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# Reservation of Rights Notice by Insurers

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# THE RESERVATION OF RIGHTS NOTICE BY INSURERS

## I. Introduction

An insurance company is precluded from asserting nonliability under the provisions of a policy when it defends an action against its insured with notice or knowledge of breaches of policy conditions by the insured and does not disclaim liability.[1] The prejudice to the insured, usually necessary for an estoppel, is found in the surrender of control of the defense by the insured to the insurer.[2]

The last phrase of the general rule, "without disclaiming liability," is the key to this article. The attempts of insurers to disclaim liability while retaining defense of the action against their insured stems from their reluctance to refuse to defend when they are not absolutely sure the policy does not apply. For example, if an employer's liability insurer refused to defend an action against its insured, believing that the plaintiff therein was not an employee of the insured, and at the trial of the case it was shown that the plaintiff was in fact an employee and he recovered a judgment against the insured, then the insurer would be liable for the amount of the judgment, up to its policy limits, without having had an opportunity to defend the suit.[3] In order to avoid this result the insurer must defend the action with a reservation of its right to rely on any defenses it might have under the policy provisions.

> [I]t is a well-established rule that a liability insurer will not be estopped to set up the defense that the insured's loss was not covered by the insurance policy, notwithstanding the insurer's participation in the defense of an action against the insured, if the insurer gives timely notice to the insured that it has not waived benefit of its defense under the policy.[4]

This general rule seems to be straightforward and to the point, but a tremendous amount of costly and needless litigation has arisen from attempted reservations of rights by insurance companies. There are three requirements for an effective reserva-

1. 45 C.J.S. *Insurance* § 714 (1946).
2. Annot., 38 A.L.R.2d 1148, 1151 (1954).
3. See Carolina Veneer & Lumber Co. v. American Mut. Liab. Ins. Co., 202 S.C. 103, 24 S.E.2d 153 (1943).
4. Annot., 38 A.L.R.2d 1148, 1161 (1954).

tion of rights notice: (1) it must be communicated to the insured; (2) it must be timely given; (3) it must fairly inform him of the insurer's position.[5]

## II. COMMUNICATION TO THE INSURED

### A. *By Letter*

Since the purpose of communicating a reservation of rights notice to the insured is to give him knowledge of the insurer's position,[6] it follows that notice by letter is sufficient[7] and the insured need not be served with notice personally. An excellent example of this is found in *Cooper v. Employers Mut. Liab. Ins. Co.*,[8] where the insurer sent the insured under its policy four separate reservation of rights letters but received no reply from the insured who had left town. The court held that the insurer acted in good faith in using every reasonable method to contact the insured and so was not precluded from asserting its policy defense.[9] While there seems to be no requirement that the reservation of rights notice go by certified mail, that would of course be the safer and more advisable method.

### B. *Orally*

Oral notice to the insured would appear to convey the necessary knowledge to prevent estoppel. Because of the difficulty of proof, however, it is not reliable and is seldom if ever used by itself. In *Basoco v. Just*[10] the insurer became aware of a policy defense open to it within four months of the accident and more than eight months before trial. It defended the action and immediately after the trial orally informed the defendant it was disclaiming liability. The company did not send him written notice until its motions for new trial and judgment

5. Nationwide Mut. Ins. Co. v. Gentry, 202 Va. 338, 117 S.E.2d 76 (1960); see State Farm Mut. Auto. Ins. Co. v. Anderson, 104 Ga. App. 815, 123 S.E.2d 191, 193 (1961).

6. See Salonen v. Paanenen, 320 Mass. 568, 71 N.E.2d 227, 231 (1947).

7. See, *e.g.*, Meyers v. Continental Cas. Co., 12 F.2d 52 (8th Cir. 1926); Hardeman v. Southern Home Ins. Co., 111 Ga. App. 638, 142 S.E.2d 452 (1965); Meirthew v. Last, 376 Mich. 33, 135 N.W.2d 353 (1965); Allstate Ins. Co. v. Manger, 30 Misc. 326, 213 N.Y.S.2d 901 (Sup. Ct. 1961); Edgefield Mfg. Co. v. Maryland Cas. Co., 78 S.C. 73, 58 S.E. 969 (1907).

8. 199 Va. 908, 103 S.E.2d 210 (1958).

