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If coverage is uncertain, an insurer should know its rights in the applicable jurisdiction to avoid paying claims that may unjustly enrich an insured.

# Settling Claims Under Reservations of Rights

A reservation of rights notifies an insured that there are reasons for which the insurer might not owe any coverage to the insured. Typically, a reservation of rights also notifies the insured that, in defending the insured, the

insurer has not waived its right to deny and will not be estopped from denying coverage. Insurers often issue comprehensive letters that reserve specific rights, such as the right to file a declaratory judgment action, to require the insured's participation to settle uncovered claims, and to obtain reimbursement for payment of uncovered claims.

While the typical commercial general liability policy provides that an insurer will pay damages that an insured becomes legally obligated to pay because of loss "to which this insurance applies," some courts have distinguished between the right to deny coverage for an uncovered claim and an insurer's right to actually obtain reimbursement from an insured if the insurer has paid to settle a claim that a court subsequently has determined was not covered. Under certain circumstances, some courts have held that an insurer did not have a right to reimbursement because no such

right has been expressly found in the policy language, an insurer could not unilaterally modify the policy by issuing a reservation of rights, and no equitable right or implied right existed under the law. As a result, a court denies an insurer its reserved rights and arguably contravenes an important defense—that the insurer has no duty to pay for uncovered claims.

If an insurer cannot obtain reimbursement when it pays an uncovered claim, despite properly defending the insured, the insured receives coverage for an uncovered claim, unjustly enriching the insured, which is unfair to the insurer. To ensure that an insurer only pays for covered claims and has reserved rights that it can vindicate, coverage counsel must understand all the applicable rules in a given jurisdiction regarding the duty to defend, the duty to settle, and how to resolve coverage disputes, bearing in mind that significant differences exist state-to-state.



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### The Reservation of Rights

Only when an insurer defends an insured without issuing a reservation of rights can the insured somewhat justifiably assume that no coverage question exists, and the insurer will pay any settlement or judgment without restriction. In many states, a unilateral reservation of rights—an insurer's written position that it will defend subject

### An insurer's obligations

when it comes to settlement can conflict with its coverage position and place the insurer in the dilemma of paying an uncovered claim or risking liability for an excess judgment.

to the right to deny coverage—is the recognized and appropriate manner by which the insurer (1) agrees to defend a matter that is potentially covered by a policy, and (2) reserves its rights to contest coverage. If an insured does not object to a reservation of rights, setting aside whether the jurisdiction allows the insured to select counsel due to a potential conflict of interest created between the insurer and the insured by a reservation of rights, the insurer generally can assert its coverage defenses, including an expressed right to reimbursement. *See, e.g., Colony Ins. Co. v. G & E Tires & Service, Inc.*, 777 So. 2d 1034, 1037 (Fla. Ct. App. 2000) (noting that an insured that accepts the insurer's defense under a reservation of rights necessarily agrees to the terms upon which defense is offered); *Nobel Ins. Co. v. Austin Powder Co.*, 256 F. Supp. 2d 937, 940 (W.D. Ark. 2003) (holding that an insurer that defends uncovered claim is entitled to reimbursement for both defense and indemnity payments only if the insurer (1) timely and explicitly reserved its rights to recoup costs and (2) provided specific and adequate notice of the possibility of reimbursement).

### The Settlement Demand

While insurers regularly defend claims under reservation of rights, complex issues arise when settlement demands are made before an insurer has (1) obtained a ruling in a declaratory judgment action as to whether coverage exists, or (2) otherwise determined whether coverage exists because the facts relevant to coverage have not yet been fully developed. An insuring agreement generally provides that an insurer "may at our discretion investigate any 'occurrence' and settle any claim or 'suit' that may result." While the right to settle allows an insurer to control its risk, most states recognize that an insurer owes a duty of good faith and fair dealing to an insured, and an insurer can be held liable for an excess judgment if it wrongfully fails to settle a claim within a policy's limit. However, an insurer's obligations when it comes to settlement can conflict with its coverage position and place the insurer in the dilemma of paying an uncovered claim or risking liability for an excess judgment.

