Delivering Bad News the Right Way: Ethical Considerations When Issuing Reservation of Rights and Denial Letters

Dan Ripper
Luther-Anderson, PLLP
P.O. Box 151
Chattanooga, TN 37402
423-756-5034
dan@lutheranderson.com

I. Introduction

Some people feel the moral and ethical fiber of our society is deteriorating rapidly. Others see both positive signs and disturbing signs but feel optimistic. While there is room for a difference of opinion on this issue, most people agree on the importance of maintaining a high ethical standard in a society that is to survive and prosper. There may be no industry more reliant on high ethical standards than the insurance industry. Insurance is an essential product that both individuals and businesses rely on to protect them from financial disaster. This is never truer than it is when decisions are being made concerning whether to provide coverage for a claimed loss. Generally speaking it is an insurance adjuster's obligation to promptly and completely investigate and evaluate a claim with an eye toward providing coverage to the insurer. It is an unfair claims practice to fail to promptly provide a reasonable explanation for denial of a claim or for the offer of a compromise settlement.

II. Timing Considerations

A. Duty to act reasonably promptly

It is always the case that an insurer has a duty to act promptly in evaluating and investigating a claim made, and this is true of coverage related issues as well as basic claim facts. There are differences in every state, but it is always the case that there is an obligation to act reasonably promptly.

In Oklahoma, within 45 days after receipt of proof of loss, the insurer must accept or deny coverage, unless more time is needed, in which case the insurer must notify the insured of that and continue to do so every 45 days thereafter until a determination of coverage is made. Okla. Admin. Code § 365:15-3-5 to § 365:15-3-7. An insurer cannot deny coverage based on a particular coverage defense unless the insurer provides notice of its reservation of rights to assert a coverage defense within 45 days after receipt of proof of loss. Okla. Admin. Code § 365:15-3-5 to § 365:15-3-7. An insurer "must disclose the rationale for coverage denial within a reasonable time." The disclaimer must make

"specific reference to the policy defense being relied upon by the insurer." Cust-O-Fab Serv. Co., LLC v. Admiral Ins. Co., 158 Fed. Appx. 123, 129 (10th Cir. 2005).

The Texas Insurance Code requires an insurer to submit a reservation of rights to a policyholder within a reasonable time. Tex. Ins. Code Ann. § 541.060(a)(4)(B). The statute does not define "reasonable," and Texas has not implemented any rules providing specific timelines for issuing a coverage position. Texas courts have demonstrated that each case will be resolved based upon its specific set of facts as to whether the issuance of a reservation of rights letter is timely. As discussed above, the main consideration in determining timeliness is whether a delay in sending a reservation of rights letter actually prejudices the insured. Accordingly, it is best practice for the insurer to send a reservation of rights letter as soon as possible after receiving notice of the lawsuit. However, a handful of Texas state and federal cases decided before Ulico provide some guidance as to what Texas courts consider to be timely.

B. Insurer obligations/Unfair claim practices

Many states have unfair claims practices statutes that are typically modeled after the National Association of Insurance Commissioners (NAIC) model Unfair Claims Settlement Practices Act. Generally, under these statutes, an unfair claims practice may be considered as follows:

-Misrepresenting pertinent facts or insurance policy provisions relating to coverage at issue.

-Failing to acknowledge and act reasonably promptly upon communications with respect to claims arising under insurance policies.

-Failing to adopt and implement reasonable standards for the prompt investigation of claims arising under insurance policies.

-Refusing to pay claims without conducting a reasonable investigation based upon all available information.

-Failing to affirm or deny coverage of claims within a reasonable time after proof of loss statements have been completed.

-Failing to effectuate prompt, fair and equitable settlements of claims in which liability has become reasonably clear.

-Compelling insureds to institute litigation to recover amounts due under an insurance policy by offering substantially less than the amounts ultimately recovered in actions brought by such insureds.

-Attempting to settle a claim for less than the amount to which a reasonable man would have believed he was entitled by reference to written or printed advertising material accompanied or made part of an application.

-Attempting to settle claims on the basis of an application which was altered without notice to, or knowledge or consent of the insured.

