.6 requires the attorney to refuse to disclose certain information to the insurance company absent the policyholder’s consent. If the insurer is entitled to obtain certain information, and the policyholder refuses to give counsel the consent to divulge the information, then defense counsel should consider recommending that the client retain separate conflicts counsel to protect the policyholder’s rights in a potential coverage dispute with the insurance company.

An attorney who learns of his client’s fraudulent acts that may impact coverage is not under a duty to inform the insurance company of the possibility of the fraudulent acts by the insured.<sup>8</sup>

In addition, because such information is learned by a lawyer in the course of his/her professional relationship with a client, such information is confidential and may not be disclosed to an insurance company, without the client’s consent.<sup>9</sup>

Whenever conflicting interests exist, dual representation of an insured and an insurer cannot continue without each client’s informed consent, and only if competent representation of both interests is possible. 22 NYCRR Part 1200, Rule 1.7(4). When an actual or potential conflict of interest exists, defense counsel must promptly, fairly and fully inform the insured of all the facts and legal consequences regarding the conflicts so the insured can make an intelligent, informed decision whether or not to

consent to counsel’s continued representation or to seek independent counsel.<sup>10</sup>

After a policyholder’s consent to continue representation is obtained, defense counsel should undertake to communicate the nature and scope of the potential or actual conflict of interest to the insurer.<sup>11</sup> In communicating with the insurer, however, defense counsel must take care not to reveal the content of privileged communications with the policyholder. Disclosing such communications is a breach of counsel’s duty of loyalty, and may also lead to the insurer being estopped from later denying coverage.<sup>12</sup>

In most circumstances, where consent has been obtained from both policyholder and insurer after full disclosure, defense counsel can continue dual representation of both clients. This may occur even where coverage is in dispute and a defense is provided subject to a ROR if: 1) counsel limits his or her involvement to the liability issues; and (2) avoids any involvement with coverage issues; and (3) the outcome of the subsequent coverage dispute will not depend upon the resolution of important factual issues in the underlying action. If liability of the insured in the underlying action will be resolved based upon factual issues important to the resolution of the coverage dispute, then an irreconcilable conflict of interest exists, and defense counsel must withdraw.<sup>13</sup>

Only after an actual conflict of interest exists can the policyholder demand independent counsel.<sup>14</sup> The most immediate problem arising once it is determined that a true conflict exists requiring the provision of independent counsel is whether the insurer or the policyholder is entitled to select independent counsel. The insurer, who will be funding the defense, will obviously seek to select counsel of its choosing, if for no other reason to assure that the counsel meets certain minimum qualifications. This raises the concern that counsel selected and funded by the insurer may favor the interests of the insurer to the detriment of the policyholder.

The majority of jurisdictions, including New York, grant the insured the right to choose independent counsel, whose reasonable fee is to be reimbursed by the insurer.<sup>15</sup>

### Conclusion

Counsel defending an insured under a ROR must be extremely vigilant to ensure that it maintains his supreme allegiance to his client, the policyholder. It is crucial for insurance defense attorneys to familiarize themselves with the new ethical rules and how they affect the obligations of counsel to their clients once a ROR is issued.

As a practical matter, counsel should also be aware that some carriers take the position that

only the policyholder should tell counsel of the carrier's coverage position and thus, the carriers deliberately omit such information in suit assignment letters. Accordingly, counsel should consider asking their clients from the onset of a case for any correspondence pertaining to the claim including correspondence from the carrier.

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<sup>1</sup> See, Commercial Union Ins. Co. v. International Flavors & Fragrances, Inc., 822 F.2d 267, 274 (2d Cir. 1987).

<sup>2</sup> Public Service Mut. Ins. Co. v. Goldfarb, 53 N.Y.2d 392 (1981).

<sup>3</sup> First Fin. Inst. Co. v. Jetco Constr. Co., 1 N.Y.3d 64 (2003).

<sup>4</sup> Village of Brewster v. Virginia Surety Company, Inc., 2010 WL 547082 (3d Dept. 2010).

<sup>5</sup> See, Kokonis v. Hanover Ins. Co., 2001 WL 42958 (3d Dep't 2001); Macon v. Arnlie Realty Co., 207 A.D.2d 268, 615 N.Y.S.2d 28 (1st Dep't 1994).

<sup>6</sup> 585 F.2d 932, 938 n.5 (8th Cir. 1978).

<sup>7</sup> State Farm Mut. Auto Ins. Co. v. Traver, 980 S.W.2d 625, 633 (Tex. 1998).

<sup>8</sup> See, Opinions of the Committee on Professional Ethics, New York County Lawyers Association, No. 659, June 30, 1983.

<sup>9</sup> See, Opinions of Committee on Professional Ethics, New York County Lawyers Association, No. 669 (89-2).

<sup>10</sup> Eric M. Holmes, A Conflict Of Interest Road Map for Defense Counsel: Walking An Ethical Tightrope Without A Net, 26 Williamette L. Rev. 1, 61-62.

<sup>11</sup> Id.

<sup>12</sup> See, e.g., Parsons vs. Continental National American Group, 113 Ariz. 223, 550 P.2d 94 (1976); Employer Casualty Co. v. Tilley, 496 S.W.2d 552 (Tex. 1973).

<sup>13</sup> See, Prashker vs. United States Guar. Co., 1 N.Y.2d 584, 154 N.Y.S.2d 910 (1956).

<sup>14</sup> See, Public Serv. Mutual Ins. Co. v. Goldfarb, *supra*.

<sup>15</sup> See, Public Service Mutual Ins. Co. v. Goldfarb, *supra* (when a conflict of interest is probable, selection of attorneys to represent the insured should be made by the insured rather than the insurance company, "whose reasonable fee is to be paid by the insurer").