To fulfill its duty to settle claims in good faith and avoid potential excess exposure to an insured and an insurer, many courts enable an insurer to fulfill its obligations by paying to settle a claim within a policy's limit and, afterwards, allow the insurer to seek reimbursement if it later determines that the policy does not cover the claim. *See Hecla Mining Co. v. New Hampshire Ins. Co.*, 811 P.2d 1083, 1089 (Colo. 1991) (holding that "The appropriate course of action for an insurer who believes that it is under no obligation to defend, is to provide a defense to the insured under a reservation of its rights to seek reimbursement should the facts at trial prove that the incident resulting in liability was not covered by the policy, or to file a declaratory judgment action after the underlying case has been adjudicated"); *Colony Ins. Co. v. G & E Tires & Service, Inc.*, 777 So. 2d 1034, 1039 (Fla. Ct. App. 2000) (allowing an unilateral reservation of rights to obtain reimbursement of defense costs incurred for uncovered claims because it encourages insurers to meet their duty to defend; holding that "where an insurer has properly met its duty and subsequently successfully challenges policy coverage, it should be entitled to the full benefit of such a challenge and be reimbursed for the benefits it bestowed, in good faith, to its insured").

### The Bilateral Non-Waiver Agreement Requirement

In Texas, however, even if an insurer's reservation of rights states that the insurer reserves the right to obtain reimbursement if it pays to settle uncovered claims, this will not suffice to protect the right to recover payments that an insurer made to resolve uncovered claims. In fact, even if an insurer files a declaratory judgment action disputing coverage but pays to settle a claim prior to a court's adjudication of coverage, an insurer has no right to reimbursement, even if the court later finds that the claim is uncovered. The Texas Supreme Court has held that to seek reimbursement from an insured, the insurer must enter into a bilateral non-waiver agreement with the insured, which clearly shows the parties' intent and agreement that (1) the insured unequivocally consents to the underlying settlement and amount, and (2) the insured acknowledges and agrees that the insurer has the right to seek reimbursement. *Texas Ass'n of Counties County Gov't Risk Mgmt. Pool v. Matagorda County*, 52 S.W.3d 128,135 (Tex. 2000).

In *Matagorda County*, prior to settling what an insurance pool—the Texas Association of County Government Risk Management Pool (TAC)—believed was an uncovered claim, the TAC sent a letter to the county, which stated that (1) the TAC reserved its right to pursue recovery of the settlement amount from the county in the declaratory judgment action, and (2) its funding of the settlement was not a voluntary payment and was specifically made without prejudicing the TAC's right to recover the entire settlement amount in the declaratory judgment action. *Id.* at 130. Finding that the insurer's unilateral reservation of rights did not allow it to obtain reimbursement, the supreme court reasoned that (1) the policy contained no language permitting reimbursement for the insurer's payment of uncovered claims, (2) no right to reimbursement could be implied from the insured's silence in response to the reservation of rights letter and for the insured's agreement that the settlement was reasonable, and (3) the insurer had no equitable right under Texas law to reimbursement for payments made for uncovered claims. *See also Mt. Airy Ins. Co. v. The Doe Law Firm*, 668 So. 2d 534, 538 (Ala.

1995) (holding that the insurer had no right to recover a settlement payment for an uncovered claim because the insurer's payment was deemed voluntary, even though the insurer gave notice to the insured that it disputed coverage and would file suit to recover the payment); *General Agents Ins. Co. of Am., Inc. v. Midwest Sporting Goods Co.*, 828 N.E.2d 1092, 1102 (Ill. 2005) (holding that "As a matter of public policy, we cannot condone an arrangement where an insurer can unilaterally modify its contract, through a reservation of rights, to allow for reimbursement of defense costs in the event a court later finds that the insurer owes no duty to defend"); *Shoshone First Bank v. Pacific Employers Ins. Co.*, 2 P.3d 510, 515-16 (Wyo. 2000) (finding that the insurer had not preserved right to reimbursement of defense costs allocable to uncovered claims because the right did not exist in the policy language and insurer could not unilaterally modify coverage by issuing a reservation of rights letter, but allowing reimbursement of costs to prosecute a counterclaim, which were not expressly provided for in the policy).