9. *Accord,* Insurors Indem. & Ins. Co. v. Archer, 208 Okla. 57, 254 P.2d 342 (1953) (six letters sent).

10. 154 Pa. Super. 294, 35 A.2d 564 (1944).

non obstante veredicto were refused. The court held that the oral statement was ineffectual to release the insurer from its liability. The reason for this decision seems to be based more on the lateness of the notice than on its oral character, but the case should be a warning against reliance on an oral communication to the insured.

C. *By Entry into the Record*

The filing of the reservation of rights in the record is not required where the insurer is defending an action against its insured under a reservation.[11] This is because the insurer's reservation of its right to assert its liability is a matter between itself and its insured.[12]

There are two notable cases in which the insurer attempted to protect its rights by an entry into the record without notice to the insured. In *Cook v. Preferred Acc. Ins. Co.*[13] the insurer defended an action against its insured despite knowledge of the nonage of the driver and made no disclaimer of liability to the insured until after an adverse verdict had been returned. During the trial, while in the judge's chambers and without the knowledge of the insured, the company caused an entry of disclaimer to be inserted in the record. The court held that the insurer was estopped to rely on the nonage of the driver. This holding, of course, could be based on the lateness of the notice as well as on the lack of communication to the insured.

In *Mundry v. Great American Ins. Co.*[14] the insureds under Great American's automobile liability policy failed to appear at the trial of the action against them. Counsel for Great American announced that he would proceed with the case under a reservation of rights, and did so. The court held that Great American was not estopped to assert lack of cooperation as a policy defense because the insureds were not prejudiced by its action in defending the suit, in that they were blatantly uncooperative and undoubtedly would not have hired counsel of their own anyway.

From these two cases it can be seen that while entry of a reservation of rights into the record may occasionally, by itself,

11. Hardeman v. Southern Home Ins. Co., 111 Ga. App. 638, 142 S.E.2d 452 (1965).

12. *Ibid.*

13. 114 N.J.L. 141, 176 A. 178 (Ct. Err. & App. 1935).

14. 369 F.2d 678 (2d Cir. 1966).

prevent an estoppel against the insurer, it is not at all a reliable method. Used as a supplement to the reservation of rights letter, however, it shows to the court and the party claiming against the insured the position of the insurer,[15] and for that purpose it is to be recommended.

While it is a general rule that a claimant party need not be notified of a reservation of rights,[16] and that a claimant's consent to the insurer's defense under a reservation of rights is not necessary,[17] it is still a good idea to notify the claimant of the reservation of rights.[18]

## III. TIMING OF THE NOTICE

In order to determine when the notice of nonwaiver should be given, it is essential to remember that the basis for estoppel of the insurer is the surrender of the defense to it by the insured,[19] and the reason that a nonwaiver notice prevents such estoppel is that it gives the insured an opportunity to hire his own counsel to take over the defense of the action against him if he so desires.[20] When the cases speak of requiring reasonable notice to the insured, they mean that the notice should give him reasonable time to assume the defense.[21]

The safest course for the insurer to follow is to give notice to the insured as soon as it obtains knowledge of the defense.[22] "Delay in absence of knowledge will not result in estoppel of the insurer if the insurer acts promptly upon obtaining knowledge."[23] The knowledge may be constructive as well as actual,[24]

15. See Shelby Mut. Cas. Co. v. Richmond, 185 F.2d 803 (2d Cir. 1950), *cert. denied,* 341 U.S. 931 (1951).

16. Fisher v. Fireman's Fund Indem. Co., 244 F.2d 194 (10th Cir. 1957).

17. 29A AM. JUR. *Insurance* § 1467 (1960).

18. See Fisher v. Fireman's Fund Indem. Co., 244 F.2d 194 (10th Cir. 1957).

19. Annot., 38 A.L.R.2d 1148, 1151 (1954).

20. Mundry v. Great American Ins. Co., 369 F.2d 678 (2d Cir. 1966); Salonen v. Paanenen, 320 Mass. 568, 71 N.E.2d 227 (1947); Myers v. Continental Cas. Co., 223 Mo. App. 781, 22 S.W.2d 867 (1929).

21. See Meirthew v. Last, 376 Mich. 33, 135 N.W.2d 353 (1965).

22. Annot., 38 A.L.R.2d 1148, 1171 (1954).

23. *Ibid; Accord,* State Farm Mut. Auto. Ins. Co. v. Anderson, 104 Ga. App. 815, 123 S.E.2d 191 (1961).

