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DOING IT RIGHT THE FIRST TIME: RESERVING RIGHTS AND DECLINING COVERAGE

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I. SCOPE OF ARTICLE

The purpose of this paper is to examine the "when, when not and how" of reservation of rights and the "how and how not" of declining coverage. First, we will look at those circumstances where a reservation of rights is appropriate and how it should be done. We will also answer the basic question—why is a reservation of rights necessary—and address the risks that a reservation of rights letter is designed to avoid, the potential rights that can be reserved, and how to actually reserve rights. We will then look at how a carrier should proceed when the reservation of rights is rejected and examine when it is appropriate to file a declaratory judgment action to determine the contract rights. Finally, we will outline what should and should not be in a denial of coverage letter.

II. WHY RESERVE RIGHTS

The first question, why should rights be reserved, derives from the potential conflict between the two separate and independent duties which exist in liability insurance contracts. The first duty, and very often the most valuable one to the insured, is the insurer's duty to defend claims brought against the insured by third parties. This is usually a very valuable asset of the insured as it gives it access to an attorney and the carrier's experience, knowledge and skill in supervising the defense of cases. Few insureds have experience in dealing with attorneys or in managing litigation.

The duty to defend is often described as "broader" than the duty to indemnify (*i.e.*, the duty to pay). This is for two primary reasons. First, the duty to defend is determined under Texas law solely from the face of the pleadings, which must be taken as true regardless of whether they are in fact true or merely frivolous.[2] Second, if an insurer has a duty to defend against part of a plaintiff's claim, it must defend the entire claim,[3] and doubts are resolved in favor of the insured.[4] Consequently, if the pleading on its face alleges a claim potentially covered by the policy, the carrier must defend the case even if it knows the alleged facts are

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[1] We would like to thank our Partner, Bob Lamb, for contributing much of the case law and analysis in this paper.

[2] *See Farmers Texas County Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81, 82 (Tex. 1997); *Nat'l Union Fire Ins. Co. v. Merchants Fast Motor Lines, Inc.*, 939 S.W.2d 139, 141 (Tex. 1997), and cases cited therein. *See also Progressive Universal Ins. Co. of Ill. v. Liberty Mut. Fire Ins. Co.*, 806 N.E.2d 1224 (Ill. App. 2004) (citing *Outboard Marine Corp. v. Liberty Mut. Ins. Co.*, 607 N.E.2d 1204 (Ill. 1992)), rev'd on other grounds, 828 N.E.2d 1175 (Ill. 2005); *Massena v. Healthcare Underwriters Mut. Ins. Co.*, 779 N.E.2d 167, 170 (N.Y. 2002).

[3] *Maryland Cas. Co. v. Moritz*, 138 S.W.2d 1095, 1097–98 (Tex. Civ. App.—Austin 1940, writ ref'd). *See also Aerojet-General Corp. v. Transport Indem. Co.*, 948 P.2d 909, 921 (Cal. 1997); *Rombe Corp. v. Allied Ins. Co.*, 27 Cal. Rptr. 3d 99 (Cal. App. 2005); *Int'l Ins. Co. v. Rollprint Packaging*, 728 N.E.2d 680 (Ill. App. 2000) (citing *JG Indus., Inc. v. Nat'l Union Fire Ins. Co.*, 578 N.E.2d 1259 (Ill. 1991)); *Massena*, 799 N.E.2d at 170.

[4] *Merchants*, 939 S.W.2d at 141 (citing *Heyden Newport Chem. Corp. v. Southern Gen. Lines Ins. Co.*, 387 S.W.2d 22, 26 (Tex. 1965) ("'Where the complaint does not state facts sufficient to clearly bring the case within or without the coverage, the general rule is that the insurer is obligated to defend if there is, potentially, a case under the complaint within the coverage of the policy.'") (quoting 50 A.L.R.2d 458, at 504)).

wholly untrue. In addition to the duty to defend, liability policies also include a duty to indemnify, or to pay, COVERED claims. In other words, if it is determined that the facts in the case fall within the coverage provided by the policy, the carrier has a duty to pay the claim up to the policy limits. The duty to pay is determined from the actual facts of the underlying case.[5]

The need for a reservation of rights arises because of the potential conflict between those two separate duties. The conflict comes into existence where there is potentially no duty to pay because the actual facts of the case do not fall within coverage, but the carrier still has the duty, or even the right, to control the defense of the case. In other words, in fulfilling its duty to defend, the carrier is in control of litigation which, if the claim turns out not to be covered by the policy, exposes the policyholder to financial risk.[6]

Therefore, the purpose of the reservation of rights is to notify the insured of this potential conflict between these contractual duties and to make the insured aware that, even though the carrier is defending the case, the insured may ultimately be responsible for paying any judgment that may be entered. This notice, which is almost always in writing, is generally referred to as a reservation of rights letter. The general principle behind such letters is that the insured must be given an opportunity to take action to protect itself.[7]

III. THE RISK

A carrier, of course, can always decide against asserting any defenses to coverage and opt to provide the insured with what is referred to as an "unqualified defense", which means nothing more than the carrier has agreed to not only defend the case, but to pay any judgment up to its limits of coverage.

If, on the other hand, the carrier seeks to reserve its right to deny its duty to pay, it runs a substantial risk if it fails to timely and properly send a reservation of rights letter. In determining the effectiveness of a reservation of rights letter, courts look to two principal theories: waiver and estoppel.

A. Waiver

As a practical matter, policyholders and courts in many jurisdictions often seem to use the terms waiver and estoppel as if they are identical and interchangeable. In fact, waiver is very seldom applicable in the reservation of rights context. This is because in order to constitute an

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[5] *Griffin*, 955 S.W.2d at 82 ("For example, a plaintiff pleading both negligent and intentional conduct may trigger an insurer's duty to defend, but *a finding* that the insured acted intentionally and not negligently may negate the insurer's duty to indemnify.") (emphasis added).

[6] *See Katerndahl v. State Farm Fire and Cas. Co.*, 961 S.W.2d 518, 521 (Tex. App.—San Antonio 1997, no writ) (citing *J.E.M. v. Fid. & Cas. Co. of New York*, 928 S.W.2d 668, 673 (Tex. App.–Houston [1st Dist.] 1996, no writ)) ("The purpose of a reservation of rights letter is to permit the insurer to provide a defense for its insured while it investigates questionable coverage issues.").

[7] First-party carriers (such as property insurers, health insurers, life insurers, and so forth) do not always issue letters reserving their rights when the insurance company is simply investigating a claim made under a policy. Even so, the issuance of a reservation of rights letter in that context is quite common.

effective waiver under Texas law, (1) the insurer must know of the right that it allegedly is giving up, (2) it must knowingly, intentionally, and voluntarily relinquish that right, and (3) it must communicate that waiver to the insured.[8] Consequently, an insurer's failure to send a reservation of rights letter, standing alone, is not a waiver of the insurer's right to deny coverage for a claim. Rather, for there to be a waiver in the reservation of rights context, the insurer must knowingly, intentionally, and voluntarily relinquish any right to deny coverage. Because an insurer's failure to send a reservation of rights letter does not in and of itself establish that the carrier intended to give up its right to deny coverage, waiver is almost never applicable.

B. Estoppel

Estoppel, on the other hand, is the principle which can cause carriers trouble. Estoppel is a principle which simply says that if I treat you badly and hurt you, the law will "stop" me from asserting rights I may have against you. There are three elements to estoppel. First, the person to be estopped must engage in conduct which the law recognizes as unacceptable. Second, the person to be estopped must know that he should have acted otherwise, or his lack of knowledge must be negligent. Third, the conduct to be estopped must injure the other person. This injury in the insurance context is called "prejudice" and occurs where a person is prevented from doing something which he otherwise would have done.

1. How Does Estoppel Work

It has been generally understood that estoppel cannot create contract rights that do not otherwise exist. In other words, "the rule" in insurance law has been historically that "while estoppel may preclude the insurer's policy defense arising out of a condition or forfeiture provision, these doctrines do not normally operate to prevent the assertion of a defense of non-coverage."