Moreover, a general non-waiver agreement will not sufficiently preserve the right to reimbursement under Texas law. In *Excess Underwriters at Lloyd's, London v. Frank's Casing Crew & Rental Tools, Inc.*, 246 S.W.3d 42 (Tex. 2008), an excess insurer sought to obtain reimbursement for a \$7.5 million payment, which a court later determined was uncovered. The settlement agreement among the claimant, the insured, and the excess insurer preserved "any claims that exist presently or may arise in the future between Defendant Frank's and Frank's Insurers arising from the claims asserted by Plaintiffs." The court found that this language did not meet *Matagorda County's* requirement that an insured acknowledge and agree that the insurer had the right to seek reimbursement because in all communications leading up to settlement, the insured had disputed the insurer's coverage position. *Id.* at 48. See also *The Medical Malpractice Joint Underwriting Ass'n of MA v. Goldberg*, 680 N.E.2d 1121, 1129 (Mass. 1997) (holding that an insurer may seek reimbursement only if (1) the insured has agreed that the insurer may commit the insured's own funds to a reasonable settlement with the

right to later seek reimbursement, (2) the insurer has secured specific authority to reach a particular settlement that the insured has agreed to pay, or (3) the insurer has notified the insured of the reasonable settlement demand and the insured has had an opportunity to accept the offer or assume its own defense).

### Unilateral Reservations of Rights

In contrast, in California, an insurer may unilaterally reserve its right to seek reimbursement for a settlement that a court later determines is uncovered if it meets three prerequisites: (1) the insurer has issued a timely and express reservation of rights; (2) the insurer has expressly notified the insured of the insurer's intent to accept a proposed settlement offer; and (3) when the insurer and insured have disagreed over whether to accept the proposed settlement, the insurer must have made an express offer to the insured for the insured to assume its own defense. *Blue Ridge Ins. Co. v. Jacobsen*, 22 P.3d 313, 320 (Cal. 2001).

In *Blue Ridge Ins. Co. v. Jacobsen*, Blue Ridge agreed to defend the insureds, subject to a reservation of rights, which specified that any contribution toward settlement was subject to the right to dispute coverage, and Blue Ridge provided the insureds with independent counsel. *Id.* at 315. Blue Ridge filed a declaratory judgment action, but the action was stayed pending resolution of the underlying suit. *Id.* On receipt of a \$300,000 policy-limit settlement demand, Blue Ridge informed the insureds that it believed that the demand was reasonable and proposed to accept the demand under a reservation of its right to seek reimbursement from the insureds. *Id.* Blue Ridge gave the insureds the option of assuming their own defense if the insureds believed that the settlement offer was unreasonable. *Id.* The insureds, however, disputed liability and refused to consent to the settlement. Blue Ridge moved to intervene in the underlying action to obtain the court's consent to participate in the settlement negotiations under the reservation of rights, but the trial court denied the motion, and Blue Ridge accepted the settlement demand over the insureds' objection. *Id.* at 316-17.

Upon resolution of the underlying action, the federal court lifted the stay on the declaratory judgment action, and

Blue Ridge amended its complaint to seek reimbursement of the settlement payment. After the district court and the Ninth Circuit found that the claims were not covered, the Ninth Circuit certified to the California Supreme Court the question of "Whether an insurer defending a personal injury suit under a reservation of rights may recover settlement payments made over the objec-

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**Even if a declaratory judgment action is filed, a court may issue a stay order if coverage issues overlap with factual issues that have not been determined in the underlying suit.**

tion of the insured when it was later determined that the underlying claims were not covered under the policy." *Id.* at 314. The California Supreme Court answered the question affirmatively, finding that an insurer can reserve the right to assert non-coverage unilaterally by providing notice to the insured. Once the insured accepts a qualified defense, the insured is deemed to have accepted the insurer's right to deny coverage. *Id.* See also *Travelers Prop. & Cas. Co. of Am. v. Hillerich & Bradsby Co., Inc.*, 596 F. Supp. 2d 1020, 1025 (W.D. Ky. 2008) (holding that "Where an insurer pays a claim... to fulfill its fiduciary obligations..., it seems logical that it might be afforded an opportunity to contest whether its insurance policy actually obligated it to make these payments. The device of the reservation of rights allows an insurer to do this...").