24. See Salerno v. Western Cas. & Sur. Co., 336 F.2d 14 (8th Cir. 1964). The court found that the insurer had equal knowledge with the insured and the means of knowing the facts that would bring the action against the insured within the business activities exclusion of the policy. Therefore, by assuming the defense of the action, it was estopped to set up noncoverage under the exclusion.

but sending the reservation of rights notice as soon as it obtains knowledge that a question exists will protect the insurer.[25] The closer it is to the trial date the greater the need becomes for speed in order to avoid prejudice to the insured. If the facts upon which a reservation of rights could be based do not, through no fault of the insurer, come to light until after it is too late for the insurer to withdraw without prejudicing the rights of the insured, then it will not be estopped by continuing the defense.[26]

There is one additional problem of timing of which the insurer must be aware. Where there is a considerable period of time between the notice and the undertaking of the defense, the insurer may be estopped by undertaking the defense without making a new reservation of rights.[27]

## IV. CONTENTS OF THE NOTICE

### A. *Use of Specific Language*

In order to be held sufficient, the notice must fairly inform the insured of the insurer's position.[28] A mere notice of general reliance upon the provisions of the policy may be insufficient.[29]

In *Meirthew v. Last*[30] the reservation of rights letter stated:

> [Y]ou are hereby notified that the Company will defend said actions pending against you through its regular attorneys, and will pay its said attorneys for all services in connection therewith, but the Company in undertaking your defense, does so under a reservation of rights, and without prejudice, and subject to the conditions, limitations, exclusions and agreements of said policy, and subject to the express understanding that by so doing the Company does not waive any of its rights to rely upon the provisions of

25. See City of Aurora v. Trinity Universal Ins. Co., 326 F.2d 905 (10th Cir. 1964).

26. Basoco v. Just, 154 Pa. Super. 294, 35 A.2d 564, 565 (1944) (dictum).

27. See Consolidated Elec. Co-op. v. Employers Mut. Liab. Ins. Co., 106 F. Supp. 322 (E.D. Mo. 1952). There was a three year period between notice of nonliability and the filing of the suit against the insured. The court held that the insurer, by defending the suit, had waived all objections to liability based on the policy provisions.

28. Annot., 38 A.L.R.2d 1148, 1167 (1954).

29. See Meirthew v. Last, 376 Mich. 33, 135 N.W.2d 353 (1965).

30. 376 Mich. 33, 135 N W.2d 353 (1965).

> said policy, and does not waive any defense it may have to any claimed liability under said policy.[31]

The court stated:

> We hold the notice legally insufficient. . . . The notice was vague and uncertain. It smacks of bad faith for want of specific reference to that clause of the policy the [insurer] . . . has pleaded.[32]

The insurer must make certain that all the policy defenses which to the best of its knowledge are available to it are set out in the nonwaiver notice, or it may be held to have waived those defenses not set out.[33] It must also be sure that, after specifying the particular policy sections on which it is basing its reservation of rights, it does not, by unnecessary language, so cloud the reservation as to prevent it from being a sufficient notice. This was the case in *Henry v. Johnson*[34] in which the notice stated:

> We are making this reservation of rights because of your failure to comply with the policy conditions entitled '2, Notice of Claim or Suit' and '8, Assistance and Cooperation of the Insured' and for other reasons.
>
> *The service of this notice upon you does not deprive you of any rights you may have against this company.*[35]

The court held that the paragraph purporting to restore to the insured any rights under the policy destroyed the clarity of the reservation of rights.[36] The insurer can rest assured, however, that if it gives explicit notice of its nonwaiver of the policy conditions, it will be protected against estoppel.[37]

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31. *Id.* at 34, 135 N.W.2d at 355.

32. *Ibid.*

33. Hickey v. Wisconsin Mut. Ins. Co., 238 Wis. 433, 300 N.W. 364 (1941). The insurer obtained a nonwaiver agreement from the insured on the ground that she had misrepresented her marital status in applying for the policy. The insurer did not mention her failure to give timely notice, although aware of it. The court held that the insurer had waived the defense of untimely notice. See Bowen v. Merchants Mut. Cas. Co., 99 N.H. 107, 107 A.2d 379 (1954).