However, the inevitable exception to the rule in this context is that "if an insurer assumes the insured's defense without obtaining a reservation of rights and with knowledge of facts indicating non-coverage, all policy defenses are waived or the insurer may be estopped from raising them."

It doesn't take a rocket scientist to figure out that this is an exception that swallows the rule. In other words, where a reservation of rights letter is either untimely or inadequate, or is not sent at all, the insurer runs the risk of being estopped from asserting defenses of non-coverage—in other words, coverage that may not have existed under the policy in the first place may be created because of the carrier's failure to properly raise the defenses of non-coverage.

A number of Texas courts of appeals have used the doctrine of estoppel to impose coverage where an insurer failed to timely send a reservation of rights letter. For example, in

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[8] *State Farm Lloyds, Inc. v. Williams*, 791 S.W.2d 542, 552 (Tex. App.–Dallas 1990, writ denied) [hereinafter, "*Williams I*"]; *Pacific Indem. Co. v. Acel Delivery Serv., Inc.*, 485 F.2d 1169, 1173 (5th Cir. 1973) (applying Texas law) (citing *Utilities Ins. Co. v. Montgomery*, 134 Tex. 640, 138 S.W.2d 1062, 1064 (1940)) ("As to the application of waiver, the proponent must demonstrate a voluntary relinquishment of a known right.").

Farmers Texas County Mutual Insurance Company v. Wilkinson,[9] a leading case on the issue, the Austin Court of Appeals wrote:

> It is well established that, whereas the doctrines of waiver and estoppel may operate to avoid conditions that would cause a forfeiture of an insurance policy, they will not operate to change, re-write or enlarge the risks covered by the policy.
>
> However, it follows from these general principles that, if an insurer assumes the insured's defense without obtaining a reservation of rights or a non-waiver agreement, and with knowledge of the facts indicating noncoverage, all policy defenses, including those of noncoverage, are waived, or the insurer may be estopped from raising them.[10]

The trouble is the conclusion expressed by the Austin court in the second sentence quoted above does not follow from the first sentence. Instead, as the Fifth Circuit recognized, the result expressed in the second sentence is better understood as an "exception" to the rule that coverage cannot be created by either waiver or estoppel.[11] Indeed, later appellate courts' decisions refer to the "*Wilkinson* exception."[12]

It should also be noted that the Texas Supreme Court may not be satisfied with the exception. In *Texas Farmers Insurance Company v. McGuire*, which did not involve a dispute over a reservation of rights, the Court reiterated that "[t]he doctrine of estoppel cannot be used to create insurance coverage when none exists by the terms of the policy."[13] In doing so, the Court avoided approving *Wilkinson*:

> A court of appeals has held that there is an exception to this general rule. If an insurer with knowledge of facts indicating noncoverage assumes or continues the defense of its insured without obtaining a non-waiver agreement or a reservation of rights, it waives all policy defenses, including those of noncoverage, or it may be estopped from raising them. *Farmers Texas County Mutual Insurance Company v. Wilkinson*, 601

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[9] 601 S.W.2d 520 (Tex. App.—Austin 1980, writ ref'd n.r.e.).

[10] *Id.* at 521–22 (citations omitted). While *Wilkinson* is a leading case and is often cited by other courts, its holding was not a new concept, as demonstrated by the two Texas state court appellate decisions cited by the *Wilkinson* court, *Ferris v. Southern Underwriters*, 109 S.W.2d 223, 226 (Tex. Civ. App.—Austin 1937, writ dism'd judgm't cor.), and *Automobile Underwriters' Ins. Co. v. Murrah*, 40 S.W.2d 233, 235 (Tex. Civ. App.—Dallas 1931, writ ref'd), as well as the primary authority relied upon by the *Ferris* and *Murrah* courts, *American Indem. Co. v. Fellbaum*, 114 Tex. 127, 263 S.W. 908, 910 (1924).

[11] *Pacific Indem.*, 485 F.2d at 1173.

[12] *See, e.g.*, *Williams I*, 791 S.W.2d at 552 (referring to the "*Wilkinson* and *Pacific Indemnity* exception").

[13] 744 S.W.2d 601, 602–03 (Tex. 1988) (citing *Washington Nat. Ins. Co. v. Craddock*, 130 Tex. 251, 109 S.W.2d 165 (1937)).

> S.W.2d 520 (Tex. Civ. App.–Austin 1980, writ ref'd n.r.e.). Because this exception is not outcome-determinative in this case, we need not discuss it.[14]

In fact, the only variance from the general rule that the Texas Supreme Court recognized was one involving "forfeiture of a policy":

> Waiver and estoppel may operate to avoid a forfeiture of a policy, but they have consistently been denied operative force to change, re-write and enlarge the risks covered by a policy. In other words, waiver and estoppel cannot create a new and different contract with respect to risks covered by the policy.[15]

Despite the Texas Supreme Court's hesitancy to embrace the *Wilkinson* exception, a number of the Texas courts of appeals have done so. For that reason, prudence dictates that the exception be considered part of the general rule espoused in *Texas Farmers v. McGuire*, at least until the Texas Supreme Court indicates otherwise in something more than a footnote.

Other jurisdictions also employ the estoppel rule against insurers. The Illinois Supreme Court, for example, has explained the operation of estoppel under Illinois law as follows:

> The general rule of estoppel provides that an insurer which takes the position that a complaint potentially alleging coverage is not covered under a policy that includes a duty to defend may not simply refuse to defend the insured. Rather, the insurer has two options: (1) defend the suit under a reservation of rights or (2) seek a declaratory judgment that there is no coverage. If the insurer fails to take either of these steps and is later found to have wrongfully denied coverage, the insurer is estopped from raising policy defenses to coverage.[16]

The court observed that the insurer will not be estopped if it had no duty to defend or its duty was not properly triggered.[17] "These circumstances include where the insurer was given no opportunity to defend; where there was no insurance policy in existence; and where, when the policy and the complaint are compared, there clearly was no coverage or potential for

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[14] *Id.* at 603 n.1 (emphasis added). While not citing *Wilkinson*, the Fifth Circuit also had difficulty with the *Wilkinson* exception in light of the rule that coverage cannot be created by waiver and estoppel, and refused to apply the exception, despite the absence of a reservation of rights letter. *See Matador Petroleum Corp. v. St. Paul Surplus Lines Ins. Co.*, 174 F.3d 653, 660–61 (5th Cir. 1999) (applying Texas law).

[15] *McGuire*, 744 S.W.2d at 603 (*quoting Great American Reserve Ins. Co. v. Mitchell*, 335 S.W.2d 707, 708 (Tex. Civ. App.—San Antonio 1960, writ ref'd)). Defenses such as late notice and failure to cooperate are forfeiture defenses.

[16] *Employers Ins. v. Ehlco Liquidating Trust*, 708 N.E.2d 1122, 1134–35 (Ill. 1999).

[17] *Id.* at 1135.

coverage."[18] As the Supreme Court explained, once it is imposed, estoppel bars all "policy defenses to coverage, even those defenses that may have been successful had the insurer not breached its duty to defend."[19]

2. Prejudice

Given this situation, it is important to make sure that the elements of estoppel are present in any case where the application of the *Wilkinson* exception is being considered. As a practical matter, the exception appears to be an application of equitable estoppel, which consists of the following elements:

(1) a false representation or concealment of material facts;
(2) that is made with knowledge (actual or constructive) of those facts;
(3) with the intention that it should be acted on;
(4) to a party without knowledge, or without the means of obtaining knowledge of those facts;
(5) who detrimentally relied upon the misrepresentation.[20]

Of these five elements, it is normally the fifth one, detrimental reliance, that is in dispute; this dispute usually concerns whether the insured suffered harm (*i.e.*, prejudice) by the lack of a reservation of rights letter.[21]

In some jurisdictions, the failure to send a reservation of rights letter will result in the presumption of prejudice. Some treat the presumption of prejudice as rebuttable, while others vary where the burden of proof is placed. Still other jurisdictions hold that no showing of prejudice at all is necessary to impose estoppel against an insurer.[22]

Texas law on prejudice is both unsettled and complex. Texas does not conclusively presume prejudice from the failure to send a reservation of rights letter. One of the leading cases on the issue, *State Farm v. Williams*, decided by the Dallas Court of Appeals, holds that Texas will not rebuttably presume prejudice unless harm is clear and unmistakable.[23] But if the harm is

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[18] *Id.*

[19] *Id.*

[20] *Schroeder v. Texas Iron Works, Inc.*, 813 S.W.2d 483, 489 (Tex. 1991) (citing *Gulbenkian v. Penn*, 151 Tex. 412, 252 S.W.2d 929, 932 (1952)).

