CLM CLAIMS & LITIGATION MANAGEMENT ALLIANCE™
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2014 CLM Annual Conference

April 9, 2014 – April 11, 2014

Boca Raton Resort
501 E. Camino Real
Boca Raton, FL 33432

Roundtable 1: Thursday, April 10, 2014 (10:10 am – 11:10 am)

When to Assert and When to Waive an Arguable Defense to Coverage in the Tender of a Defense to the Insured – the Rights, Obligations, Law and Strategy Behind the Decision

DEFENDING UNDER RESERVATION OF RIGHTS ("ROR")

I. OBLIGATIONS AND OPTIONS OF INSURER ON PRESENTATION OF CLAIMS

A. Obligations of Insurer on Presentation of Claims

When presented with a claim by its insured, an insurer may have a duty both to defend and to indemnify the insured.

1. Duty to Defend

The insurer's duty to defend claims against its insured is broader than the duty to indemnify and is determined from the complaint; generally when the complaint on its face discloses a claim within or arguably within the coverage of the policy, an insurer is required to defend its insured regardless of whether the insurer believes there is any coverage for the claim. If an insurer is required to defend a claim in the complaint, it is required to defend all claims until the resolution of all claims which triggered the duty to defend.

2. Duty to Indemnify

The duty to indemnify is narrower than the duty to defend because it only arises when the liability of the insured is covered by the policy.

B. Options of Insurer on Presentation of Claims

1. Accept Coverage and Defend

Generally, if the insurer accepts coverage, it retains counsel to defend its insured, pays such counsel, controls the defense of the claim(s) against the insured and pays any settlement amount or any judgment, subject to policy deductibles and limits

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2. Deny Coverage

Generally, if the insurer denies coverage and refuses to defend its insured, the insured has the right to retain defense counsel and control its defense and can settle without the consent of the insurer or take the claims against the

insured to judgment, and the insurer is obligated to pay the settlement amount or any judgment against the insured, subject to policy deductibles and limits.

3. Investigate Claims while Defending under ROR

Where an insurer believes, based on the allegations in the complaint, it has a duty to defend but also believes there is no coverage under its policy for the claims in the complaint or believes that at some later point in the litigation it may be able to establish that it does not owe a duty to defend, the insurer may preserve its ability to challenge both its defense and indemnity obligations by defending under a reservation of rights. To defend under a reservation of rights, the insurer must timely notify its insured in writing that while it will defend the insured, it is reserving its rights under the policy to challenge at a later time whether it owes a duty to defend or a duty to indemnify. If an insurer reserves such rights, the insurer will not be deemed to have waived its right to raise, or to be estopped from raising, the defense that the insured's loss was not covered by the policy, notwithstanding the insurer's participation in the defense of the action against its insured. An insurer may conduct an insured's defense in good faith without waiving its right to assert any policy defenses, provided it gives the insured notice of any reservation of rights.

II. RIGHTS, OBLIGATIONS AND ISSUES IF INSURER CHOOSES TO DEFEND UNDER ROR

When an insurer tenders a defense subject to a reservation of rights, the insured has two options: 1) to accept the defense; or 2) to reject the defense. Various rights and obligations of the insurer and the insured arise depending on which option the insured choses.

A. If Insured Accepts Defense Under ROR

Generally, if the insured accepts a defense under a reservation of rights, the insurer retains full control over the litigation, selects and pays defense counsel for the insured, chooses whether to settle or go to trial, and pays any settlement or any judgment against the insured, subject to policy deductibles and limits. However, in some cases, the insurer may be able to recover all or some of its costs paid to counsel selected by it to defend the insured and all or some of any settlement amount or judgment it paid on behalf of the insured.

B. If Insured Rejects Defense under ROR

Generally, if an insured objects or declines a defense tendered under a reservation of rights, the insured selects its own counsel, pays its selected counsel and controls the defense, including deciding whether to settle or to take the underlying claim(s) to judgment, and the insurer would be liable for the costs incurred by the insured to defend the claim(s) against the insured and for the amount of the settlement of the claims against the insured or the amount of the judgment against the insured, subject to policy deductibles and limits. However, in many cases, the insurer may not be liable for any of the insured's defense costs and may not be liable for all or some of any settlement or judgment amount.

