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CLIENT UPDATE

TWO'S COMPANY, THREE'S A CROWD? WHEN INSURANCE DEFENSE COUNSEL ARRIVE AT THE PARTY UNDER A RESERVATION OF RIGHTS

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THE THREE-PARTY RELATIONSHIP AND THE RESERVATION OF RIGHTS DILEMMA

The standard general liability policy imposes upon the insurer two separate and distinct obligations for the benefit of the insured: the duty to defend and the duty to indemnify.[1] In the typical policy, the insurer agrees to provide a defense against a claim for damages, including the cost of engaging a lawyer for the insured, and to pay damages for which the insured is found responsible. The insurer, in turn, maintains the right to control the defense and to make decisions on settlement. In most states, the lawyer engaged by the carrier to defend the policy holder is deemed to be in an attorney-client relationship with both the insured and the insurer. When the insurer agrees that a claim is covered by the policy and within the dollar limits of coverage, the interests of the insured and the insurer are aligned. Usually, the insurance company's selected lawyer handles the joint representation without running afoul of any ethical concerns and the insured is content to let the insurer control the defense. But what happens when the interests of the insurer and the insured are not aligned on coverage, and what are the insured's rights in the event of such a conflict?

It is often said that the insurer's duty to defend is broader than its duty to indemnify. This means that, in the circumstance where at least one or a portion of the claims asserted against the insured are covered by the policy, the insurer has a duty to defend *all* of the claims that might possibly be covered.[2] When this happens, the insurer will notify the policy holder that it will provide a defense subject to a reservation of rights to contest coverage for specific aspects of the claim against the insured. When a reservation of rights letter is sent, the interests of the insurer and the insured naturally diverge, and the lawyer may be conflicted between two clients with potentially differing interests.[3]

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[1]The standard ISO general liability policy states: "[The insurer] will pay those sums that the insured becomes legally obligated to pay as damages because of 'bodily injury' or 'property damage' to which this insurance applies. We will have the right and duty to defend the insured against any 'suit' seeking those damages. However, we have no duty to defend the insured against any 'suit' seeking damages for 'bodily injury' or 'property damage' to which this insurance does not apply." ISO Form CG 00 01, §1, ¶1.

[2]See *Bankwest v. Fidelity & Deposit Co.*, 63 F.3d 974, 978 (10th Cir. 1995) (finding insurer's duty to defend arises "whenever there is a 'potential of liability' under the policy"); *Intex Plastics Sales Co. v. United Nat'l Ins. Co.*, 23 F.3d 254, 256 (9th Cir. 1994) ("duty to defend exists if there is a 'possibility' or 'potential' for coverage"); *Boston Symphony Orchestra, Inc. v. Commercial Union Ins. Co.*, 545 N.E.2d 1156, 1158 (Mass. 1989) ("duty to defend is based on the facts alleged in the complaint and those facts which are known by the insurer"); *Commercial Union Ins. Co. v. Royal Ins. Co.*, 658 A.2d 1081, 1083 (Me. 1995) ("insured is entitled to a defense if there is any legal or factual basis that could obligate an insurer to indemnify... . The complaint must show only a potential that the facts ultimately proved could come within coverage." (citations omitted))

[3]In the construction litigation context, the lines between tort and contract claims are often blurred and disputes over coverage are frequent. Suffice it to say, however, when a complaint includes both tort and contract claims, defense to purely contractual claims that do not implicate the same conduct as the tort claims, as well as the prosecution of counterclaims, remain the responsibility of the insured.

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Examples of potential conflict are easy to imagine. If the insurer contends that a particular loss is not covered under the policy, the lawyer hired by the insurer might offer a less than strident defense of the potentially *non-covered* claim or otherwise conduct the case in a way that increases the likelihood of a decision in favor of the plaintiff on the *non-covered* claim. Or, the lawyer hired by the insurer might become privy to otherwise confidential information during the defense that the insurer could use to contest coverage. It is even possible to conceive that, either overtly or subconsciously, the lawyer retained to defend the claim might tend to favor the company over the policy holder stemming from a desire to receive future legal work from the insurer. Given the often subtle distinctions over insurance policy definitions, such as "property damage," "your work," and "occurrence," the potential exists for conscious or unconscious shading of the facts and legal argument to the detriment of the insured.