[21] *See Williams I*, 791 S.W.2d at 552 (citing *Employers Cas. Co. v. Tilley*, 496 S.W.2d 552, 560 (Tex. 1973)) ("Estoppel requires a showing that the insured was prejudiced by the conduct of the insurer."); *State Farm Lloyds, Inc. v. Williams*, 960 S.W.2d 781, 785 (Tex. App.—Dallas 1997, writ dism'd by agr.) [hereinafter, "*Williams II*"] (same). Interestingly, *Wilkinson* does not discuss harm or prejudice.

[22] *See, e.g., Ehlco*, 708 N.E.2d at 1138.

[23] *Williams I*, 791 S.W.2d at 553. *Accord Katerndahl*, 961 S.W.2d at 524; *Williams II*, 960 S.W.2d at 785–86; *Paradigm Ins. Co. v. Texas Richmond Corp.*, 942 S.W.2d 645, 652-53 (Tex. App.–Houston [14th Dist.] 1997, writ denied). *See also Matador Petroleum*, 174 F.3d at 660–61; *Pennsylvania Nat'l Mut. Cas. Ins. Co. v. Kitty Hawk Airways, Inc.*, 964 F.2d 478, 481 (5th Cir. 1992) (applying Texas law); *Pacific Indem.*, 485 F.2d at 1173; *Hertz Corp. v. Pap*, 923 F. Supp. 914, 918 (N.D. Tex. 1995), *aff'd*, 98 F.3d 1339 (5th Cir. 1996).

clear, then no prejudice needs to be presumed because it has already been proven. Simply put, prejudice is injury.

In Texas, what is clear is that an actual showing of prejudice is required before the carrier's failure to send a reservation of rights letter creates estoppel. In any case, like so many other legal questions, prejudice is too subjective to allow an exhaustive or complete definition. However, the paradigm example of estoppel gives a strong idea of its parameters. Specifically, if an insurer provides its insured a defense and deliberately utilizes the defense counsel to help build a case to deny its duty to pay, there is prejudice.

This in fact was the issue dealt with in the landmark case of *Employers Casualty v. Tilley*, decided by the Texas Supreme Court in 1973.[24] *Tilley* involved an insurer that provided its insured a defense and deliberately utilized the assigned defense counsel to also help build a coverage case based on late notice.[25] But in the context of a reservation of rights discussion, this example may not be a very good one because, simply on the basis of legal ethics and public policy,[26] not even a "gold-plated" reservation of rights would have avoided the result reached by the Texas Supreme Court in that case.[27]

More realistic examples are found in *Pacific Indemnity Company v. Acel Delivery Services, Inc.* and *State Farm Lloyds, Inc. v. Williams* (*Williams II*). In *Pacific Indemnity*, the Fifth Circuit found prejudice from discovery sanctions imposed against the insured after plaintiff's interrogatories were not adequately answered.[28] The Fifth Circuit also held that the insurer's "untimely withdrawal less than one month prior to trial of the [underlying] case" compelled a finding of prejudice.[29] The federal district court in the coverage case had also held that other possible sources of prejudice were the waiver of the insured's plea of privilege and an improper admission in an interrogatory answer.[30] However, the Fifth Circuit did not address

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[24] 496 S.W.2d 552, 560 (Tex. 1973).

[25] *Id.* at 554, 557.

[26] *Id.* at 561 (insurer's violation of public policy and the ABA's "Guiding Principles" for insurers appointing defense counsel for insureds resulted in the insurer being estopped to deny coverage "as a matter of law").

[27] *Tilley* does not specify the language used by the insurer to reserve its rights. While the Texas Supreme Court stated that "[e]mployers . . . secured a standard-non-waiver agreement from Tilley," the Court did not quote the non-waiver agreement. *Id.* at 554. Later, the Court did quote the allegation in Tilley's summary judgment motion that "'the non-waiver agreement is a broad form which is not limited to late notice.'" *Id.* at 556. In any event, as the court observed:

> The printed non-waiver form signed by Tilley . . . did not authorize Employers to use the same attorney to represent Tilley in the personal injury suit and to actively work against Tilley on the conflicting coverage question, without informing Tilley of the specific conflict and affording him the opportunity to employ his own counsel . . . .

Id. at 559.

[28] *Pacific Indem.*, 485 F.2d at 1175. Initially in the underlying case, the state district court imposed a $300 fine to cover attorney expenses incurred to compel further answers, and ultimately that court imposed further discovery sanctions by accepting the plaintiff's allegations as true. *Id.* at 1175–76.

[29] *Id.* at 1175.

[30] *Id.* at 1175 n.1.

these other two grounds for prejudice because it agreed that the insured was prejudiced by the discovery sanctions.[31]

In *Williams II*, the Dallas Court of Appeals concluded that the lack of a reservation of rights letter prejudiced the insured as follows:

> By not advising [the insured] of its potential coverage defenses, State Farm deprived [the insured] of the opportunity to (1) reject State Farm's offer of a qualified defense, (2) assume its own defense, and (3) accept [the third-party plaintiff's within-limits] settlement offer. Instead, State Farm's actions resulted in the entry of a judgment against the estate in excess of $600,000. This evidence presents some evidence of harm suffered by [the insured's] estate.[32]

At least the first two reasons recited in *Williams II* as supporting a finding of prejudice are open to question. In almost any instance, the lack of a reservation of rights letter arguably deprives the insured of the opportunity to reject the insurer's qualified defense and assume its own defense. If these events are always prejudicial to the insured, the need for the insured to prove prejudice is eliminated. The Dallas Court of Appeals probably did not intend this result.

Undoubtedly more influential to the outcome in *Williams II* was the non-superseded judgment that the insurer allowed to exist against the insured for a period of at least two months.[33] The appellate court found prejudice, despite the fact that during the two-month period the judgment was outstanding, no attempts were made to execute on it.[34]

Some of these examples can be laid at the feet of the insurer, such as the failure to supersede a judgment. But other examples, such as discovery abuse, are likely the fault of the defense attorney assigned to the case. Since the Texas Supreme Court has held that "a liability insurer is not vicariously responsible for the conduct of an independent attorney it selects to defend an insured,"[35] should it make any difference whether the act creating the harm is caused by the insurer or its appointed defense counsel? Strictly looking at the Supreme Court's decision in *State Farm Mutual Automobile Insurance v. Traver*, which set forth that rule, the answer is probably yes. But *Traver* is likely to hold little sway with the Texas courts of appeals that have

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[31] *Id.*

[32] *Williams II*, 960 S.W.2d at 786 (footnote omitted).

[33] *Id.* at 787.

[34] *Id.* ("[T]he fact that [the insured] was subject to execution on the judgment for a two-month period prior to execution of the covenant [not to execute] . . . presents some evidence of harm suffered by the [insured].").

[35] *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 628 (Tex. 1998). *See also Feliberty v Damon*, 527 N.E.2d 261 (N.Y. 1988) ("given the insurer's inability to provide or control the legal services in issue, and the existence of a remedy for incompetence against counsel, we conclude that the imposition of vicarious liability . . . is unwarranted"). *But see Young v. Nationwide Mut. Ins. Co.*, 21 A.D.3d 1099, 1101 (N.Y. App. Div. 2005) (insurer was potentially vicariously liable for malpractice of law firm hired by insurer to defend insured if the retained counsel did not exercise independent judgment on insured's behalf in the course of defending her).

followed *Wilkinson*. This is because the real problem is the absence of a reservation of rights letter, and that problem is clearly the fault of the insurer.