1. Right of insured to independent counsel (known as "*Cumis*" counsel) paid by insurer

i. Merely because defense tendered under ROR

The court, in *San Diego Federal Credit Union v. Cumis Ins. Society, Inc.*, 162 Cal. App. 3d 358 (1984), held that an insured may have a right to select independent counsel, paid by the insurer, merely because the insurer reserves its right to assert non-coverage at a later date, even if the insurer agrees to provide counsel for the insured. The basis of this decision was that whenever multiple theories of recovery are alleged and some theories involve uncovered conduct under the policy, a conflict of interest exists between the insurer and the insured such that the insurer may not compel the insured to surrender control of the litigation. Subsequent California case law now requires an actual conflict of interest in order to give rise to the obligation of an insurer to provide *Cumis* counsel.

ii. Need for potential or actual conflict (*i.e.*, whether coverage can be controlled by counsel selected by insurer)

In *Federal Ins. Co. v. MDL* (2013) 219 Cal. App. 4th 29, a case where the insurer tendered a defense under a general reservation of rights denying coverage for damages claimed beyond the policy period and in excess of the policy limits, the court, citing *San Gabriel Valley Water Co.*, 82 Cal. App. 4th 1230 (2000), held that insureds are not entitled to *Cumis* counsel absent a showing of an actual conflict of interest, that an actual conflict of interest exists only if counsel can control the determination of the issue controlling coverage and that because the time when property damage occurred was not something defense counsel could control, these general reservations did not trigger the right to *Cumis* counsel.

In *Socony-Vacuum Oil Co. v. Continental Casualty Co.* (1945) 144 Ohio St. 382, the insurer, after defending the insured for about a year through counsel retained by the insurer, gave notice to the insured that the insurer did not believe there was coverage for the claims against the insured and invited the insured to employ its own independent counsel to work with counsel selected by the insurer. The court ruled that because liability against the insured in the underlying claim depended on whether an individual was an employee or an independent contractor of the insured, an issue which could be controlled by counsel selected by the insurer, there was a conflict and the insured was entitled to independent counsel paid by the insurer. *See also Schaefer v. Elder* (2013) 217 Cal. App. 4th 1, which reached the same conclusion on the same issues.

Not every defense tendered under a reservation of rights creates a conflict of interest allowing an insured to select independent counsel; rather, the existence of a conflict depends on whether the coverage issues are independent of the liability issues in the underlying case, *i.e.*, whether the outcome of coverage is identical in the underlying case and is an issue which can be controlled by counsel retained by the insurer. *RX.com, Inc. v. Hartford Fire Insurance Co.* (426 F.Supp. 2d 546) (2006).

C. General reservations vs. detailed reservations

As held in *Federal Ins. Co. v. MDL* (2013) 219 Cal. App. 4th 29, a general denial, such as reserving all rights that damages occur during the coverage period or that the insurer will only pay up to the policy limits does not trigger the right to *Cumis* counsel. However, a reservation of rights can be too general as a reservation of rights, in order to be effective, must inform the insured of the insurer's position in regard to coverage defenses. *Socony-Vacuum Oil Co. v. Continental Cas. Co.*, 45 Ohio Abs. 458 (Ct. App. 8th Dist. Cuyahoga County 1994).

D. Right of insurer to recover defense costs

An insurer which has paid defense costs, either to counsel selected by it or to *Cumis* counsel, may be able to recover some or all of such costs.

Where an insured insists, after the insurer has tendered a defense under a reservation of rights, on independent counsel but it is ultimately determined that the insured was not entitled to such independent counsel, the insured's refusal to accept the insurer's counsel relieves the insurer of the duty to defend and where an insurer has paid independent counsel fees, the insurer can seek reimbursement of those fees from the insured. *Federal Ins. Co. v. MDL* (2013) 219 Cal. App. 4th 29.

An insurer may recover its defense costs from the insured where the insurer specifically reserves the right to do so if it is later determined that the insurer did not have a duty to defend and if the insured accepted the defense without objection. *Resure, Inc. v. Chemical Distributers, Inc.*, 927 F.Supp. 190 (M.D.La. 1996). *See also Colony Insurance Co. v. G & E Tire & Service, Inc.*, 777 So.2d 1034 (Fla. Ct. App. 2000).

An insurer may recover defense costs paid to *Cumis* counsel with respect to claims that are not potentially covered by the applicable policy if the insurer can show which fees were applicable to such uncovered claims. *Buss v. Superior Court*, 16 Cal. 4th 35, 65 Cal. Rptr. 2d 366 (1997).

The majority of jurisdictions appear to allow an insurer to seek reimbursement of defense costs if it later determined the insurer owed no duty to defend and if the insurer gave express notice that it reserved its right to recover

defense costs and gave specific and adequate notice to the insured of the potential for recoupment. *United Nat'l Ins. Co. v. SST Fitness Corp.*, 309 F .3d 914 (6th Cir. 2002).

But, it has also been held that unless such right is contained in the policy, an insurer may not recover defense costs it paid on behalf of the insured. *Texas Ass'n of Counties Gov't Risk Mgmt. Pool v. Matagorda County*, 52 S.W.3d 128 (Tex. 2000).