34. 191 Kan. 369, 381 P.2d 538 (1963).

35. *Id.* at 370, 381 P.2d at 541.

36. *Id.* at 374, 381 P.2d at 545; see Beatty v. Employers Liab. Assur. Corp., 106 Vt. 25, 168 A. 919 (1933).

37. See Meyers v. Continental Cas. Co., 12 F.2d 52 (8th Cir. 1926); Edgefield Mfg. Co. v. Maryland Cas. Co., 78 S.C. 73, 58 S.E. 969 (1907).

B. *Use of General Language*

In a number of cases the insurers have successfully used a general reservation of rights without stating the particular policy provisions upon which they relied.[38] The most notable of these is *Atlantic Lighterage Corp. v. Continental Ins. Co.*[39] The tug Dixie, owned by Atlantic and insured by Continental, was towing a barge which collided with another vessel, resulting in injury to the plaintiff who brought suit against Atlantic. Atlantic settled the claim and brought an action against Continental to recover for attorneys' fees and the amount of the settlement. The court held that a letter written by Continental to Atlantic suggesting that the summons and complaint should be turned over to a particular law firm, which had handled a suit by the barge's owners against the tug, "on behalf of the tug Dixie and/or underwriters as their interests may appear," constituted a clear reservation of Continental's rights under the policy.[40] The language in this notice, when compared to the language that was held insufficient in either *Meirthew v. Last*[41] or *Henry v. Johnson*,[42] is anything but clear. Whether this reflects a trend toward requiring more specific notice in the recent cases or merely demonstrates the lack of uniformity in treating the question is open for debate. It seems clear, however, that the general reservation of rights falls short of adequately informing the insured of the insurer's position as is required by the general rule.[43] With the number of provisions in the present day liability insurance policy, unless there has been a flagrant breach it would be unrealistic to expect the layman to know which of the conditions he has violated.

## V. Reaction of the Insured to the Notice

Once a reservation of rights notice has been sent to the insured, his reaction to it determines the insurer's next move. If he refuses to accept a defense by the insurer under the terms

38. See James v. Pennsylvania Gen. Ins. Co., 349 F.2d 228 (D.C. Cir. 1965); Atlantic Lighterage Corp. v. Continental Ins. Co., 75 F.2d 288 (2d Cir. 1935); Allstate Ins. Co. v. Manger, 30 Misc. 326, 213 N.Y.S.2d 901 (Sup. Ct. 1961); Connolly v. Standard Cas. Co., 76 S.D. 95, 73 N.W.2d 119 (1955).

39. 75 F.2d 288 (2d Cir. 1935).

40. *Id.* at 290.

41. 376 Mich. 33, 135 N.W.2d 353 (1965).

42. 191 Kan. 369, 381 P.2d 538 (1963).

43. Annot., 38 A.L.R.2d 1148, 1167 (1954).

of the notice and so notifies the insurer, then the insurer must elect whether to withdraw or whether to proceed with the defense, in which latter instance its defenses are waived. The insurer under a duty to defend does not have the right to insist that the insured first agree to its reservation of rights.[44]

A. *Implied Acceptance of the Reservation of Rights*

The insured may expressly consent to the nonwaiver notice or his consent may be implied from his tacit acquiescence "where the insured, after receiving such notice, permits the insurer to continue the defense of the suit."[45] To acquiesce by silence, the New Jersey court stated, in *Merchants Indem. Corp. v. Eggleston*,[46] that the letter must clearly show the insured that the offer to defend under a reservation of rights may be accepted or rejected. This requirement may apparently be met by stating in the letter that if the insurer does not hear to the contrary from the insured in a certain number of days it will assume the insured agrees to the reservation of rights.[47] If it is clear that the insurer gave explicit notice of its reservation of rights and that the insured fully understood the position of the insurer and accepted the defense of the suit without protest, then the insured's acquiescence will be implied.[48]

B. *Rejection of the Reservation of Rights*

Rejection of the proposal to defend under a reservation of rights can be of benefit to the insured. Such is the case where the insurer defends the action despite the rejection, either by mistake or because the evidence of a violation of the policy provisions which originally caused the insurer to issue the notice was so weak that the insurer felt it would be safer to defend.