-Making claims payments to insureds or beneficiaries not accompanied by a statement setting forth the coverage under which payments are being made.

-Making known to insured or claimants a policy of appealing from arbitration awards in favor of insureds or claimants for the purpose of compelling them to accept settlements or compromises less than the amount awarded in arbitration.

-Delaying the investigation or payment of claims by requiring that an insured or claimant, or the physician of either, submit a preliminary claim report and then requiring the subsequent submission of formal proof of loss forms, both of which submissions contain substantially the same information.

-Failing to settle claims promptly, where liability has become reasonably clear, under one portion of the insurance policy coverage in order to influence settlements under other portions of the insurance policy coverage.

-Failing to provide promptly a reasonable explanation of the basis in the insurance policy in relation to the facts or applicable law for denial of a claim or for the offer of a compromise settlement.

The evaluation and investigation of every claim made should be guided by consideration of the potentially unfair practices, and every effort made to avoid them.

III. Reservation of rights

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. The first purpose of reservations of rights is to permit the insurer to undertake an investigation and take initial steps connected with the claim without suffering waiver or estoppel. The second purpose, particularly in connection with liability policies, is to permit the insurer, following the initial investigation, to continue to defend the claim under a reservation of certain rights. A carrier waives coverage defenses if it prejudices the insured by accepting defense without timely reserving rights. A carrier waives coverage defenses if it prejudices the insured by accepting defense without timely reserving right.

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

The reservation of rights letter should fully and fairly apprise the policyholder of the basis for the insurer's position. It should also invite the policyholder to provide all facts, analysis,

or information that the policyholder deems relevant. Finally, it should make clear that the insurer reserves the right to rely upon additional policy provisions or facts that may be relevant after further review. If and when additional reasons for denial or reservation of rights are determined, a supplemental letter should be sent. By specifying all possible grounds for denying coverage, the insurer prevents the policyholder from later making allegations, possibly in a bad faith claim, that the insurer failed to deal reasonably with the policyholder or induced reliance upon the insurer-provided counsel who had a conflict of interest.

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.

Outside of the context of defending third-party claims, the issuance of a reservation of rights letter is still often necessary. The insurer should always protect against the possibility that the policyholder could claim that the insurer induced the policyholder into taking certain actions. In addition, policyholders are entitled to a prompt response to any claim, even if the response simply notes the need for further investigation. Thus, before the insurer undertakes any substantial investigation, it should inform the policyholder that it has made no coverage determination and that it reserves its right to either grant or deny coverage based upon the results of its investigation.

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.

A. Notice

What is required to be contained within a reservation of rights letters varies from state to state. Rather than engage in a 50 state survey this paper will address some relevant states.

In Oklahoma the reservation of rights letter should identify those relevant provisions of the policy on which the insurer may rely to disclaim coverage. In addition, the insurer should make apparent that any further actions taken by it shall not be construed as a waiver of any rights or defenses. Melton Truck Lines, Inc. v. Indem. Ins. Co. of N. Am.,

2006 U.S. Dist. LEXIS 43179, *9-10 (N.D. Okl. 2006). An insurer "must disclose the rationale for coverage denial within a reasonable time." The disclaimer must make "specific reference to the policy defense being relied upon by the insurer." Cust-O-Fab Serv. Co., LLC v. Admiral Ins. Co., 158 Fed. Appx. 123, 129 (10th Cir. 2005).

In Texas any defects in the contents of the reservation of rights letter will not result in estoppel without a showing of actual prejudice to the insured. That notwithstanding, the provisions of a reservation of rights letter will be construed strictly against the insurer and will not be extended by implication beyond their exact terms. W. Cas. & Sur. Co. v. Newell Mfg. Co., 566 S.W.2d 74, 76 (Tex. Civ. App. San Antonio 1978). The reservation of rights letter must be sufficient to inform the insured of the insurer's position. Am. Eagle Ins. Co. v. Nettleton, 932 S.W.2d 169, 174 (Tex. App. El Paso 1996). Accordingly, the letter should detail specific coverage problems that the insured might face, inform the insured that a conflict of interest exists, and inform the insured that they have the right to seek outside counsel. The letter should set out the policy provisions or exclusions that the insurer is relying on to disclaim coverage. See, e.g., Nguyen v. State Farm Lloyds, Inc., 947 S.W.2d 320, 322 (Tex. App. Beaumont 1997). The letter should also identify the name of the insurer reserving its rights under the policy at issue. Canal Ins. Co. v. Flores, 524 F. Supp. 2d 828, 835 (W.D. Tex. 2007) (applying Texas law).