Likewise, if the insurer controls the litigation and unnecessarily puts the insured in jeopardy, then the insured has suffered prejudice. This would also be the case where defense counsel answers discovery in such a way that the insured unnecessarily confesses to an uncovered claim or where the insurer conducts settlement negotiations in a way detrimental to its insured when it could have conducted settlement negotiations in a way to protect its insured.

But the mere appearance of a conflict of interest is not sufficient to give rise to estoppel. Rather, there must be actual prejudice. In other words, the mere fact that an insured has lost the opportunity to control his defense does not inherently create prejudice. Likewise, the mere fact that an insured has lost the opportunity to hire counsel who reports only to him is not necessarily prejudice. Estoppel in Texas requires the element of causation. In other words, the prejudice alleged has to flow from the unacceptable conduct of the carrier. Without that nexus, estoppel cannot be established.

IV. WHAT CAN BE RESERVED

Once it is decided that a reservation should be sent, the question arises as to what rights can be reserved. As a practical matter, a carrier can reserve just about any right that may ultimately bar the insured's recovery under an insurance policy. Generally, there are two types of defenses or bars to recovery under an insurance policy. The first are the procedural aspects of the insurance policy or the "conditions precedent" to recovery. These include the notice requirements, which require that the insured provide the carrier notice of both the occurrence or accident that may give rise to a claim as well as the actual suit or the receipt of any pleadings filed by a third party when they are received. Also, insurance policies regularly include conditions and terms requiring the insured to cooperate in the defense of the case.

The second types of defenses are called the "defenses of non-coverage". Specifically, the defense of non-coverage refers to either the failure of the actual facts developed in the underlying claim to fall within the provisions conferring coverage in the policy or to the facts developed in the case falling within an exception to coverage. In other words, there are provisions in the insurance policy which give or confer coverage and define the scope of that coverage. There are also exclusions or exceptions to coverage which carve out some claims that would otherwise be covered. For instance, occurrence-based liability policies require that an injury from an accident be unexpected and unintended. Therefore, if the insured acted intentionally and caused an obviously foreseeable injury, there would be no duty to pay because there was no accident.

V. HOW TO RESERVE RIGHTS

Given the potentially Draconian effect of estoppel, which, as discussed, is often nothing less than the creation of coverage under a policy for a claim which was never contemplated to be covered, it is all the more important to make sure that a reservation of rights is handled effectively. There are four general areas of focus in reserving rights: (1) when to reserve rights; (2) the content of the reservation of rights letter; (3) its style; and (4) how to send it or, more accurately, *who* should send it.

A. Timing

The timing question should be self-evident. Obviously, if the carrier is unaware of a problem jeopardizing the insured's right to a defense or indemnity, it has no duty to send a reservation of rights letter.[36] But when it does learn of a problem it should issue the reservation of rights letter as soon as possible. The question is "when is as soon as possible?" For purposes of protecting itself, the phrase "as soon as possible" should mean just that—"do it now!" In the context of claims handling, the phrase means just that, although from a litigation standpoint, it usually does not mean "immediately". But it does mean soon.[37]

For example, in *Paradigm Insurance v. Texas Richmond Corporation*, the insureds, d/b/a The Men's Club of Houston, were sued because one of the club's allegedly inebriated customers had an accident while driving after enjoying the club's festivities.[38] The club's liability insurer retained defense counsel to defend the suit, and that counsel filed an answer on behalf of the insureds. Fifteen days after that answer was filed, the insurer sent to the insureds a reservation of rights letter asserting policy exclusions that barred coverage for liquor-related accidents.[39]

In an effort to defeat these exclusions, the insured argued that the fifteen-day delay in the reservation of rights letter resulted in the insurer waiving its policy defenses.[40] The Houston Court of Appeals, however, rejected the insureds' argument, noting that after the reservation of rights letter was issued, the insureds had notice of the potential conflict of interest with respect to their defense, and that they had failed to offer any proof of harm suffered in the fifteen days before the reservation of rights letter was issued.[41]

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[36] *Williams I*, 791 S.W.2d at 552 (citing *Wilkinson*, 601 S.W.2d at 521–22; *Pacific Indem.*, 485 F.2d at 1173, 1174–75) ("[T]he application of the *Wilkinson* and *Pacific Indemnity* exception requires a showing that the insurer was aware of facts or circumstances indicating noncoverage."). Remember also that, as discussed earlier in this paper, the second element of equitable estoppel requires that the false representation or concealment of material facts be "made with knowledge, *actual or constructive*, of those facts." *Schroeder*, 813 S.W.2d at 489 (emphasis added).

[37] The Texas Insurance Code states that an insurer commits an "Unfair Settlement Practice" by "failing within a *reasonable amount of time* to . . . submit a reservation of rights to a policyholder." *See* TEX. INS. CODE ANN. § 541.051 (West 2006) (former art. 21.21, § 4(10)(a)(v)(B)) (emphasis added).

[38] *Paradigm*, 942 S.W.2d at 647–48.

[39] *Id.* at 652.

[40] *Id.*

[41] *Id.* at 653.

While *Paradigm* may indicate that courts are generally sympathetic about how long it takes a carrier to obtain information and then react, it also is a demonstration that time is of the essence. What if the insureds in *Paradigm* had been able to raise proof of harm during the fifteen-day period between when the answer was filed and the reservation of rights letter was sent? If nothing else, the case demonstrates that neither the insurer nor its counsel charged with responsibility to draft a reservation of rights letter can wait very long to send that letter to an insured.

It should also be noted that the facts have much to do with the timing. For example:

- If the claim has just been reported, no suit has been filed, and the investigation has not yet begun, the insurer probably has more time to send the reservation of rights letter.
- If suit has been filed, and defense counsel is about to file an answer, the time period is probably shorter.
- If suit has been filed, and defense counsel has filed an answer, the time period is probably even shorter, as *Paradigm* demonstrates.
- And if the case is about to go to trial, and new facts indicating lack of coverage come to light, the time period for the reservation of rights letter is likely to be very short.[42]

Obviously, "as soon as possible" does not mean preparing and sending a reservation of rights on the same day it becomes clear that a problem has arisen. The practical point of view, which is from the retrospective litigation standpoint, is that an insurer probably has at least a couple of months to forward a reservation of rights letter after its claims person discovers a problem. Courts are knowledgeable and sympathetic about how long it takes a carrier to obtain information, get advice from counsel where appropriate, and to prepare the reservation of rights letter.

Having said that, timing remains critically important. If a carrier takes much more than a couple of months, estoppel becomes a consideration. If it takes as long as six months, estoppel becomes a serious possibility. If it takes a couple of years, estoppel is certain.

Of course, there are circumstances when the information that is being received is fragmentary or insufficient to identify all the possible coverage defenses or to even identify with any certainty that there is a problem. If so, the carrier may consider sending "phased" reservation of rights letters.[43] In other words, the carrier will send an initial reservation of rights letter identifying the preliminary indications that may give rise to a problem and indicate that a

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[42] *Cf. Pacific Indem.*, 485 F.2d at 1175 (finding of prejudice compelled by insurer's "untimely withdrawal less than one month prior to trial of the [underlying] suit").

[43] *Cf. Katerndahl*, 961 S.W.2d at 523 (insurer sent an initial reservation of rights letter advising of six potential coverage defenses; a little over four months later, insurer sent a "revised" reservation of rights letter stating that two of the potential coverage defenses had been resolved in the insured's favor, but specifically reserving the insurer's right to withdraw its defense on the basis of the four remaining coverage defenses).

more detailed reservation of rights letter will follow as the investigation develops. Such a letter has the beneficial effect of putting the insured on notice as soon as possible, while on the other hand, it gives the carrier the flexibility to prepare a more full-fledged reservation of rights when more detailed information is available. Remember—the goal is to alert the insured to the "potential conflict of interest with respect to [the insured's] defense."[44]

When you use the phased reservation of rights letter, it is important to follow up with a second or even third letter so as to document the completion or continuation of the investigation. But also remember, if the preliminary letter promises a follow-up reservation of rights letter, and such a letter is not sent, there will be the appearance (and possible accusation) that the insurer's investigation was not continued or completed or that its coverage defenses were abandoned.