44. See Youghiogheny & Ohio Coal Co. v. Employers Liab. Assur. Corp., 114 F. Supp. 472 (D. Minn. 1953), *aff'd*, 214 F.2d 418 (8th Cir. 1954).

45. State Farm Mut. Auto. Ins. Co. v. Anderson, 104 Ga. App. 815, 123 S.E.2d 191, 193 (1961).

46. 37 N.J. 114, 179 A.2d 505 (1962).

47. United States Cas. Co. v. Home Ins. Co., 79 N.J. Super. 493, 192 A.2d 169 (App. Div. 1963) (insurer allowed five days for a contrary statement).

48. See Hankins v. State Farm Mut. Auto. Ins. Co., 379 S.W.2d 829 (Mo. Ct. App. 1964); Edgefield Mfg. Co. v. Maryland Cas. Co., 78 S.C. 73, 58 S.E. 969 (1907).

By its defense the insurer is thereafter estopped from asserting the policy provisions.[49]

The average layman is incapable of balancing the various considerations in order to determine whether to accept or reject the reservation of rights, and for this reason would be well advised to retain counsel immediately upon receipt of a reservation of rights letter. Against the possibility that the insurer would proceed with the defense and thereby estop itself into coverage (which possibly would have varying degrees of likelihood depending on the facts of the case) must be weighed the possibility that the insurer might correctly withdraw from the case and thereby deprive the insured of the benefit of the experienced defense counsel retained by the insurer. Entering into the considerations also would be the possibility of settling the case at a lower figure once it became known that the insurer had disclaimed liability.

## VI. Conclusion

A large portion of the litigation concerning estoppel of the insurer to rely on its policy provisions because of defending the action without a reservation of rights or with a defective reservation of rights could be avoided if the insurance companies would follow these few simple rules. As soon as the possibility of a policy defense is raised the insurer should immediately prepare a reservation of rights letter. Together with such facts as the policy number and the date, place, and other facts of the occurrence which caused the liability, the letter should state the following: (a) the particular policy provisions relied on by the insurer; (b) the facts which, if proved, would result in a denial of liability; (c) that these are not meant to be the only defenses available and if any other policy defenses arise they will be relied on also; and (d) that if the insured has not notified the insurer to the contrary within ten days (or some other reasonable period of time), then he will be assumed to have accepted the reservation of rights. No attempt to lessen the sting of the notice should be made if it could possibly be construed as distorting the clarity of the reservation.

49. See Salerno v. Western Cas. & Sur. Co., 336 F.2d 14 (8th Cir. 1964); Schmidt v. National Auto. & Cas. Ins. Co., 207 F.2d 301 (8th Cir. 1953), 38 A.L.R.2d 1142; DeHart v. Illinois Cas. Co., 116 F.2d 685 (7th Cir. 1940); Beatty v. Employers Liab. Assur. Corp., 106 Vt. 25, 168 A. 919 (1933).

Copies of this letter should be sent by certified mail to every known home or business address of the insured. If an action has already been brought against the insured at the time of the reservation of rights, copies should also be sent to the complaining party or parties and to the judge who is to hear the case. If an action has not been brought at that time, copies should be sent at such later time as an action is brought. Giving notice to the claimant party and the trial judge is a matter of courtesy, however, and failure to do so should not be the basis for estoppel.

Should new facts raising new policy defenses come to light at a later date, the entire process should be repeated.

Not only must the insurance companies follow these rules, but equally as important, the courts must enforce them uniformly if the purpose of reducing needless litigation is to be achieved. Under the present state of the law it is easy to see how an insurance company operating in many states could occasionally send out a general reservation of rights notice to an insured when the state in which the action is to be tried requires specific notice. By requiring in every case specific notice of the policy provisions which the insurer is relying upon, the courts could make certain that the insured was adequately and clearly informed of the insurer's position. This would enable the insured to make a more intelligent decision on whether to accept or reject the offer of defense under a reservation of rights.

The greatest benefit would be that the insurance companies would have to examine each case carefully for possible policy defenses or risk estoppel. This would mean that they would catch many of the cases where reservations of rights would be appropriate but which now slip through without being caught. Therefore, not only would strict enforcement reduce litigation concerning the reservation of rights itself, but by increasing the number of effective reservation of rights notices sent it would decrease the litigation under the general rule of estoppel where the defense is undertaken without a reservation of rights.

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