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The Historical Development Of The Reservation Of Rights Letter

I. The Precipitation of the Reservation of Rights Letter Through Seminal Bad Faith nsurance Cases

A. Early History of Bad Faith Liability: Insurer Liability for Damages to Insured Resulting from Third Party Claims Against Insured

California courts have produced many of the leading decisions in bad faith liability case law which has shaped today's common insurance practices. The earliest reported case involving what is now considered bad faith dates back to 1899, but the tort of bad faith was not fully developed until 1931, when the Wisconsin Supreme Court recognized an insurer's duty to act in good faith in its decision to settle or defend a claim. (Michael J. Gainer, *The Overruling of Royal Globe: A "Royal Bonanza" for Insurance Companies, But What Happens Now?,* 16 Pepp.L.Rev.3 (1989)), citing *Hilker v. Western Auto Ins. Co.*, 204 Wis. 1, 231 N.W. 257 (1930)). The first California case to establish bad faith was *Brown v. Guarantee Insurance Co.*, which held that the insured's cause of action was bad faith instead of negligence, and also set forth the factors to be considered when determining whether an insurer had acted in bad faith in its refusal to settle a claim. *Brown v. Guarantee Ins. Co.*, 155 Cal. App.2d 679, 319 P.2d 69 (1957). The *Brown* Court set forth the following factors in determining whether an insurer's refusal to settle constitutes bad faith:

1. The strength of the injured claimant's case on the issues of liability and damages;
2. Attempts by the insurer to induce the insured to contribute to a settlement;
3. Failure of the insurer to properly investigate the circumstances so as to ascertain the evidence against the insured;
4. The insurer's rejection of advice of its own attorney or agent;
5. Failure of the insurer to inform the insured of a compromise offer;
6. The amount of financial risk to which each party is exposed in the event of a refusal to settle;
7. The fault of the insured in inducing the insurer's rejection of the compromise offer by misleading it as to the facts; and
8. Any other factors tending to establish or negate bad faith on the part of the insurer.

Id. at 689.

B. The *Comunale & Crisci* Cases

Next, in *Comunale v. Trader's & General Insurance Co.*, the Supreme Court of California recognized that in every contract of insurance, there is an implied covenant of good faith and fair dealing, which may include an affirmative duty to settle under certain circumstances. *Comunale v. Trader's & General Insurance Co.*, 50 Cal. 2d 654, 328 P.2d 198 (1958). In *Comunale*, the insured brought suit against its insurer for bad faith after the insurer refused to settle a claim within policy limits, which exposed the insured to a much larger verdict against him following a jury trial that the insurer had also refused to defend. The insured brought an indemnity action against the insurance company for the policy limits, and then assigned the bad faith action to the injured third party. The court found that the insurer was liable for the full judgment, including the excess award, and held that in considering offers of compromise, the insurer "must take into account the interest of the insured and give it at least as much consideration as it does to its own interest." *Id.* at 659. "When there is great risk of a recovery beyond the policy limits so that the most reasonable manner of disposing of the claim is a settlement which can be made within those limits, a consideration in good faith of the insured's interest requires the insurer to settle the claim. Its unwarranted refusal to do so constitutes a breach of the implied covenant of good faith and fair dealing." *Id.* The court did not find that the insurer's refusal to defend constituted bad faith.

In *Crisci v. Security Insurance Co.*, the Supreme Court of California relied on the holding in *Comunale*, and was the first case to allow recovery of damages against an insurer for mental sufferings resulting from the insurer's bad faith. *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 426 P.2d 173 (1967). In *Crisci*, the insurer declined to settle the case for the $10,000 policy limits, despite knowing the likelihood of excess liability exposure in the event the injured third party was successful on her claims. A jury awarded the injured party $100,000. The insurance company paid $10,000 of this amount, and a settlement was negotiated by which the insured used a property interest to satisfy $22,000 of the excess judgment to the injured party. As a result of having to satisfy the excess judgment, the insured, a 70 year old widow, became indigent and her physical and mental health declined, resulting in hysteria and suicide attempts.