B. Structure and Content

There are approximately 14 general categories of information which should appear in most, if not all, reservation of rights letters. Most of them, like the first three, are very straightforward, but are very often done incorrectly. These are (1) the carrier name, (2) the policy number, and (3) the claim number. For example, assume there are numerous carriers that operate under the name Trustworthy Insurance Group. It is very important to identify the specific company at issue. Therefore, if the policy was issued by Honest Abe Insurance, it is important to put Honest Abe and not simply TIG, Trustworthy Group, or some other variation. Give the insured the benefit of knowing which specific insurance company it is dealing with. A mistake in this regard will probably not negate the effect of the letter or create estoppel.[45] Nevertheless, this sort of mistake creates the wrong impression and should be avoided.

The same is true of policy numbers and claim numbers. Policy numbers are important as many claims, especially those involving long tails, or multi-year situations, may trigger multiple policies, multiple policy years and multiple limits. If more than one policy is at stake, then each policy should be identified and discussed in the reservation of rights letter.[46] Alternatively, a separate reservation of rights letter could be sent as to each policy. Sending multiple letters is not a legal requirement, but it may simplify the letters in some contexts where different issues may pertain to different policies.

Number 4, the letter should always clearly identify itself as a reservation of rights letter. As a practical matter, I like to use the term "full" in describing the reservation of rights and informing the insured that we will require strict compliance with the insurance contract. But be careful when demanding strict compliance, because it can backfire if the insurance company itself has not been acting in strict compliance.

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[44] *Paradigm*, 942 S.W.2d at 653.

[45] *See Rodriquez v. Texas Farmers Ins. Co.*, 903 S.W.2d 499, 510 (Tex. App.—Amarillo 1995, writ denied) (reservation of rights letter written on behalf of "Fire Insurance Exchange," instead of "Texas Farmers Insurance Company"; insured failed to show any reliance or prejudice as a result of this error).

[46] For example, in one case, "six home owner's policies were at issue, varying in dates from 1985 to 1990." *Katerndahl*, 961 S.W.2d at 520 n.2.

Number 5, the letter should immediately let the insured know that the carrier, though reserving its rights, is providing a defense to the insured. This is probably the most important piece of information from the insured's standpoint.

Number 6, the insured must be informed that the carrier may, under certain circumstances, withdraw the defense. For example, where two causes of action are identified, only one of which is covered, the carrier is likely to withdraw the defense if the covered cause of action is dismissed.[47]

Number 7, the letter should describe the history of the claim. Specifically, this is referring to the receipt of the notice of the claim, when it was reported, and a recitation of any investigation the carrier has completed.

Number 8, the letter should always identify the basic facts or nature of the underlying lawsuit. This can be especially helpful where there are facts alleged in the petition which strongly indicate that there may be no duty to pay.

This leads invariably to number 9, which is identifying the potential reasons for denying indemnity. If there is a question as to the duty to defend, the carrier should identify the provisions of the policy and the allegations in the petition which support a potential denial of a defense. It is customary to quote the relevant portions of the insuring agreement, the appropriate definitions and any applicable endorsements or exclusions. When the policy defense pertains to conditions or late notice, those provisions are quoted.

If there are questions as to the duty to pay, the focus shifts from the allegations in the petition to the development of the "true facts." It is customary in this context to quote the relevant policy provisions and to identify the essence of the true facts as the carrier understands them.

Of course, any discussion of the facts will have to be as the insurer understands them. This understanding may result from the insurance company's investigation. Or it may arise from what the insured or the insured's employees told the insurer. Or, the insurer's understanding may simply derive from what tends to be true about the pattern of facts alleged against the insured.

Any discussion of the facts needs to be made with the recognition that such a discussion, as well as any legal arguments and explanations, may potentially be discoverable in the underlying case. This is because it is not uncommon for plaintiff's lawyers in underlying tort cases to seek insurance policies, reservation of rights letters, and other information that impacts coverage.[48]

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[47] Strictly speaking, it is the "facts pled"–not "causes of action alleged"–that lead to the determination of the duty to defend. *Id.* at 522 (citations omitted). *See also Griffin*, 955 S.W.2d at 82 (*citing Merchants*, 939 S.W.2d at 141) ("A court must focus on the factual allegations rather than the legal theories asserted in reviewing the underlying petition."). Nevertheless, this way of speaking is common enough and thus appropriate in this context.

[48] *See, e.g., In re Senior Living Prop., L.L.C.*, 63 S.W.3d 594, 597–98 (Tex. App.—Tyler 2002) (because the information "'is needed to determine settlement and litigation strategy,'" no abuse of discretion to allow underlying

Number 10, if the carrier has identified the lawyer to whom the case will be referred, the letter should say so and request that the insured and the lawyer meet promptly.

Number 11, the carrier should always reserve the right to amend or supplement the reservation of rights letter based upon factual developments or changes in the plaintiff's pleadings. The insurance company should request that the insured immediately forward any revised pleadings it receives and emphasize the importance of the insurer receiving successor pleadings. This request is particularly important in light of the fact that the insurer may have a duty to defend as the result of facts pled in one petition or complaint, but not in an amended pleading, or vice versa.[49]

Number 12, remind the insured that the carrier is not waiving any other rights or defenses it may have which either may not be identified at this time or simply not included in this "full" reservation of rights letter. The intent of this paragraph is to make it possible for the carrier to reserve its rights with respect to things it knew before it sent the first letter, but had not properly understood or identified as relevant.

Number 13, it is always advisable to invite the insured to comment about any aspect of the letter about which it disagrees or does not understand. The carrier should always invite dialogue with the insured. If the insured fails to raise any complaints, the insured's lawyer may have trouble explaining this at a trial of the coverage dispute.

Finally, number 14, the insurer should advise the insured of its right to obtain independent counsel at the insured's own expense.[50] This is particularly important when the insurer is relying upon defenses of no coverage; that is, where the insurer may defend the case but is not likely to contribute to settlement. It is also important where the insured faces excess exposure, exposure for events that are not covered, or exposure for a type of damages that are not covered. For example, some courts have held that there is no coverage for punitive damages.[51]

Having discussed what should go into a reservation of rights letter, there are some things

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plaintiff to discover nursing home's insurance coverage, the extent that it had been eroded or compromised, including the number of claims competing for the coverage, the effect of any pending litigation on the coverage, and information on the self-insured retention and whether it impaired the insurance coverage) (*quoting Carroll Cable Co. v. Miller*, 501 S.W.2d 299, 299 (Tex. 1973)), *abrogated by In re Dana Corp.*, 138 S.W.3d 298, 302 (Tex. 2004) (holding that a party may discover information beyond an insurance agreement's existence and contents only if the information is otherwise discoverable under the scope-of-discovery rule, TEX. R. CIV. P. 192.3(a)).

[49] *See, e.g., Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 119 (5th Cir. 1983) (applying Texas law), *rev'd on other grounds, Motiva Enter., LLC v. St. Paul Fire & Marine Ins. Co.*, 445 F.3d 381, 385 (5th Cir. 2006).

[50] *See J.E.M.*, 928 S.W.2d at 674 (quoting with approval such a provision from a reservation of rights letter considered in *Ideal Mut. Ins. Co. v. Myers*, 789 F.2d 1196, 1201 (5th Cir. 1986) (applying Texas law)).