### Consideration of Coverage in Settlement

While the California and Texas Supreme Courts reached opposite results in answering the same question, a review of those states' rules with respect to an insurer's duties and obligations in response to a set-

tlement demand provides some explanation and, hence, guidance to an insurer handling a claim governed by Texas law to avoid the result reached in *Matagorda County* and *Frank's Casing*.

In Texas, an insurer may consider whether or not a claim is covered when responding to a settlement demand. An insurer has a duty to settle if the demand

**The burden may rest on the insured to show that the claim is covered in the first instance.**

meets the following criteria, known as a “*Stowers* demand”: (1) the demand proposes to fully release the insured in exchange for a stated sum of money or for “policy limits”; (2) the claim against the insured is within the scope of coverage; and (3) the terms are such that an ordinarily prudent insurer would accept it, considering the likelihood and degree of the insured’s potential exposure to an excess judgment. See *American Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 848–49 (Tex. 1994). Not only may an insurer take into consideration whether a claim is covered in responding to a demand, but the Texas Supreme Court in *Frank's Casing* sanctioned using a coverage dispute as leverage to lower a claimant’s demand. *Frank's Casing*, 246 S.W.3d at 46. With the benefit of hindsight, in both *Matagorda County*, due to a jailhouse exclusion, and *Frank's Casing*, due to business-risk exclusions, among other provisions, the paid claims were not covered.

In Texas, an insurer should not only take into consideration whether its policy covers the claim, but should also consider whether another insurer’s policy covers the claim. In *Mid-Continent Ins. Co. v. Liberty Mut. Ins. Co.*, 236 S.W.3d 765, 772 (Tex. 2007), the court held that an insurer does not have a right of contribution against a coinsurer to recover indemnity payments because an insurer is not liable for more than its pro rata share of a loss when its pol-

icy contains a pro rata “other insurance” clause. Accordingly, an insurer that pays more than its contractually specified, proportionate share of a covered loss does so voluntarily and has no contribution claim against a coinsurer. *Id.* at 772–73. Additionally, because the insured has been fully indemnified, the insurer has no subrogation claim against a coinsurer. *Id.* at 777.

In contrast, California law does not allow an insurer to consider coverage in determining whether a settlement offer is reasonable. *Johansen v. California Auto. Ass'n Inter-Ins. Bureau*, 538 P.2d 744, 748 (Cal. 1975). The only permissible consideration is whether, in light of the claimant’s injury and the insured’s probable liability, the judgment is likely to exceed the policy limit such that good faith requires the insurer to settle the claim. *Id.* An insurer may not consider the policy limit, a desire to reduce the amount of future settlements, or the insurer’s belief that the policy does not cover the claim. *Id.* at 749. If an insurer breaches the duty to accept a reasonable settlement offer, it is liable for breach of contract and for bad faith. *Id.* at 750. Even if an insurer has a good faith, albeit erroneous, belief that the claim is not covered, the insurer is liable for failure to settle. *Id.* at 747.

An insurer’s inability in California to consider its coverage position in the settlement context justifies recognizing that the insurer has an implied-in-law right to obtain reimbursement. While the Texas cases discussed here appear to fail to provide an insurer with leverage to obtain a bilateral non-waiver agreement, and further, to allow an insured to manipulate the situation by soliciting a policy-limit demand, which is what occurred in *Frank's Casing*, an insurer maintains some control in that it can offer to pay for only covered portions of a claim or otherwise negotiate with the claimant to pay a lower amount based on the fact that coverage is questionable. Moreover, it is difficult to dispute that an insurer is generally better-equipped than an insured to determine the course of action when it comes to defense and settlement because the insurer is in the business of analyzing risk and evaluating coverage.