E. Right of insurer/insured to recover settlement contributions or judgment payments

In *Auto-owners Insurance Co. v. J.C.K.C., Inc.*, 2004-Ohio-5186, 2004 WL 2244484 (Ohio Ct. App. 9th Dist. Summit County 2004), the court held that the insured, which, without the consent of the insurer, settled with the third-party claimant (which settlement was filed with the court in the form of a consent judgment against the insured), was not permitted to recover the amount of the settlement from the insurer where the insurer, although defending under a reservation of rights, had continued defending the insured in the underlying case. The court distinguished its decision from cases holding that an insured was permitted to enter into a settlement without the consent of the insurer because the insurer, in such cases, had denied coverage and refused to defend.

An insurer which defended personal injury claims against its insured under a reservation of rights pertaining to whether the insured's policy was, prior to the date of the accident, effectively and validly cancelled due to nonpayment of premiums, and which settled the claims against the insured, was, when it was judicially determined that the policy was effectively and validly canceled before the date of the accident, entitled to recover from the insured the amount paid by the insurer in such settlement. *Permanent General Insurance Company v. Bedwell* (2001) 111 Ohio Misc. 2d 8

An insurer may seek reimbursement for settlement funds paid by the insurer on claims later determined not to be covered when there was a timely and expressed reservation of rights, an express notification to the insureds of the insurer's intent to accept a proposed settlement offer and an expressed offer to the insureds that they may assume their own defense when the insurer and the insureds disagreed on whether to accept the proposed settlement. *Blue Ridge Ins. Co. v. Jacobsen*, 25 Cal. 4th 489 (2001). The majority of jurisdictions which have addressed this issue have found that there is an implied-in-fact or implied-in-law contract between the insurer and the insured which allows the insurer to seek reimbursement for settlement. *Travelers Property Casualty Company of America v. Hillerich & Bradsby Company, Inc.*, 598 F.3d 257 (6th Cir. 2010). However, some courts have held that there is no such implied contract and if such reimbursement is not provided for in the policy, an insurer is not entitled to recover such settlement funds. But, some of these courts have held that the insurer can recover such settlement funds if the insured agrees to such reimbursement. *Excess Underwriters at Lloyd's, London v. Frank's Casing Crew & Rental Tools, Inc.* 246 S.W. 3d 42 (Tex. 2008).

Insurers, if not entitled to reimbursement of all of the settlement or judgment amount, may be entitled to reimbursement of some of the settlement or judgment amount. In *Remodeling Dimensions, Inc. v. Integrity Mut. Ins. Co.* 819 N.W. 2d 602 (Minn.2012), the court, on the basis that insurer has a duty to indemnify its insured only when its insured is found liable for a third-party claim within the terms of the policy and not when its insured is found liable for a third-party claim which is outside the policy's scope, held that an insurer, even when controlling the defense of the case, is required to pay only that part of a judgment attributable to a covered claim if damages can be so allocated; but, while the insured initially bears the burden of proving allocation of an award in subsequent litigation with its insurer over coverage, such burden shifts to the insurer if the insurer failed to give notice to the insured that the insurer was seeking an allocation of damages to the various claims asserted against the insured.

In regard to the burden of allocating damages, most courts have held that when an insurer's reservation of its rights to contest coverage was not sufficient to advise its insured of the insured's interest in obtaining an allocated judgment, the insured was relieved of the burden to prove allocation of the judgment and the insurer was obligated to pay the entire amount of the judgment against the insured unless the insurer could prove the judgment amount(s) represented, in whole or in part, non-covered claims. *Duke v. Hoch*, 468 F.2d 973 (5th Cir. 1972); (*Also, see Buckley v. Orem*, 112 Idaho 117 (Idaho Ct. App. 1986) – applying *Duke* to a settlement context.). Also, courts have held that the insured's burden to allocate a judgment between covered and non-covered claims does not shift to the insurer unless the insurer had a duty to defend the underlying claims. *Gay & Taylor. Inc. v. St. Paul Fire & Marine Ins. Co.*, 550 F.Supp. 710 (W.D. Okla. 1981). Basically, these cases hold that even if the insurer controls the defense, the insurer must specifically advise the insured of the insurer's intent to obtain an allocation of the damages in order for the burden to be placed on the insured

to allocate such damages and; if such notice is not given, the burden is on the insurer to allocate such damages. But, in *Travelers Indemnity Company of Illinois v. Royal Oak Enterprises, Inc.* (344 F.Supp. 2d 1358), the court held that when an insured, which could have hired independent counsel to represent it when the insurer tendered the defense under a reservation of rights, did not have an obligation to allocate the damages in a settlement when the insurer retained counsel for the insured and maintained control over the settlement; however, if the insurer was successful in allocating damages to an uncovered claim, it would not have to pay the settlement amount attributable to the settlement of such claim despite the fact that it appears as if the reservation of rights letter did not specifically state that the insurer intended to allocate damages. Additionally, some courts have held that if the insurer controls the litigation, the insurer has the duty to obtain an allocation of the damages. *Cannon-Clark Memorial Hospital Association v. St. Paul Fire & Marine Insurance Company*, 224 W.Va. 228 (2009).