Courts across the country have addressed this dilemma by ruling that, if an attorney would be conflicted between the legal interests of the policy holder and the insurance company due to a reservation of rights, then the insured is entitled to select counsel of its choice to handle the defense at the insurance company's expense. Courts in some states, including Massachusetts, have ruled that the mere reservation itself establishes the right to select separate counsel.[4] Other courts require a more in-depth analysis of facts and circumstances of the alleged conflict to determine, on a case-by-case basis, whether the conflict is significant enough to merit departing from the strict terms of the insurance contract.[5] Either way, whenever an insurance company notifies the insured that the company will provide a defense subject to a reservation of rights, the insured should take steps to preserve its rights and, in most cases, the insured should insist on being allowed to select an attorney who is independent from the control of the insurer, but whose bills will be paid by the insurer.

RESPONDING TO THE RESERVATION OF RIGHTS LETTER

The standard CGL insurance policy obligates the policy holder to provide notice that a third party has made a covered claim and to cooperate with the insurance company in defending against any claim that might be covered.[6] In response to a claim, the carrier will issue a coverage letter that acknowledges receipt of the claim and provides the carrier's initial interpretation of coverage, which will be either to deny coverage, accept coverage or accept with a reservation.[7] If the insurance company takes the position that some, but not all, claims are covered, it will assert its intention to defend the claims subject to a reservation of rights to contest coverage later depending on the outcome of the matter. In such cases, the insurer will usually advise the insured as to the identity of the lawyer or law firm that it has selected to defend the insured.

A policy holder receiving a reservation of rights letter should immediately begin creating a record to support the application of coverage to all the claims and to preserve the right to select independent legal counsel at the insurance company's expense. A letter should be sent to the carrier challenging the

[4] *Magoun v. Liberty Mut. Ins. Co.*, 195 N.E.2d 514, 518 (Mass. 1964); *D'Amico v. City of Boston*, 186 N.E.2d 716, 722 (Mass. 1962). *See also Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 120 (5th Cir. 1983) (applying Texas law); *Howard v. Russell Stover Candies, Inc.*, 649 F.2d 620, 625 (8th Cir. 1981) (predicting Missouri law); *Union Ins. Co. v. Knife Co., Inc.*, 902 F. Supp. 877, 880 (W.D. Ark. 1995) (predicting Arkansas law); *CHI of Alaska, Inc. v. Employers Reinsurance Corp.*, 844 P.2d 1113, 1118 (Alaska 1993).

[5] E.g., *Twin City Fire Ins. Co. v. Ben-Arnold Sunbelt Beverage Co.*, 433 F.3d 365, 373 (4th Cir. 2005) (predicting South Carolina law); *Travelers Indem. Co. v. Royal Oak Enters.*, 344 F. Supp. 2d 1358, 1374 (M.D. Fla. 2004) (predicting Florida law); *Fed. Ins. Co. v. X-Rite, Inc.*, 748 F. Supp. 1223, 1229 (W.D. Mich. 1990) (predicting Michigan law)

[6] The standard ISO policy states: "You must see to it that we are notified as soon as practicable after an 'occurrence' or an offense which might result in a claim." ISO GC 01 10 §IV, ¶ a. The form policy also states that the insured must: "cooperate with us in the investigation or settlement of the claim or defense against the 'suit.'" Id. at §IV, ¶ c(3).

[7] If the carrier accepts coverage without reservation, then there is no issue. If the carrier denies coverage entirely, and cannot be quickly convinced to change its position, then the insured would be forced to engage its own lawyers and fund the defense effort alone. Typically, when that happens, the insured will bring a separate legal action against the insurer seeking a declaration that coverage exists. If the insured prevails, the carrier could be liable for any settlements or judgments in the original suit, and the attorneys' fees incurred by the insured both for the original defense and the declaratory judgment action.

reservation and advising of the policy holder's intention to engage independent counsel at the carrier's expense if the carrier does not withdraw the reservation. Very often, merely sending a well-reasoned response to the reservation of rights letter is all that is necessary to convince the insurer to retract its initial position and accept coverage.