### Declaratory Judgment Actions

While an insurer has the option to file a declaratory judgment suit, it may not be

able to obtain a ruling on its duty to indemnify prior to determining its duty to settle. Although the Texas decisions recommend pursuing a declaratory judgment action to determine the coverage position early, this is not always feasible. In fact, in *Matagorda County*, the insurer had filed a declaratory judgment action but no rulings yet had been made when the insurer was presented with a settlement demand. This option was unworkable in *Frank's Casing*. As the dissent pointed out, the underlying suit was pending for 11 months, but the coverage case took nearly three years to resolve. *Frank's Casing*, 246 S.W.3d at 66. Even if a declaratory judgment action is filed, a court may issue a stay order if coverage issues overlap with factual issues that have not been determined in the underlying suit, or in jurisdictions that hold that ruling on indemnity is premature before the underlying suit is resolved. In fact, some jurisdictions prefer to resolve coverage issues after resolving an underlying suit.

In Washington, an insurer risks committing bad faith if it advocates a coverage position in a declaratory judgment action that is adverse to the insured’s position in the underlying action. In Washington, once an insurer accepts responsibility for an insured’s defense, the insurer must not engage in any actions that demonstrate a greater concern for the insurer’s financial interests than for the financial interests of the insured. *Tank v. State Farm Fire & Cas. Co.*, 715 P.2d 1133, 1137 (Wash. 1986). This “enhanced duty” is also recognized in Alabama. See *L & S Roofing Supply Co. v. St. Paul Fire & Marine Ins. Co.*, 521 So. 2d 1298 (Ala. 1987) (finding that an insurer that undertook a defense under a reservation of rights had an “enhanced obligation of good faith,” which required the insurer to refrain from engaging in any action that would demonstrate a greater concern for the insurer’s monetary interest than for the insured’s financial risk). While an insurer may defend under a reservation of rights and file a declaratory judgment action seeking a court’s ruling that it has no duty to defend, the insurer must “avoid seeking adjudication of factual matters disputed in the underlying litigation because advocating a position adverse to its insured’s interests would ‘constitute bad faith on its part.’” *Mutual of Enumclaw Ins. Co. v. Dan*

*Paulson Constr., Inc.*, 169 P.3d 1, 7–8 (Wash. 2007) (quoting Windt, Insurance Claims & Disputes: Representation of Insurance Companies and Insureds §8:3 at 8-11 to 8-12 (5th ed. 2007)).

In *Dan Paulson Construction*, Mutual of Enumclaw Insurance Company agreed to defend its insured in an arbitration alleging a construction defect, but determined that its policy covered work performed for the insured by subcontractors but not work performed by the insured. On learning that the insured had agreed that an award would take lump sum form without itemizing damages, Mutual asked the insured if it could intervene in the arbitration or otherwise have a coverage representative present. *Dan Paulson Constr.*, 169 P.3d at 5. While Mutual could have sought permission from the arbitrator to attend because the American Arbitration Association rules vest an arbitrator with discretion to permit a party with a direct interest in an arbitration to attend, the insured rejected Mutual's request. Prior to the arbitration hearing, Mutual issued a subpoena duces tecum to the arbitrator scheduling the arbitrator's deposition on written questions after the arbitration concluded. Mutual also sent an *ex parte* letter to the arbitrator, which advised the arbitrator that the insurer needed specific information about the basis of any award due to the "your work" exclusion. Mutual also sent the arbitrator a copy of its declaratory judgment complaint, which had been filed but not yet served to the insured. The court held that Mutual's conduct constituted bad faith because it demonstrated a greater concern for its monetary interest in establishing which of the alleged claims were excluded from coverage than for the insured's monetary interest, and Mutual had acted without concern for how its conduct might affect the insured's liability. *Id.* at 9–10.