[51] *See, e.g., Hartford Cas. Ins. Co. v. Powell*, 19 F. Supp. 2d 678, 696 (N.D. Tex. 1998) (public policy prohibits insurance companies from paying punitive damage awards). *But see St. Paul Fire and Marine Ins. Co. v. Convalescent Services, Inc.*, 193 F.3d 340, 345 n.13 (5th Cir. 1999) (applying Texas law) (because no tort duty breached in the case before it, Fifth Circuit refused to consider the holding in *Powell*).

which are wise to leave out. For instance, a reservation of rights letter is not designed and should not purport to explain to policyholders the legal significance of the reservation of rights. The carrier has no obligation to do this. Nevertheless, one problem that arises frequently is that some lawyers treat a reservation of rights letter as an opportunity to present the insured with unnecessary legal arguments and explanations. The risk in that context is that they may incorrectly state the law or may provide information which could be harmful to the insured if the letter is seen by the wrong eyes.

Also, the risk of inaccuracy demands that all legal explanations and principals in a reservation of rights letter be black letter and unassailable. Where the law is not settled, the explanation either should not be included or should be carefully worded to indicate the possibility of other results. For instance, a letter could describe a legal issue as "our understanding" where there is no law or "based on current law" where there is some precedent, but is not yet definitive.

C. Style

What should be the style of a reservation of rights letter? The answer is determined by the purpose of the letter. The reservation of rights letter has at least three purposes. The first is to successfully reserve the carrier's rights. The second is to communicate important information to the insured. The third purpose is that it should be a favorable exhibit at trial if there is ultimately a coverage dispute. Having accomplished all of these goals, the letters should be drafted so as to be helpful to the carrier's position.

All of these purposes suggest adherence to the time-honored rule: keep it simple, stupid. Admittedly, a reservation of rights letter is a complex legal instrument. Where there are a number of rights to be reserved, and where they pertain to both the duty to defend and indemnify, the letter will necessarily be conceptually complex and will usually be very lengthy. Even so, the style should be as simple and clear as possible.

Despite this, many reservation of rights letters include string citations for even the simplest legal principles. This is unnecessary and counter-productive since the letter should strive for clarity. Statements of law must be absolutely accurate when they are included, but citation is almost always unnecessary. The one exception will likely be where the reservation of rights turns on a recent case. Then, it is probably helpful to cite and discuss the case and possibly even provide a copy of it for the insured. However, these situations are extremely rare.

D. Who Should Send the Letter

Invariably, the question arises as to who should sign the reservation of rights letter. The general practice is for the claims person who is handling the file to sign it. In many cases, the reservation of rights letter is actually written by the attorney but signed by the claims person. The reason for this is more practical than legal. Most coverage lawyers would prefer not to expose themselves to the potential of being a fact witness or being deposed if there is some inadequacy in the claims handling or in the content of the reservation of rights letter. There is nothing in the law which requires the reservation of rights letter to be signed by a claims person,

but there is no question that the potential for becoming a fact witness regarding the handling of the claim is a strong disincentive to discourage most coverage lawyers from signing reservation of rights letters.

The one frequent exception is where the insured is very sophisticated and has its own counsel or risk manager. In that context, it is very common for the carrier's coverage counsel to sign the reservation of rights letter, especially where the parties are already discussing the matter.

VI. THE INSURED'S RESPONSE

Having sent the reservation of rights letter to the insured, the next question is, how will the insured respond?

A. Silence

In the vast majority of cases, there is no response and the matter proceeds to resolution. From the insurer's point of view, silence by the insured is good, as this comment in *Texas Association of Counties v. Matagorda County* demonstrates: "By allowing the insurer to defend the action, the insured impliedly agrees that the insurer will not thereby waive its right to later contest coverage."[52]

Either the case is settled for a nominal amount or the carrier defends it to a successful resolution. On occasion, the reservation of rights is effective and the plaintiff presses its case to conclusion and the defendant pays the judgment.

B. Asking Questions

In other cases, the policyholder or its lawyer responds to the reservation of rights by asking detailed questions. This is often an effective strategy as the policyholder can count on the insurer taking a substantial amount of time to answer the questions, if it answers them at all. If, in fact, the insurance company fails to answer them either promptly or comprehensively, it will look very bad in subsequent litigation.

Consequently, when faced with this approach by the insured, the carrier should simply answer the questions promptly, thoroughly, comprehensively, and in an open-ended way. This last point is of crucial significance because the carrier need not box itself in. It can point out that there are all sorts of alternative options available. It is also frequently appropriate for the insurer to try to set up a meeting to discuss these issues. This is almost always a good idea and gives strong evidence of cooperation.

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[52] *Texas Assn. of Counties County Gov't Risk Mgmt. Pool v. Matagorda County*, 52 S.W.3d 128, 132 (Tex. 2000) (citing *Western Cas. & Sur. Co. v. Newell Mfg. Co.*, 566 S.W.2d 74, 76 (Tex. Civ. App.–San Antonio 1978, writ ref 'd n.r.e.)).

C. Rejection

Finally, the policyholder may make the decision to reject the reservation of rights. In Texas, an insured does not have a right to an unburdened defense. In general, if an insured rejects the reservation of rights, the insurer is put to an election.

The carrier may (1) defend unconditionally, (2) deny coverage completely, (3) ignore the insured's reaction to the reservation of rights letter and keep on defending as though nothing has happened, or (4) acquiesce to the insured's demand by permitting the insured to select independent counsel who will be the attorney for the insured only. This counsel would only report to the insured and would not take instructions from the carrier. The carrier's only responsibility would be to pay reasonable attorney's fees.

Oddly, many people believe that this last scenario is firmly established as the legal obligation of the liability carrier when faced with the reservation of rights. There is some Fifth Circuit authority that supports this view,[53] but little Texas state court authority. In fact, most states take the view that defense counsel retained by an insurer ordinarily represents both the insurer and the insured, absent a conflict of interest.[54] In reality, insurers and insureds can negotiate all sorts of individualized arrangements about how to handle the defense in the face of a reservation of rights letter.

It is almost never a good idea for the carrier to simply ignore the insured's rejection and to continue defending the case. If the carrier keeps defending, it will try to take the position that the insured acquiesced in the reservation after all. The insured, on the other hand, will take the position that it did not quite know what to do when the insurance company refused to relinquish its defense file. The insured is likely to have the better argument.[55] Given the factual subtleties involved on a case-by-case basis, the outcome of any such case is largely unpredictable. Obviously, this is a situation to be avoided.

Likewise, it is seldom a good idea for the carrier to simply refuse to pay any of the fees of the insured's independent counsel simply because the counsel refuses to agree to the insurer's normal fee schedule. At the same time, an insurer is only obligated to pay reasonable fees; it is not obligated to pay attorneys at an inflated rate.

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[53] *See Rhodes*, 719 F.2d at 120 ("When a reservation of rights is made, however, the insured may properly refuse the tender of defense and pursue his own defense. The insurer remains liable for attorneys' fees incurred by the insured and may not insist on conducting the defense."). *Accord LaFarge Corp. v. Hartford Cas. Ins. Co.*, 61 F.3d 389, 397 (5th Cir. 1995) (applying Texas law) (citing *Rhodes*, 719 F.2d at 119–20), *abrogated on other grounds by Grapevine Excavation, Inc. v. Maryland Lloyds*, 35 S.W.3d 1, 5 (Tex. 2000). Neither *Rhodes* nor *LaFarge* cite any Texas state court appellate cases on this point.

[54] *See, e.g., Gulf Ins. Co. v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone*, 93 Cal. Rptr. 2d 534 (Cal. App. 2000); *Waste Mgmt Inc. v. Int'l Surplus Lines Ins. Co.*, 579 N.E.2d 322, 329 (Ill. 1991); *Cincinnati Ins. Co. v. Wills*, 717 N.E.2d 151 (Ind. 1999).

[55] *Cf. Pacific Indem.*, 485 F.2d at 1173-74 (insurer accepted the defense of its insured and issued a reservation of rights letter which the insured rejected, demanding an unqualified defense; insurer continued its defense without resolving the reservation of rights issue, and court found that insurer had not effectively reserved its rights).