In Ideal Mutual Insurance Co., the Fifth Circuit, applying Texas law, found that the insurer's reservation of rights letter was adequate and noted the following qualities: 1. the letter specifically identified the policy in question; 2. the letter specifically informed the insured that an attorney had been retained to defend the case; 3. the letter specifically apprised the insured of the initial results of the insurer's investigation; 4. the letter specifically identified the insurer's reservation of rights under the policy, i.e., policy exclusions and exceptions relied upon; 5. the letter specifically identified the insurer's reservation of its right to withdraw from the defense of the Plaintiff's cause of action; 6. the letter specifically advised the insured that they were at liberty to secure counsel of their own choice, at the insured's expense, to represent the insured in regard to the amount sued which is in excess of the insured's insurance coverage; 7. the letter specifically advised the insured that as to such excess there could be a conflict of interest between the insurer and the insured; and 8. the letter specifically advised that if the negligence of the insurer causes a judgment to be rendered against the insured in excess of the insurance limits, it could be that the insurer might be responsible for the excess judgment. Ideal Mut. Ins. Co., 789 F. 2d at 1201.

Lastly, In Texas the reservation of rights letter may provide the insurer with the right to seek reimbursement for defense costs it pays if it later establishes that those costs were incurred in defending non-covered claims. If the insurer intends to seek reimbursement, it should give notice in the reservation of rights letter that it intends to seek reimbursement from the insured for defense costs of uncovered claims to avoid being precluded from later pursuing such a claim against the insured. See Alliance Gen. Ins. Co. v. Club Hospitality, Inc., No. 3:97-CV-2448- H, 1999 WL 500229, at *1 (N.D. Tex. July 14, 1999).

B. Attempted Intervention and/or Declaratory Judgment to Deny or Limit Coverage (for some or all claims)

When a claim has been denied and the denial is contested, the question becomes “what next”? Particularly in the case of liability policies, where there is an ongoing underlying action, it is often not a safe course of action for the insurer to deny and take no further steps. The most common course of action by which the insurer may seek to protect its interests in this situation is a declaratory action. The carrier may provide a defense subject to reservation of rights, and simultaneously challenge coverage in a DJ action. Otherwise, it risks being collaterally estopped from challenging the factual determinations in the underlying tort action.

C. Independent Counsel

A reservation of rights may allow the insured to retain independent counsel. In Oklahoma, no statute or case law requires an insurer to pay for independent counsel whenever it asserts a reservation of rights. In Nisson v. American Home Assurance Co., an insurer retained one counsel to represent multiple insureds (psychiatrists practicing in the same office) who had conflicting interests. One insured became concerned and retained his own counsel, then sought to have the insurer pay for that representation. The court found that the insurer "did not owe [the insured] a duty to provide independent counsel when a potential conflict arose over extent of coverage." 917 P.2d 488, 490 (1996 OK Civ. App. 40) (emphasis added). However, when it became apparent that the insurer and insured would pursue conflicting defense strategies, the insurer "had a duty to pay reasonable fees for the independent representation of [the insured] under the duty to defend clause of the insurance contract." Id.at 490-491.

Texas does not have a statute requiring an insurer to provide independent counsel to represent its insured in a lawsuit when a conflict of interest arises between the insurer and the insured. Cf. Cal. Civ. Code § 2860. However, in some circumstances, an insured does have a right to select its own independent counsel. Texas courts have provided some guidance as to what triggers this right. In 2004, the Texas Supreme Court addressed what constitutes a sufficient reason for an insurer to lose its right to conduct the insured's defense, while remaining obligated to pay for it. N. County Mut. Ins. Co. v. Davalos, 140 S.W.3d 685, 686 (Tex. 2004). In Davalos, the Court stated that generally, an insurer may insist upon its contractual right to control the defense of its insured, which includes authority to select the attorney who will defend the claim. See id. at 688. However, an insurer may not insist upon its contractual right to control the defense where a disqualifying conflict of interest exists. A disqualifying conflict of interest exists under the following circumstances: 1. The facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends; 2. The defense tendered by the insurer is inadequate; or 3. The defense is conditioned on an unreasonable, extra-contractual demand that threatens the insured's legal rights. See id. at 689.