The Washington Supreme Court held that filing a declaratory judgment action did not immunize the insurer's bad faith conduct simply because the insurer properly sought adjudication on coverage. While Mutual's actions in issuing the subpoena and communicating with the arbitrator *ex parte* were held to constitute bad faith, the court held that Mutual also would have risked committing bad faith if it had litigated coverage prior to the arbitra-

tion hearing because Mutual would have sought to establish in the declaratory judgment action that the insured caused certain defects, which fell within the "your work" exclusion. Meanwhile, in the arbitration action, the insured contended that its work was not defective. Accordingly, if Mutual had prevailed, it would have prejudiced the insured's defense in the arbitration, which constituted bad faith. *Id.*

Wisconsin courts, on the other hand, prefer to resolve coverage before resolving an insured's underlying liability. In Wisconsin, an insurer may seek to have the coverage issues resolved in a declaratory judgment action. See *Fire Ins. Exch. v. Basten*, 549 N.W.2d 690, 693–94 (Wis. 1996). An insurer also may intervene in the underlying action and request a bifurcated trial, and further, an insurer may seek to stay the underlying proceeding to have a court decide coverage before a court determines the insured's liability. *Id.* While not the exclusive means, "joinder or intervention of all concerned parties followed by bifurcation of the coverage and liability issues... is the preferred procedure to determine insurance coverage." *Basten* at 696. According to the Wisconsin Supreme Court, "The consolidation of the coverage issue with the underlying lawsuit is simply a prudent policy designed to eliminate the inefficiency of conducting separate trials in multiple courts, as well as simplifying the work of the circuit court. *Id.* at 699.

### **Burden to Allocate Between Covered and Uncovered Claims**

An insurer's options in Washington appear limited at first glance. In *Dan Paulson Construction*, the insurer had a coverage defense, but it could not litigate coverage without risking bad faith, and the arbitration award would not have itemized damages in a manner that would have enabled the insurer to determine which part of the award was covered. However, the Washington Supreme Court found that the insurer was not actually placed in this predicament because the insurer could litigate coverage after resolution of the underlying claim, and the insured had the burden to allocate the settlement to show which portions of the claim were covered under the policy. *Dan Paulson Constr.*, 169 P.3d at 10. In Washington, therefore, while an insurer

must act cautiously in determining whether its coverage issues should be litigated in a declaratory judgment action prior to resolution of an underlying claim and cannot inject coverage issues into underlying settlement discussions, on the other hand, an insurer that properly defends under a reservation of rights can obtain reimbursement for amounts paid to settle claims that are determined to be uncovered. Further, an insured bears the burden to allocate a settlement and establish that the settlement, or portions of the settlement, are covered under a policy.

Therefore, if a loss involves covered and uncovered claims or damages and an unallocated judgment is entered or the insured agrees to a lump sum settlement, the burden may rest on the insured to show that the claim is covered in the first instance. *Peterson Tractor Co. v. The Travelers Indem. Co. of Illinois*, 156 Fed. Appx. 21, 24 (9th Cir. 2005) (predicting that the California Supreme Court would find that the burden rests with the insured to show initially that at least a portion of the settlement is for damages attributable to covered claims, but once the insured satisfies its burden, it shifts to the insurer to show which portion actually is attributable to covered claims); *Perdue Farms, Inc. v. Travelers Cas. & Surety Co. of Am.*, 448 F.3d 252, 262 (4th Cir. 2006) (applying Maryland law) (holding that the insured had the burden to prove which settlement amount was attributable to the covered claims); *Clackamas County v. Midwest Employers Cas. Co.*, No. CV.07-780-PK, 2009 U.S. Dist. Lexis 118195 (D. Ore. Oct. 8, 2009) (holding that the insured had the burden of allocating a lump sum settlement and showing which portion was covered under the policy); but see *Public Utility Dist. No. 1 of Klickitat County v. International Ins. Co.*, 881 P.2d 1020, 1032 (Wash. 1994) (requiring proof that a settlement was covered under the policy but finding that the trial court did not err when it failed to instruct the jury to allocate the settlement between covered (intentional acts) and uncovered claims (negligent acts) because the claims consisted of "the same factual core" and, therefore, neither the claims nor the damages could be separated or allocated).