In fact, the carrier's responsibility for legal fees is a difficult problem. Attorneys are usually defensive about their fees and defense lawyers inevitably argue that the best defense is an aggressive offense. The insured is already unhappy with the carrier for sending the reservation of rights and so is ill-disposed to cooperate. If the insured is using its usual law firm, it may be happy to give its attorneys an opportunity to bill someone else. In these circumstances, the carrier must proceed carefully. One way of handling such a matter is to agree to an auditor or to seek an arbitrator to review and approve attorney's bills.

VII. WITHDRAWING THE DEFENSE

Suppose that a reservation of rights has been sent to which the insured has acquiesced. The plaintiff has amended his pleading several times, but in the last amendment the carrier fails to issue a new reservation of rights letter even though the latest amended pleading extinguishes the duty to defend. Suppose that this state of affairs lasts for two or more years, at which point the insurance company wakes up and withdraws from the defense of the case.

Can the carrier do this? The *Pacific Indemnity* case considered essentially this exact issue and concluded that the carrier could not withdraw under those particular circumstances, especially where the case was drawing near to trial. It appears the rule is that short delays are not a problem, but long delays are never permitted. Within that guideline, the length of the permissible delay is probably related to the proximity of the trial date.

In any case, the carrier should never just "jerk" a defense. The carrier must give explanations, lay its ground work, and give the insured an opportunity and time to comment. In other words, the carrier should keep the model of due process in mind—the insured should get notice and a hearing. Only after clearly explaining the basis for withdrawal, and giving the insured a chance to respond, should the defense be withdrawn.

VIII. WHEN TO "DJ"

A question with great significance in the context of insurance coverage is: When should a liability insurer who has reserved its rights file a declaratory judgment action, or a "DJ", against its insured? Until very recently, this was not usually a difficult question in Texas courts. Under the Texas Supreme Court's 1968 ruling in *Fireman's Insurance v. Burch*, there was no case or controversy pertaining to the duty to pay until after the underlying tort case was resolved.[56] In other words, you could not file your DJ regarding the duty to pay even though you could proceed with a DJ action regarding the duty to defend.

The practical result of this rule was that carriers would often deny coverage or defend under a reservation of rights and hold off any final determination as to indemnity until the underlying case was resolved. This allowed carriers to be reactive to events in the underlying case. In other circumstances, especially where there was clearly no defense obligation, carriers would file a DJ focusing on the defense obligation alone, but this obviously limited the

[56] *Firemen's Ins. Co. v. Burch*, 442 S.W.2d 331 (Tex. 1968), *superseded by* Tex. Const. of 1876, art. V, § 8 (amended 1985), as stated in *Griffin*, 955 S.W.2d at 83.

usefulness of the DJ because it would often require an abeyance of the action pending resolution of the underlying case.

The standard has long been substantially different in the federal courts, which allowed DJs to proceed both as to defense and indemnity even though the underlying case was unresolved. But an amendment to the Texas constitution caused the Texas Supreme Court to recently adopt a new rule in *Farmers County Mutual v. Griffin* that the duty to indemnify is justiciable before the insured's liability is determined in the liability lawsuit when the insurer has no duty to defend and the same reasons that negate the duty to defend likewise negate any possibility the insurer will ever have a duty to indemnify.[57] In other words, a carrier can now resolve its defense and indemnity obligations in the DJ unless the one exception identified in *Griffin* applies. The exception noted by the court is simply that it may sometimes be necessary to defer resolution of indemnity issues until the liability litigation is resolved—in some cases, coverage may turn on facts actually proven in the underlying lawsuit.

While this standard may seem somewhat difficult to apply, it nevertheless has the practical effect of requiring carriers to carefully consider and determine when a DJ is appropriate. This is a very serious issue for many reasons, but mostly because of the Texas Supreme Court's 1996 decision in *State Farm v. Gandy*.[58] In *Gandy*, the Texas Supreme Court held that sham judgments based upon a defendant's assignment of its claim against its insurer to the underlying tort plaintiff are invalid if either (a) the defendant's insurer has accepted coverage or (b) the defendant's insurer has made a good faith effort to adjudicate coverage issues prior to the adjudication of the plaintiff's claim.

As a practical matter, the *Gandy* concern can probably be addressed in most reservation of rights scenarios by entering into a tolling agreement with the insured whereby the indemnity issues are put off until resolution of the underlying matter. However, where such an agreement cannot be reached, a DJ action will be necessary to avoid the type of sham judgments which used to be much more common in Texas.

About four and one half years after *Gandy*, the Texas Supreme Court returned to its *Gandy* decision in *Matagorda County* and stated as follows:

> [A]n insurer [faced with a reasonable settlement offer within policy limits] that cannot obtain the insured's consent may, among other options, seek prompt resolution of the coverage dispute in a declaratory judgment action, a step we have encouraged insurers in [such a] position to take.[59]

The *Matagorda County* court then went on to state that, "[i]n *Gandy*, we required insurers either to accept coverage or make a good-faith effort to resolve coverage before resolving the

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[57] 955 S.W.2d 81 (Tex. 1997).

[58] *State Farm Fire & Cas. Co. v. Gandy*, 925 S.W.2d 696 (Tex. 1996).

[59] *Matagorda County*, 52 S.W.3d at 135 (citing *Gandy*, 925 S.W.2d at 714; *Griffin*, 955 S.W.2d at 84).

underlying claim."[60] What does the court's use of the word "required" mean? And how is an insurer to "make a good-faith effort to resolve coverage before resolving the underlying claim"? Given *Matagorda County*'s referral to *Gandy* and the reference in both cases to the filing of a declaratory judgement action, the Texas Supreme Court appears to be saying that an insurer is "required" to "adjudicate" (*i.e.*, bring a declaratory judgment action) if a coverage dispute cannot be otherwise resolved.

While some declaratory judgment actions seeking to determine coverage will be protracted, at least as to the final outcome, they hopefully will offer a vehicle with which the insurer can determine the coverage facts early through discovery taken in the declaratory judgment action. This should allow the insurer to make a determination as to whether it wants to accept coverage without limitation or press forward with the declaratory judgment action in an effort to obtain a no-coverage determination. Either way, the insurer will have fulfilled the admonition of the Texas Supreme Court that the insurer "either . . . accept coverage or make a good-faith effort to resolve coverage before resolving the underlying claim."[61]

IX. DENIAL OF COVERAGE

A. The Decision to Deny

Denial of coverage, whether it is as to the defense obligation, the indemnity obligation, or both, should only take place after a good faith determination that there is no defense or indemnity obligation under the insurance contract.

1. Duty to Defend

Obviously, where there is a defense obligation, the carrier should proffer either a qualified or unqualified defense. As noted earlier in this paper, the existence of a defense obligation under Texas law is determined by performing an "eight-corners" analysis. This is a comparison of the four corners of the petition or complaint with the four corners of the insurance policy, irrespective of the true facts of the claim.[62] By comparing the factual allegations of the petition or complaint with the provisions of the policy, it may be determined that all the factual allegations either fall outside the grant of coverage or are precluded by an exclusion in the policy.[63] In either case, the carrier is entitled to deny its duty to defend. On the other hand, if any of the allegations of the petition or complaint fall inside the coverage grant and are not precluded by a policy exclusion, the carrier has a duty to defend.

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[60] *Id. See also Griffin*, 955 S.W.2d at 84 (citing *Gandy*, 925 S.W.2d at 714) ("*Gandy* requires an insurer to either accept coverage or make a good faith effort to resolve coverage before adjudication of the plaintiff's claim, and also suggests that the plaintiff may wish to participate in that litigation.").

[61] *Matagorda County*, 52 S.W.3d at 135. The Texas Supreme Court does not seem to be saying that the coverage action must be resolved before the resolution of the underlying case, but only that the insurer make a "good-faith" effort to resolve the coverage dispute first. Hopefully, an insurer's prompt filing of a declaratory judgement action seeking a coverage determination, combined with a steady and aggressive pursuit of that action, will meet the Texas Supreme Court's requirements in *Matagorda County*.

[62] *See, e.g.*, *Griffin*, 955 S.W.2d at 82; *Merchants*, 939 S.W.2d at 141.