D. Bad Faith

Every insurance contract has an implied duty of good faith and fair dealing. The insurer and insured, generally, have a mutual or recipricol duty to treat each other in good faith and fair dealing. An insurer is not to put its interests above the interests of its insured. Breach of the duty of good faith and fair dealing is the tort of "bad faith" law. This tort, generally, allows consequential damages, and tort like damages, i.e. emotional distress damages, and punitive damages. The type of conduct that is necessary to constitute breach of the duty of good faith and fair dealing, typically are defined with such words as "deliberately", "willfully", "maliciously", "with reckless disregard", "unreasonable", "without probable cause", or "with knowledge of its unreasonableness". There generally is an allegation that the insurer unreasonably delayed or denied paying a claim. The insurer's conduct is examined to determine if the duty of good faith and fair dealing is breached. When a claim is "fairly debatable", generally, there will be no bad faith damages.

Bad faith law has evolved, since 1973, by making available extra contractual damages in favor of an insured against an insurance company. Gruenberg v. Aetna Insurance Company, 510 P.2d 1032 (Cal. 1973). Bad faith law applies to third party claims and first party claims. Depending on your state, a cause of action for bad faith may be driven by statute or common law. Some states require an insurer intentionally fail to pay a valid claim with knowledge or reckless disregard of the lack of knowledge of a reasonable basis for denying a claim. Other states require that an insurer's delay or denial in paying a claim be dishonest, malicious or oppressive.

IV. Denials

A. Grounds for Denial

The primary grounds on which claims may be denied, under both first party and liability policies, are as follows: 1. claims or losses outside policy cover and/or excluded; 2. pre-loss breach of condition or breach of other duty owed by the insured under the policy (including misrepresentation/failure to disclose); 3. post-loss breach of conditions/breach of other duty by the insured; 4. claim brought or proceedings commenced outside an applicable limitation or notice period; and 5. existence of other insurance alleged to be primary.

The standard in deciding whether a claim should be accepted or denied is not whether the evidence can be construed in favor of a denial; rather, the standard should be when all of the evidence is considered does it leave you any reasonable alternative other than to deny the claim. This standard is in keeping with the guidelines set forth by courts that all matters of coverage should be resolved in favor of the insured where there is any reasonable doubt. Remember, though, the standard is still reasonable justification. You should never twist and turn the facts either to implicate or exonerate the insured. The test should be whether when the evidence is considered in its totality the insurance company has a reasonable basis for the denial. If the evidence, when Page 21 considered in the light most favorable to the claimant, still leads you to the conclusion a denial is proper, then you have reached an appropriate decision.

B. Possible consequences of failure to defend

Any denial must give consideration to at least two obligations under the policy. One is the duty to defend, the other is the duty to indemnify. Even if there is no duty to indemnify, there may well still be a duty to defend. It is important to remember this because the failure to defend can have significant consequences.

The failure to defend can expose the insurer to potential bad faith liability and create the potential for punitive damages. Should the insure be wrong in its decision to deny coverage there can be exposure to unfavorable settlement if the insured obtains independent counsel and resolves the matter. In this case the insurer potentially bound to defense conducted by the insured and any bad settlement reached. Finally, there can be exposure to additional defense costs. For these reasons, absent a judicial confirmation of a coverage denial, it is rarely a good idea to leave the insured to handle the matter as they see fit.

V. Conclusion

There are often questions about whether coverage exists when a claim is made for insurance coverage. When those questions arise, act reasonably promptly to evaluate these issues, communicate them to the insured by way of reservation of rights letters and always remember to keep the insured's interest ahead of the insurer's.