The *Crisci* Court awarded the insured pecuniary damages, holding the insurance company liable for the resulting judgment from its refusal to settle within policy limits, plus $25,000 for mental suffering. In doing so, Court noted that the action sounded in both contract and tort and that liability was based upon the insurer's "failure to meet the duty to accept reasonable settlements, a duty included within the covenant of good faith and fair dealing." *Id.* at 430. The court also held that the absence of evidence proving actual dishonesty, fraud or concealment was not fatal to the insured's bad faith claim. *Id.*

C. *Royal Globe* & *Moradi-Shalal* Cases

By 1979, insureds had a firmly established common law cause of action against insurance companies for bad faith in both third party claims and first party claims. (Michael J. Gainer, *The Overruling of Royal Globe: A "Royal Bonanza" for Insurance Companies, But What Happens Now?*, 16 Pepp.L.Rev.3 at 782 (1989). Since third party victims lacked privity of contract with the insurer, they were required to obtain an assignment from the insured before bringing an action for bad faith. In *Royal Globe*, the court held, for the first time, that a third party plaintiff, who had slipped in the insured's grocery store, could sue the insurer for violation of section 790.03 of the Insurance Code. *Royal Globe Ins. Co. v. The Superior Court of Butte County*, 23 Cal. 3d 880, 592 P.2d 329 (Ca. 1979). The *Royal*

Globe decision allowed third-party plaintiffs to sue insurers directly for bad faith practices and suddenly gave third party plaintiffs a "more equal bargaining position" in settlement negations with the insured. Michael J. Gainer, *The Overruling of Royal Globe: A "Royal Bonanza" for Insurance Companies, But What Happens Now?,* 16 Pepp.L.Rev.3 at 786 (1989).

The Court in *Moradi-Shalal* overruled the *Royal Globe* decision nine years later, holding that the *Royal Globe* Court had incorrectly evaluated the intent of the Insurance Code section 790.03, and that the Code does not create a private right of action for a third party claimant against an insurer. *Moradi-Shalal v. Fireman's Fund Ins. Co.*, 46 Cal.3d 287, 758 P.2d 58 (1988). *Moradi-Shalal* ended the private, statutory cause of action for third party victims of bad faith insurance practices. Instead, the court held that the Insurance Commissioner may impose administrative remedies by enforcing the code and imposing appropriate sanctions on insurers. The courts retain jurisdiction for civil damages and other remedies against insurers in common law actions such as breach of contract or breach of the implied covenant of good faith and fair dealing. The court affirmed that punitive damages would be available where fraud, oppression or malice is proved and that a final determination of the insured's liability must be made before the insurer may be held liable to third-party claims. *Id.*

Following the ruling in *Moradi-Shalal*, insureds may still pursue bad faith actions against their insurers, but third party plaintiffs may do so only with an assignment of a bad faith claim from the insured, or through traditional tort actions.

In *Sparks v. Republic National Life Insurance*, claimants Sparks purchased an air conditioning business in Mesa, Arizona, and purchased a healthy insurance policy from defendant insurer for their family and employees. *Sparks v. Republic National Life Ins.*, 132 Ariz. 529, 647 P.2d 1127 (1982). One month after purchasing the policy, the family was involved in a plane crash, wherein Calvin suffered permanent brain damage and one of the children was rendered a paraplegic. On account of his injuries, Calvin was no longer able to run the business, which went bankrupt, and the policy was terminated. The defendant insurer then informed the Sparks that they would be discontinuing medical payments since the policy was no longer in effect. The Sparks brought an action for breach of contract and various tort claims against the insurer and were awarded compensatory and punitive damages. On appeal, the court rejected the insurer's defense that its practices conformed with "commercial customs," and held that the meaning of an insurance policy should instead "be viewed from the standpoint of the average layman who is untrained in the law or insurance." *Id.* at 537. The court also held that an insurer may not rely on an ambiguous policy provision as a defense to bad faith conduct.

D. ***Damron & Morris***

In *Damron v. Sledge*, the insurer refused to defend its insured following an automobile accident and denied coverage. The insured entered into a stipulated agreement with the plaintiff in exchange for a covenant from the plaintiff not to collect against the insured. In exchange, the insured also assigned his rights to the plaintiff for a bad faith action against the insured. When a default action was entered against the insured, the court held that the agreement was properly executed in order to protect the insured, and was not collusive. An insured being defended under a reservation of rights may enter into a *Damron*

agreement without breaching the policy's cooperation clause. *Damron v. Sledge*, 105 Ariz. 151, 460 P.2d 997 (1969).

In *United Services Automobile Association v. Morris*, the parties entered into a stipulated settlement which they agreed would be solely collected from USAA. *United Services Automobile Association v. Morris*, 154 Ariz. 113, 741 P.2d 246 (1987). The court found that the two insureds were being defended under a reservation of rights by USAA, and considered whether the insureds may enter into a settlement agreement to protect themselves without breaching the policy's cooperation clause. The *Morris* Court found that the insureds were faced with the need to protect themselves from potential of personal liability resulting from a trial, and that the settlement agreement was not prohibited by the cooperation clause when the insurer had not unconditionally assumed liability under the policy. *Id*. at 119. The court further held that the insurer is not bound by the insureds' agreement unless the insured, or assignee of rights, can show that the settlement was reasonable and prudent. The insurer would also not be bound if it could prove there was no coverage under the policy. When entering into a stipulated agreement, the insured must give the insurer notice of such agreement and give the insurer the opportunity to defend unconditionally.

