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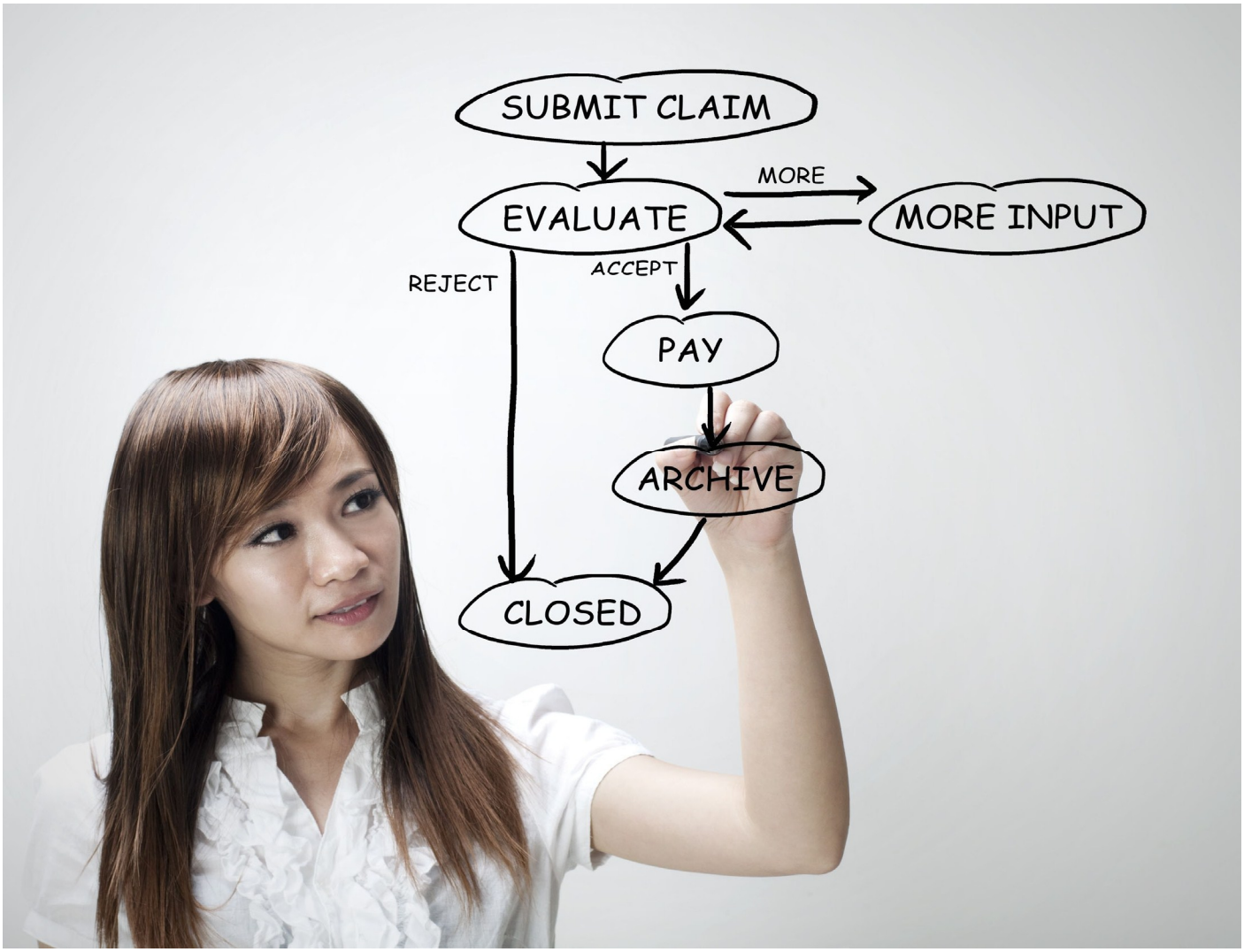

The Duty to Indemnify: Making Your Reservation of Rights Work for You

When is the last time someone reminded you that the duty to indemnify is narrower than the duty to defend?


Mary Beth Sipos

The corollary principle regarding the breadth of the duty to defend is reiterated so often as to be cliché. But insurance personnel and attorneys are remiss if they do not think actively about the extent of the duty to indemnify where they have reserved valid coverage defenses.

Early in a case, considerable resources may be devoted to assuring that potential coverage defenses are preserved when a defense is provided the insured pursuant to a reservation of rights or non-waiver agreement. The backbone of the reservation is the premise that indemnity, unlike defense, depends on proof of coverage. "The insurer's duty to indemnify runs to claims that are actually covered, in light of the facts proved." *Buss v. Superior Court*, 16 Cal.4th 35, 45, 939 P.2d 766 (Cal. 1997).

Too often, however, the scope of the duty to indemnify is forgotten at other important junctures in the litigation when it can be of considerable use.