If the insurer holds its ground in the face of the insured's challenge to the reservation, the insured should focus on developing a paper record that demonstrates appropriate notice to the insurer and a good faith effort to cooperate despite the reservation. This record will be critical if later needed to establish the fulfillment of notice and cooperation obligations in a subsequent declaratory judgment action against the insurer, should that become necessary. In many cases though, using the leverage of the law regarding the insured's right to independent counsel paid for by the insurer, the insured and its legal team are able to negotiate a reasonable accommodation with the carrier.

Additional insured status is another common circumstance that adds complexity to litigation management in the construction context. A general contractor and owner are often named as additional insureds on the policies of their subcontractors. In many states, including Massachusetts, the general contractor and owner may be entitled to indemnity and defense from the subcontractor's insurers on a primary and non-contributory basis. More often than not, the insurer for the subcontractor will defend only with a reservation of rights. The uncertainty created by these overlapping defenses to coverage should encourage the parties to negotiate a workable plan that assures independent counsel early in the process.

When an insurer agrees (or is forced to acknowledge) that it is appropriate for the insured to engage independent counsel of its own choosing due to a reservation of rights, the lawyer so selected is entitled to control the defense independent of the insurance company. This may include the freedom to render services independent of any standard billing guidelines published by the insurer when following those guidelines would interfere with the lawyer's independent professional judgement regarding the defense.[8]

If a negotiated plan is not possible or the insurer refuses to pay for the defense unless it retains complete control in the face of an unacceptable conflict, then the insured should consider the option of bringing a declaratory judgment action compelling the carrier's performance of its duty to defend. Only after efforts at negotiating a reasonable plan have failed should the insured unilaterally take control over the defense, and even then the insured should continue to provide regular progress reports and copies of legal bills to the carrier and inform the carrier of potential settlement opportunities on aspects of the case in which the insurer has an interest.

WHEN COVERED CLAIMS AND RESERVED CLAIMS ARE MIXED WITH OTHER CLAIMS

Construction industry disputes frequently include a mix of contract and tort claims and counterclaims, all under the umbrella of one legal proceeding. When claims that cannot possibly be covered by the insurance policy are combined in the same action with covered or arguably covered claims, the insured and the insurer will have no choice but to reach an accommodation that protects their mutual and separate interests via some form of litigation management/cost sharing arrangement.

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[8] *See In re Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedure*, 2 P.3d 806, 814, 815 (Mont. 2000) ("requirement of prior approval fundamentally interferes with defense counsels' exercise of their *independent* judgement" (emphasis in original)).

A plan to manage litigation notwithstanding a reservation of rights should take into account the order, magnitude, and practical reality of the conflict, as well as the prominence of other, non-tort causes of action or counterclaims. This plan should include an understanding about the absolute independence of the lawyers working for the insured and how those lawyers will interact with the insurance company, corporate counsel, and, when needed, other independent counsel representing other interests at the insurer's expense. The plan should also include an understanding about how strategy and settlement decisions will be communicated and how legal bills will be reviewed and paid. In any event, special care should be taken to make sure that legal bills that may be submitted to the carrier (or to the court where fees are recoverable) are drafted (or redacted) to maintain the attorney-client relationship.

Joint defense arrangements between the insured and the insurer can take a wide range of forms depending on the circumstances, including the relative leverage of the parties regarding the coverage issue which is the subject of the reservation of rights and the practical merits of the conflict. Sometimes the arrangement is as simple as having the insured's outside law firm file a notice of appearance with the court solely to monitor and advise on the defense at the insured's expense, while the insurer's panel counsel provides the defense. This is typical when the only source of conflict is a sizable deductible. In other circumstances, the insured and insurer might agree to engage counsel selected by the insured at the shared cost of the parties, or the insured and the insurer may agree on separate counsel to handle discreet aspects of the same litigation. Either of these approaches is common when tort and contract issues are joined in the same dispute, or when a dispute involves a counterclaim by the insured against the party that filed the original complaint.

CONCLUSION

When the insurer offers to defend with a reservation of rights, there are a number of options available to the policy holder to allow it to effectively align the interests of the insured and the insurer, while assuring the independence of the legal defense. Being knowledgeable about the insured's legal rights and obligations, and proactive from the start, will allow the policy holder to develop strategies that optimize the benefits of insurance coverage, enhance the effectiveness of the defense effort, and minimize the likelihood of collateral disputes over the competence of representation and the prudence of settlement and trial decisions.

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