F. Reasonable fees of *Cumis* counsel

Under California statutory law, an insurer must pay *Cumis* counsel only those fees equivalent "to the rates which are actually paid by the insurer to attorneys retained by it in the ordinary course of business in the defense of similar actions in the community where the claim arose or is being defended. Cal. Civ. Code § 2860(c).

In *Azar v. Farmers Insurance Exchange*, No. 13-658 (D. Colo. Sept. 26, 2013) the insurer argued that the hourly rates of its independent counsel ranged between $415 and $450 per hour with junior attorneys being billed at $315 per hour. The insurer argued that the appropriate rate would be $232 per hour which was the blended rate it paid its own counsel. The court rejected the insurer's argument and concluded, based on its knowledge of rates charged in the Denver metropolitan area, and without any apparent evidence being presented as to such rates, that the rates of independent counsel, based on their experience, skill and specialization, were reasonable.

G. Obligation of defense counsel selected by insurer to explain to insured the full implications of accepting a defense under ROR

In *San Diego Navy Federal Credit Union v. Cumis Insurance Society, Inc.* 162 Cal. App. 3d 358 (1985), when the court determined that an insured had the right to independent counsel merely upon the tender of a defense under a reservation of rights, it also stated that attorneys hired by the insurer have an obligation to explain to the insured and the insurer the full implications of joint representations in situations where the insurer has reserved its rights to deny coverage and if the insured does not give an informed consent to continue the representation, counsel must cease to represent both. This holding could suggest that if an insurer tenders a defense under a reservation of rights and the insured accepts such defense, counsel selected by the insurer for the insured may have a duty to advise the insured of the full implications of accepting such defense.

H. Waiver of right to assert policy defenses and defend under an ROR

An insurer may waive its right to assert policy defenses and defend under a reservation of rights if it fails to reserve its right and thereafter defends for such a period of time so as to prejudice the insurer. *Socony-Vacuum Oil Co. v. Continental Casualty Co.* (1945) 144 Ohio St. 382. In this latter regard, generally, where an insurer assumes the defense of a lawsuit brought against its insured with full knowledge of facts in the case which would bring the claim within an exception in the policy to coverage which would relieve the insurer of its duty to indemnify, the insurer must seasonably give notice to the insured that it disclaims liability and failure to give such notice constitutes a waiver of the right of the insurer to thereafter avoid liability provided for in such exception. *Socony-Vacuum Oil Co. v. Continental Cas. Co.*, 45 Ohio Abs. 458 (Ct. App. 8th Dist. Cuyahoga County 1944).

The court in *Collins v. Grange Mut. Ins. Co.*, 124 Ohio App. 3d 574 (1997), assumed, without taking any evidence that an insurer which retained defense counsel and assumed control of the insured's defense against a personal injury claim for over 16 months without any reservation of rights prejudiced the insured and thus the insurer was estopped from denying its obligation of indemnification and was required to pay the settlement amount agreed to by the insurer in settlement of the claims when the insurer hired its own attorneys after the issuance of the reservation of rights letter.

In many cases, it is presumed that the rights of an insured has been prejudiced when an insurer defends the insured for a considerable period of time without giving notice of any reservation of rights which presumption in some cases is conclusive. Some courts have held that not asserting a reservation of rights for periods of time ranging from 1-

year to 2 years amounts to prejudice as a matter of law. *Dietz-Britton v. Smythe, Cramer Co.* (2000) 139 Ohio App. 3d 337. But, other courts have required that the insured must demonstrate actual prejudice. *Roark v. Medmarc Cas. Ins. Co.* 2007-Ohio-7049, 2007 WL 4554279 (Ohio Ct. App. 9th Dist. Lorain County 2007).

An insurer which retained defense counsel for, and assumed the defense of, the son of a named insured under the insurer's policy and defended such son for approximately one year before issuing a reservation of rights letter to the son and withdrawing appointed counsel for the son, did not waive its rights to assert its defenses to coverage because the son was neither a named insured nor an additional insured under the policy and the mistaken or inappropriate representation of an otherwise non-insured does not create a new contract of insurance or contract for defense; rather, the son simply had been the beneficiary of a gift of services and there was no obligation to continue to give those services. *Grange Mutual Insurance Company v. Martin*, 1994 WL 603073 (Ohio App. 6th Dist.) 1994.