Leverage in Settlement with the Claimant

Coverage issues can and should frequently arise in settlement negotiation. Good faith does not require that an insurer accept a settlement demand requiring performance beyond that due under its policy. As one court put it, "The insurer does not . . . insure the entire range of an

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insured's well-being, outside the scope of and unrelated to the insurance policy . . . It is an insurer, not a guardian angel." *Camelot by the Bay Condominium Owners' Association, Inc. v. Scottsdale Ins. Co.*, 27 Cal.App.4th 33, 52, 32 Cal.Rptr.2d 354 (Cal. Ct. App. 1994).

Thus, the reservation of rights can affect the claimant's settlement posture. Trying a case to an eventual judgment that is not covered should not be any claimant's Plan A.

To the extent the reservation of rights is discoverable or can be disclosed to adverse parties without infringing on the rights of the insured, it may be wise to do so. Unless the claimant is absolutely certain of satisfying any judgment from a defendant's own assets, disclosing that there is a reservation of rights can help create leverage in settlement.

Of course, dynamic tension arises from the possibility that the insured will settle with an adverse party by stipulating to judgment in exchange for a covenant not to execute. There are even jurisdictions where a reservation of rights letter alone will entitle the insured to settle in such a fashion without breaching the cooperation clause. See *Damron v. Sledge*, 105 Ariz. 151, 460 P.2d 997 (Ariz. 1969).

Thus, "Since an insurer, by reserving its right to deny coverage, loses its right to control the litigation, an insured does not breach a policy's 'duty to cooperate with insurer' provision by entering into an unauthorized settlement or stipulated liability, so long as such agreements are made fairly, with notice to the insurer, and without fraud or collusion on the insurer, and the settlement is reasonable and prudent. . . . ." 14 Couch on Ins. § 199.48 (3d ed. 2011).

Nonetheless, "An insured's settlement agreement should not be used to obtain coverage that the insured did not purchase," and coverage may still be litigated. *United Services Auto. Ass'n v. Morris*, 154 Ariz. 113, 120, 741 P.2d 246, 249 (Ariz. 1987) citing 7 C J. Appleman, Insurance Law and Practice § 4690 at 235 (1979).

If there is not going to be a duty to indemnify, that is true as against the insured or an assignee of the insured. In short, where the coverage defenses are strong, there is actually little down side to the parties "settling around" the carrier in this fashion, especially since the costs of defense are minimized by an early settlement of the underlying matter.

Contribution from the Insured

The reservation of rights may also affect the insured's conduct in settlement. While a carrier does indeed rely on coverage defenses at its own peril, it is entitled to decline settlement demands that are not covered. *Heredia v. Farmers Ins. Exchange*, 228 Cal.App.3d 1345, 279 Cal.Rptr. 511 (Cal. Ct. App. 1991).

The fact is that when the carrier has reserved rights, it may eventually be freed from satisfying a judgment that consists on only uncovered damages. Even in a "mixed" action, if the covered exposure represents only minimal damages relative to the uncovered damages, an insured should be motivated to contribute to settlement.

The implied covenant of good faith and fair dealing largely prohibits a carrier from conditioning its willingness to settle on contribution from the insured. However, a well-informed and advised insured facing uncovered exposures may well contribute to a pre-trial settlement to avoid being left with an uncovered judgment against it.

For the carrier, timely, confident assertion of legitimate coverage defenses may be the best antidote to clamor for settlement at all costs.

Withdrawing from the Defense

It is also vital to monitor discovery in litigation being defended under a reservation of rights. Keeping an eye on evidence and admissions developed through discovery and motion practice can resolve disputed facts and end the duty to defend.

If defense is provided under a reservation, later discovery of undisputed facts ends the duty to defend and makes withdrawal appropriate. See generally 14 Couch on Insurance § 198:32 (3d ed. 2011) (Effect of nonwaiver agreement); see also Buss, 16 Cal.4th at 46; *General Acc. Ins. Co. of America v. Allen*, 547 Pa. 693, 692 A.2d 1089 (Pa. 1997); *Maxum Indemnity Co. v. Selective Ins. Co. of S.C.*, 971 N.E.2d 372 (Ohio Ct. App. 2012).

Only staying abreast of factual developments material to the coverage defense reserved will permit swift action when withdrawal is proper.

Post-Judgment Negotiations

After trial, when facts and liability have been adjudicated, the opportunity to determine the extent of the duty to indemnify may have arrived. If the coverage and liability issues overlapped, the judgment may specifically reveal the extent of the duty to indemnify.

Even if the coverage issues remain open, the threat of coverage litigation provides leverage for including both the plaintiff and the insured in settlement discussions. That may be heightened if the carrier seeks reimbursement of costs. 16 Couch on Ins. § 226:123 (Overview on Liability Insurer's Right to Recover Defense Costs Associated with Uncovered Claims).

Limitations on the duty to indemnify should be kept in mind throughout the case, from tender through settlement negotiations, at trial and beyond. Successful utilization of the reservation of rights at any stage of a case depends upon:

- Documenting and understanding the rights reserved;
- Monitoring factual development in discovery and motion practice; and
- Knowing when and how to assert limitations on the duty to indemnify.

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Sipos is a partner at Haight Brown & Bonesteel and a member of the Risk Management & Insurance Law Practice Group. Phone: (619) 961-4815; Email: Mbsipos@hbblaw.com.