The use of *Damron* and *Morris* agreements have been adopted by the Ninth Circuit Court of Appeals, as well as the test for binding the insurer to the settlement, which considers "what a reasonably prudent person in the insured's position would have settled for on the merits of the claimant's case. This involves evaluating the facts bearing on the liability and damage aspects of claimant's case, as well as the risks of going to trial." *Lozier v Auto Owners Ins. Co.*, 951 F.2d 251, 256 (9th Cir. 1991) (Citing *United Services Automobile Association v. Morris*, 154 Ariz. 113, 741 P.2d 246 at 254 (1987)). *Morris* has also been upheld in Wyoming and Minnesota. *See Insurance Co. of North America v. Spangler*, 881 F.Supp 539 (D. Wyo. 1995); *Miller v. Shugart*, 316 N.W.2d 729, 733 (Minn. 1982). The Third Circuit Court of Appeals has similarly held an insurer who defends subject to a reservation of rights thereby relinquishes control of the defense the insured may enter into a stipulated settlement. *Cay Divers, Inc. v. Raven*, 812 F.2d 866 (3rd Cir. 1987).

II. Historical Development of the Reservation of Rights Letter

A. Insurer's Options in Responding to Tenders

The insurer owes its insured two express duties, the duty to defend and the duty to indemnify. When faced with impending litigation against its insured, the insurer has two options. The insurer may obtain a prior declaratory determination of coverage from the courts, or proceed under a reservation of rights. If the insurer refuses to defend the insured, such refusal disclaims all obligations under the policy, and the insured is no longer bound to the cooperation clause. The insured may then take whatever action he deems necessary to protect himself, so long as the action does not involve fraud or collusion against the insurer. *See* 32 Ariz. L. Rev. 387.

In order to preserve its right to later contest coverage under the policy, the insurer must notify the insured that it is reserving its rights. *Farmers Insurance Co. of Arizona v. Vagnozzi*, 138 Ariz. 443, 675 P.2d 703 (1983). After many of the early bad faith decisions (discussed above), insurers became accustomed sending reservation of rights letters in response to all tenders by insureds. Under early bad

faith case law, if an insurer withdrew its defense without first reserving its rights, the insurer was liable for the resulting damages, including in excess of policy limits.

When coverage is disputed, and the insurer proceeds to defend under a reservation of rights, a conflict of interest arises involving the interests of the insurer and the insured. Following the *Cumis* decision, insurers were prohibited from undertaking the defense of the insured in such cases but instead required the insurers to fund the insured's defense by independent counsel. *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y Inc.,* 208 Cal. Rptr. 494 (Ct. App. 1984). The result of *Cumis* leaves an insurer the options to either deny coverage or obtain a judicial declaration of coverage (or lack thereof), accept the tender without a reservation of rights and defend the insured up through a final judgment, or accept the tender subject to a reservation of rights (which may allow the insured to exercise his right to *Cumis* counsel). A reservation of rights allows the insurer to undertake the insured's defense without obligation to pay the resulting judgment. *See* 32 Ariz.L.Rev. 387, 402 (1990).

B. Original Purpose of the Reservation of Rights Letter

The purpose of a reservation of rights letter is to give the insured the opportunity to make an informed decision as to whether they should take action to protect their interests in a claim, due to the existence of conflicts between themselves and the insurer. Allan D. Windt, Insurance Claims & Disputes: Representation of Insurance Companies & Insureds, §2:14 (6th Ed. 2013). Therefore, it is not generally acceptable that an insurer be permitted to simply state that it is reserving its rights under the policy, but should set forth the reasons which it is aware that the insured may not be entitled to coverage. Additionally, when an insurer sends its insured a reservation of rights letter, this creates an inherent conflict of interest which obligates the insurer to fund separate counsel for its insured (this is known as the *Cumis* rule). *See State Farm Fire & Casualty Co. v. Superior Court.*, 216 Cal.App 3d 1222 (1989).