Importantly, if an insurer follows the sanctioned approach to resolving coverage disputes, the insurer cannot be held liable

for breach of the duty to defend or for bad faith if it fails to settle a claim within the policy's limit, even if the insurer ultimately loses on its coverage position. In *Mowry v. Badger State Mut. Cas. Co.*, 385 N.W.2d 171 (Wis. 1986), the insurer intervened in the underlying action, sought to stay the liability case, refused a demand to settle for the policy's limit, but ultimately lost on its coverage position. The court held that the insurer did not act in bad faith and, therefore, was not liable for the judgment in excess of the policy's limit. Even though the insured's liability was probable and damages were likely to be in excess of the policy's limit, the court held that "it is not bad faith for an insurer to refuse to settle an injured's claim within the policy limits when the question of policy coverage is fairly debatable and when the grounds for the refusal, if determined in the insurer's favor, would wholly defeat the indemnity responsibility of the insurer to its insured." *Id.* at 181.

### Endorsements to the Policy

While the right to obtain reimbursement for payments made to settle uncovered claims has not been addressed directly by many courts, more case law exists on the right to obtain reimbursement for defense costs paid for uncovered claims, which offers the insurer some guidance on how a court may view the right to reimbursement for settlement payments in the particular jurisdiction. Due to application of rules of construction in jurisdictions that limit an insurer's rights to those found expressly in a policy's language, insurers are endorsing policies with language to permit reim-

bursment of defense costs. An example of language found in a defense costs endorsement may provide as follows:

If we initially defend an insured or pay for an insured's defense but later determine that the claim(s) is (are) not covered under this insurance, we will have the right to reimbursement for the defense costs we have incurred. The right to reimbursement for the defense costs under this provision will only apply to defense costs we have incurred after we notify you in writing that there may not be coverage, and that we are reserving our rights to terminate the defense and seek reimbursement for defense costs.

Insurance Services Offices, Inc. 2005 Defense Costs Endorsement.

If jurisdictions refuse to permit an insurer to obtain reimbursement for uncovered claims, we may find that more insurers will endorse policies with language similar to that which has been used to address the issue of reimbursement of defense costs in states that have disallowed unilateral reservations of rights.

### Practical Considerations When Settling Claims Under a Reservation of Rights

While it is preferable to have coverage issues resolved prior to or at the time of payment, this will not always be attainable. An insurer may have to defend a claim for which coverage is uncertain or for which the policy ultimately will provide no coverage once all the factual issues have been decided, given that the courts have expansively interpreted the duty to defend and allowed alternative pleading. Even if cov-

erage is uncertain, an insurer should know its rights in the applicable jurisdiction to avoid paying claims that are uncovered and to properly reserve rights that it can vindicate. While a review of cases nationwide reveals that no single strategy will apply in all cases, an insurer and coverage counsel are well-advised to

- Review the insurer's reservation of rights regularly to determine which portions of a claim are covered and which are not and which facts are necessary to assist in finalizing the insurer's coverage position and supplement the reservation of rights accordingly
- Discover whether an insurer can unilaterally reserve rights to obtain reimbursement and whether the insured will be able to reimburse the insurer if it turns out that the claim is not covered, or whether an insurer must obtain a bilateral, non-waiver agreement
- Consider filing a declaratory judgment action, if appropriate, or pursue other procedures available in the particular jurisdiction to resolve coverage disputes
- Understand an insurer's settlement-related duties in the particular jurisdiction, including the duty of good faith, whether the insurer can consider coverage in responding to a settlement demand, and whether the insurer or the insured bears the burden to prove whether the claim is covered
- Keep the insured informed of settlement demands, negotiations, and the likelihood of exposure above the policy's limit, and include the insured in settlement discussions. 