[63] *Id.*

2. Duty to Indemnify

In contrast, the determination of a duty to indemnify rests not on the allegations of the petition or complaint, but upon the true facts of the claim, which are often only established by the underlying case. For this reason, while the underlying case is in discovery or pending, it may be premature to deny the indemnity obligation. Indeed, as discussed above, until relatively recently, it was the rule that the duty to indemnify was not justiciable until after the underlying case had been resolved.[64] But in *Griffin*, the Texas Supreme Court opened the door to not only a determination of the duty to defend during the pendency of the underlying case, but also to a determination of the duty to indemnify: "the duty to indemnify is justiciable before the insured's liability is determined in the liability lawsuit when the insurer has no duty to defend and the same reasons that negate the duty to defend likewise negate any possibility the insurer will ever have a duty to indemnify."[65]

However, the court also indicated that it might still be necessary to defer resolution of the indemnity questions until after the completion of the underlying case because "[i]n some cases, coverage may turn on facts actually proven in the underlying lawsuit."[66] But, as mentioned above, even the court's position on that exception may be changing. In urging carriers to bring declaratory judgment actions to resolve their coverage disputes, the Texas Supreme Court reiterated its *Griffin* holding in *Matagorda County*.[67] Thus, *Matagorda County* seems to signal that the court may now be willing to allow the resolution of coverage facts in the declaratory judgment action that would have previously waited to be resolved in the liability suit.[68] Otherwise, as the court observed in *Griffin*, "it would be impossible for an insurer to make a good faith effort to fully resolve coverage before a judgment has been rendered in the underlying claim."[69]

B. Mechanics of Denial Letters

In any case, when the determination is made that the duty to defend, and potentially the duty to indemnify, should be denied, the carrier must notify the insured of this decision and its basis. This denial almost always takes the form of a denial of coverage letter. Of course, if the determination of no coverage is reached as the result of a judgment or opinion in a declaratory

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[64] *See Burch*, 442 S.W.2d at 334–35.

[65] *Griffin*, 955 S.W.2d at 84.

[66] *Id.*

[67] *Matagorda County*, 52 S.W.3d at 135 (*citing Griffin*, 955 S.W.2d at 84).

[68] In *American States Ins. Co. v. Bailey*, the court stated:

> Under Texas law, the duty to defend is broader than the duty to indemnify. Logic and common sense dictate that if there is no duty to defend, then there must be no duty to indemnify . . . .

133 F.3d 363, 368 (5th Cir. 1998) (applying Texas law) (citations omitted). This is probably an abuse of the axiom that the duty to defend is broader than the duty to indemnify. One can imagine circumstances where the facts pled do not give rise to a duty to defend, but where the facts actually developed at trial fall within coverage.

[69] *Griffin*, 955 S.W.2d at 84.

judgment action, a formal denial-of-coverage letter hardly seems necessary. For that reason, the following discussion assumes that the no-coverage decision was not reached as the result of the resolution of a declaratory judgment coverage action.

The timing and types of information in a denial letter are very similar to those set out above in connection with the reservation of rights letter. The timing should be on an "as soon as possible" basis, recognizing that the insurer will need some time to process the information necessary to determine whether there is a defense obligation based on the insurance policy and the facts in the petition.

As a practical matter, the same timing factors that apply to a reservation of rights letter apply here. If the claim is in its early stages, there may be as long as a couple of months from the receipt of a claim to get the denial letter sent. If the claim is in its later stages, for example, where trial is approaching, the time period is obviously shorter. There is not the same risk of waiver or estoppel as exists in the reservation of rights context, but the insurer should be concerned with avoiding allegations of bad faith or Insurance Code violations if there is an unreasonable or unexplained delay.[70]

If a defense is being provided and is to be withdrawn as part of the claim denial, additional timing considerations come into play. There is no authority that says exactly when a withdrawal must take place.[71] Nevertheless, any withdrawal from the defense should be accomplished as soon as reasonably possible after the insurer is able to determine facts establishing no coverage. The withdrawal should be accomplished in a manner that causes as little harm to the insured as possible and facilitates the hand-off to the insured's personal counsel. Again, keep in mind, the admonition in *Pacific Indemnity*, where the Fifth Circuit was "compelled" to find prejudice because of the insurer's "untimely withdrawal less than one month prior to trial of the [underlying] case."[72]

In addition, the structure and content of the denial letter should have many of the same components of the reservation of rights letter discussed above. These include identifying the carrier and correct policy number, outlining the facts relevant to the denial, as well as identifying the particular policy language relevant to the carrier's analysis.

Also important is the inclusion of a paragraph asking the insured to comment upon any disagreement with the analysis and requesting that it provide any further information that may affect the coverage analysis. Again, keep in mind that the defense and indemnity obligations are

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[70] Bad faith and Texas Insurance Code risks are beyond the scope of this paper. But as an example of the dangers that lurk, the Texas Insurance Code makes it an "Unfair Settlement Practice" for an insurer to fail to "provide promptly to a policyholder a reasonable explanation of the basis in the policy, in relation to the facts or applicable law, for the insurer's denial of a claim or for the offer of a compromise settlement of a claim." *See* TEX. INS. CODE ANN. § 541.051 (former art. 21.21, § 4(10)(a)(iv)). An insurer also commits an "Unfair Settlement Practice" by "failing within a reasonable amount of time to . . . affirm or deny coverage of a claim to a policyholder." *See id.* (former art. 21.21, § 4(10)(a)(v)(A)).

[71] *Cf. Katerndahl*, 961 S.W.2d at 523 ("[T]here is no authority for the [insured's] contention that a reservation of rights must specify the point at which a defense may be withdrawn in order to be valid.").

[72] *Pacific Indem.*, 485 F.2d at 1175.

separate and distinct. For that reason, even though there may not be a defense obligation, the facts actually developed in the case may indicate that there will still be an indemnity obligation. This again points to the value of a declaratory judgment action during the pendency of the underlying case if there is any doubt about coverage for indemnity. Otherwise, how can the carrier meet its *Matagorda County* obligations to resolve those coverage questions before the underlying liability case is resolved?

Furthermore, while under the current petition there may be no defense obligation, later amended petitions may allege facts that do fall within the scope of coverage. Also keep in mind that where there is a duty to defend one claim in a lawsuit, there is a duty to defend the entire suit.[73] Consequently, it is very important to let the insured know the precise scope of the denial and that a change in circumstances may alter or change the carrier's coverage position.

In general, the responses to a denial of coverage range from the insured bringing a coverage case to acquiescence in the denial. At times, insureds will provide additional information, such as amended petitions, which will require the carrier to reconsider its coverage position. The carrier should remain open to consideration of any additional information, and particularly any pleadings that are provided by the insured. All new facts and all new pleadings should be carefully evaluated. This way, hopefully the carrier will avoid unnecessary complications in the majority of the claims for which it issues a denial letter.

X. CONCLUSION

The main points to keep in mind with the reservation of rights are: (1) act promptly, both in investigating and in responding to the insured; (2) identify the coverage issues to the extent possible given the information that you have; and finally (3) respond carefully to any requests for information or rejections of the reservation.

As a matter of legal theory, estoppel should be difficult to prove. On the other hand, insurers are not very favored by juries. From a practical point of view, this often makes estoppel easier to prove than it should be. The loss of the right to deny coverage when coverage does not exist is admittedly a harsh remedy. But again, as the Dallas Court of Appeals noted, "in the face of any doubts concerning coverage, application of the [estoppel] rule can be simply and easily avoided if the insurer reserves its rights as to coverage under the policy."[74]

The bottom line is this: When in doubt as to coverage, send a reservation of rights letter. Such a letter should be sent to every person or entity claiming coverage under the policy. Remember the main point of the reservation of rights is to give notice to the insured which is both timely and informs it of the potential conflict between the carrier's duty to defend and duty to indemnify. If you do this, you have accomplished the purpose of a reservation of rights.

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[73] *Rhodes*, 719 F.2d at 119.

[74] *Williams I*, 791 S.W.2d at 553.