If an the insurer is defending under a reservation of rights and a coverage determination might turn upon facts to be determined in the litigation, "it is important that the insurer adequately inform the insured of the rights which it intended to reserve; for it is only when the insured is adequately informed of the potential policy defense that he can intelligently choose between retaining his own counsel or accepting the tender of defense counsel from the insurer." *Cowan v. Insurance Co. of North America*, 22 Ill.App.3d 883, 318 N.E.2d 315, 326 (1974). In fact, multiple jurisdictions agree that a primary purpose of requiring an insurer to set forth the reasons for its position in a reservation of rights letter, is to put the insured in a position to make a choice about how best to protect himself moving forward in the litigation. *Bogle v. Conway*, 199 Kan. 707, 433 P.2d 407, 412 (1967); *Ideal Mut. Ins. Co. v. Myers*, 789 F.2d 1196, 1201 (Tex. 1986); *Equitable Life Assurance Society of the U.S v. Schwartz*, 291 Fed. Appx 25, 27 (9th Cir. 2008) (Observing that "the reservation of rights requirement is important in the third party defense context because it puts the insured on notice that he has to protect his interests where the differ from the insurance company's interests.")

C. Reservation of Rights Letter to Sophisticated Insureds

1. Availability of Estoppel Argument to Sophisticated Insureds

Reservation of rights letters were originally sent by insurers for two main purposes, which included fulfilling its contractual obligation to defend the insured without assuming the obligation to indemnify, and allowing the insured an opportunity to protect his interests at an early stage in the litigation when the insurer knows of a potential conflict of interest**.** This allows the insured the option of taking actions to protect itself. For a sophisticated insured such one with corporate counsel, the insured's interests are already protected, therefore many of the policy reasons for sending a reservation of rights to a non-sophisticated insured may not apply.

For an insurer to be precluded from denying coverage due to its failure to send a reservation of rights letter, the insured must prove the elements of estoppel. To prove estoppel, the insured must have suffered actual or presumed prejudice. Allan D. Windt, Insurance Claims & Disputes: Representation of Insurance Companies & Insureds, §2:10, Ch. 2 (6th Ed. 2013). The most common situation in which an insurer may be estopped from denying coverage involves the insurer learning of possible coverage exclusion while continuing to defend the insured and without sending a reservation of rights letter. In this common scenario, the insured would typically be deprived of learning of the potential conflict of interest and the option to hire independent or *Cumis* counsel.

However, is this necessary for all insureds? Is it always necessary to send a reservation of rights letter to a sophisticated or otherwise knowledgeable insured? Clearly. One might argue that an insurer's failure to do so should not give way to estoppel or waiver arguments the same way it might if an insurer fails to inform a private insured or layperson of its reservation of rights.

An insured capable of understanding the terms of its policy is also less prone to suffer actual prejudice from the unintentional waiver of rights by an insurer. "To overcome the rule that an insurer does not waive its right to deny coverage by undertaking the defense of its insured under a reservation of rights, an insured must show that, after the insurer reserved its rights, the insurer either intentionally relinquished a known right, or acted in such a manner as to cause the insured reasonably to believe that the insurer had relinquished such right, *and that the insured relied upon this conduct to his or her detriment." J.C. Penney Casualty Ins. Co. v. M. K.*, 52 Cal.3d 1009, 1017-1018, 804 P.2d 689 (1991). (Emphasis added.) Under this rule, in the case of sophisticated insureds, an insured that has unlimited access to its own corporate counsel will undoubtedly find itself in a better position when faced with impending litigation, and therefore it should be more difficult for these types of insureds to prove prejudice or prove that they detrimentally relied upon the acts of the insurer. *See Hatco Corp. v. W.R. Grace & Co. – Conn.*, 801 F.Supp 1334, 1363 (D.N.J. 1992) (Noting that insured, a "sophisticated party, well-represented by legal counsel," could not contend that it was prejudiced by the insurer's actions or by the reservation of rights letter and having to defend itself, and therefore, was unable to prove the required elements of estoppel under New Jersey law.) Clearly, if an insured has negotiated the terms of a manuscripted policy, the necessity to tell the insured what the terms of in that policy may be lessened.

2. Construction Against Drafter May Not Apply to a Knowledgable Insured

If a sophisticated insured participated in the drafting of the policy terms, it likely has a greater comprehension of its rights under the policy than does a layperson insured, and is less dependent upon a reservation of rights letter from an insurer to give notice of its rights and options. In fact, various

jurisdictions have held that the commonly applied rule of construing policy language against the insurer-drafter does not apply when the insured is actually a sophisticated party that participated in the drafting of the contract. Steven Plitt, Daniel Maldonado, Joshua D. Rogers, and Jordan R. Plitt, Couch on Insurance Third Edition, 2 Couch on Ins. §22:24 (2013) (Citing, *inter alia, First State Underwriters Agency of New England Reinsurance Corp. v. Travelers Ins. Co.*, 803 F.2d 308 (3d Cir. 1986); *Eagle Leasing Corp v. Hartford Fire Ins. Co.*, 540 F.2d 1257 (5th Cir. 1976); *Playtex FP, Inc. v. Columbia Cas. Co.*, 609 A.2d 1087 (Del. Super. Ct. 1991); *Eastern Associated Coal Corp. v. Aetna Cas. & Sur. Co.*, 632 F.2d 1068 (3d Cir. 1980); *Koch Engineering Co., Inc. v. Gibraltar Cas. Co., Inc.*, 878 F.Supp 1286 (E.D. Mo. 1995). When the insured is a party with equal bargaining power, courts will be less likely to apply the doctrine of *contra proferentem* (construction against the drafter), which may make it more difficult for the insured to prove their claims for redress against the insurer in certain cases.

3. Insurers Should Not be Penalized for Failure to Send Reservation of Rights Letters to Sophisticated Insureds

In Arizona and a number of other jurisdictions, once an insured receives a reservation of rights letter, he is permitted to enter into a *Damron* agreement without breaching the cooperation clause of the insurance policy. *United Services Auto Association v. Morris*, 154 Ariz. 113, 741 P.2d 246 (1987). If the insurer is liable under the policy, the insurer will be obligated to pay the settlement amount, if reasonable. *Id.*

In determining whether USAA had reserved its rights as to both insureds in *Morris*, the court noted that "the intent of the parties – insurer and insured – must prevail." *Id.* at 250. The fact that one of the insureds had not signed a nonwaiver agreement did not alter the fact that USAA was defending both insureds under a reservation of rights, when that insured acknowledged that he was aware all along that that he was being defended under a reservation of rights. *Id.*

Many of the policy considerations for sending a reservation of rights letter do not apply when the insured is a sophisticated party, as discussed *supra.* However, if out of an abundance of caution and good practice does an insurer reserve its rights with respect to a sophisticated insured, the sophisticated insured should not be permitted to enter into a *Damron* agreement under the reasoning of *Morris.* The *Morris* Court noted that insured's settlements are often motivated "solely by their strongly-felt need for economic survival and the claimant's desire for a quick judgment that will enable him to get after …collecting from the insurer." *Id.* at 252. The court further noted that from a public policy standpoint, the result of such settlements is often unfair to one of the parties. *Id.*

Morris involved two layperson insureds, "placed in a precarious position" and facing the possibility of significant personal liability, who needed to act to protect themselves. *Id.* at 251. The claimant, Morris, was also an individual. In the case of a sophisticated insured being defended under a reservation of rights, we are unlikely to see the same pressing need for settlement motivated by "economic survival." The sophisticated insured will likely be better suited to handle the potential exposure to liability, and therefore the policy reasons behind allowing an insured to enter into such a settlement become illusory.

Furthermore, in the event the sophisticated insured wishes to enter into an agreement with an individual claimant, the relatively equal bargaining power between claimant and insured that was present in *Morris* no longer exists. A sophisticated insured may find itself it a position of higher bargaining power in relation to an individual claimant if it attempts to enter into a *Damron* settlement, which may ultimately prejudice the insurer. The sophisticated insured should not be permitted to take advantage of the protections that were put in place to protect the average layperson insured. Moreover, the insurer should not be prejudiced as a result of attempting to set the parameters of its defense through a reservation of rights. Allowing a sophisticated insured to enter into a *Damron* agreement permits the insured to extract more coverage and benefits than originally bargained for, to the potential detriment of the claimant and insurer.

III. Conclusion

Many of the public policy reasons for requiring a reservation of rights letter to an individual insured are not applicable when it comes to sophisticated insureds. Given the significant number of knowledgeable sophisticated insureds who participate in the drafting of their insurance agreements and act under the direction and supervision of their own counsel, the requirement of sending reservation of rights letters to these types of insureds may not need to be strictly enforced, as they do not serve the original purpose or policy considerations for informing the average layperson of a potential conflict of interest in his or her case. Failure by an insurer to fully explain its position to an insured that is guided by its own counsel should not open the door to the waiver and estoppel arguments that have been permitted to level the playing field for the average layperson. If a knowledgeable and sophisticated insured claims that an insurer is estopped as a result of its actions, the insured should prevail only when there is actual detriment suffered, which may occur less often than with layperson insureds. In sum, courts should not automatically apply the same standards to all types of insureds. When a sophisticated insured seeks recourse against an insurer for failure to send a reservation a rights, courts should look to the reasoning behind decisions such as *Damron*, *supra*, and weigh the position of the insured, its resources, and knowledge about the policy to determine whether the insured suffered actual prejudice when evaluating the insurer's duties with respect to reservation of rights.