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Can an Insurance Company Write a Reservation of Rights Letter that Actually Protects Their Right to Deny Coverage in Light of Advantage Buildings?

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The Court of Appeals for the Western District of Missouri handed down a case on September 2, 2014 that has caused no small degree of confusion and concern for Missouri's insurance carriers when it comes to issuing Reservation of Rights letters. The case is going to have a major impact on insurance claims handling, particularly in the drafting of reservation of rights letters and in responding to demands for policy limits. *See generally Advantage Bldgs. & Exteriors, Inc. v. Mid-Continent Cas. Co.* 449 S.W.3d 16 (Mo. App. W.D. 2014). The opinion reviews a bad faith failure to settle judgment against Mid-Continent for both compensatory and punitive damages. Ultimately the part of the case dealing with punitive damages was reversed on instructional error and sent back to the trial court for a new trial. Conversely, the compensatory damage award was upheld. Motions for Rehearing and Transfer to the Missouri Supreme Court were denied. What is left on the books is a confusing and troubling opinion until its true scope can be further reviewed in future cases. Apparently, the case was settled during remand, so insurance companies, coverage lawyers, and defense trial lawyers could be dealing with the fall-out from this case for a long time.

Mid-Continent Casualty Company insured Advantage Buildings & Exteriors, Inc. under a Commercial General Liability policy. Advantage was sued because of construction problems on a building in Vallejo, California where Advantage had assembled and painted some concrete panels that were attached to the exterior of the newly constructed building. At some point, the panels began to fail, and a lawsuit was filed against Advantage. Eventually there was a co-defendant and a third party defendant brought into the action. Advantage tendered the case to Mid-Continent for defense. Mid-Continent had a $1 million primary policy and a $2 million umbrella issued to Advantage. Mid-Continent had various coverage issues under the policy.

There were two reservation of rights letters sent out promptly by Mid-Continent. Although these letters appear rather detailed as far as setting out the allegations of the Petition and portions of the insurance policy, they arguably do not clearly set forth the insurance company's coverage position analyzing how the language of the policy was applicable to the facts. The letters do reference policy exclusions for "property damage to the part of real property on which you are working or performing operations" and exclusions for property damage to "your work" or "your product." Further, the letters do not mention that the policy may only cover damage the insured caused to pre-existing property (like the interior of the building) or that it may not cover the potential multi-million dollar exposure for the failing exterior panels themselves. This became a crucial point in the court's ruling on the case.

The insurance company's claim file apparently indicated that only about $50,000 worth of the claims were covered, but that the insured was exposed to millions of dollars in damages. Defense counsel advised Mid-Continent that Advantage would lose at trial. He further advised the insurance company to settle, but no offer was made. Later, personal counsel for the insured also made demands that the case be settled. A mediation was held, and Mid-Continent attended, but allegedly did not notify the insured of the mediation, and consequently the insured did not attend. At the mediation, a $50,000 offer was made by Mid-Continent, but was considered so minimal that the mediator asked Mid-Continent to leave the mediation.

Personal counsel for the insured continued to make demands that the case be settled within the $1 million policy limits in the weeks and days leading up to trial. The trial was scheduled only nine days after the mediation. The Court of Appeals pointed out that only days before the trial, Mid-Continent withdrew defense counsel on the case and filed a declaratory judgment action on the coverage issues. The court further noted that in the same time frame Advantage lost the use of the expert witness they were counting on for their position at trial without Mid-Continent explaining the circumstances leading up to the withdrawal of defense or the loss of the expert.

Although the opinion does not state the circumstances, a lawyer familiar with Missouri litigation and coverage law can deduce only one explanation for these occurrences. It must be assumed that the settling co-defendants had hired the expert, and, as part of their settlement agreement had to make the expert unavailable to Advantage. There is no other reason that an expert would become unavailable to a party at the last minute before trial. It can further be assumed that the only reason the insurance company would withdraw their defense at this point was because they were required to do so by their insured, who must have demanded that they settle the case or withdraw their defense. It is possible that these conclusions are incorrect, but they are the only explanation that makes sense based on the facts as described in the case. Someone who knew just how to do it was clearly setting up Mid-Continent for a bad faith claim.

When the final demand to settle was declined by Mid-Continent, plaintiff and Advantage entered into an agreement whereby Advantage agreed to file a bad faith claim against Mid-Continent with any recovery being paid to plaintiff in full satisfaction of any judgment obtained against Advantage. On July 22, 2010, a bench trial was conducted wherein the trial judge found Advantage negligent and awarded damages in the amount of $4,604,000.00, less any amounts paid by the co-defendants. Mid-Continent then amended their declaratory judgment petition to allege that the bench trial judgment should not be covered under their policy. Advantage filed a counter-claim seeking the establishment of coverage and asserting a bad faith failure to settle claim against Mid-Continent.

Mid-Continent won a summary judgment with a finding that there was no coverage under the policy; however, the court allowed the bad faith action against Mid-Continent to proceed. It ruled that the jury would not be allowed to hear that there had been a finding that the policy did not cover the damages entered in the previous bench trial. The jury returned a verdict of $3 million for compensatory damages in the bad faith action, along with a $2 million punitive

verdict. The trial judge refused to reduce the compensatory award to the net judgment from the bench trial or reduce the punitive damage award.

On appeal, the Western District focused on the reservation of rights letters. They pointed out that, "[t]he reservation of rights letters should be specific and unambiguous, should fully explain the insured's position . . . with respect to the coverage issue, and thus avoid any confusion." They went on to state that a "proper reservation of rights must be both clear and timely, and the insured must fully understand the insurer's position." The court held that neither letter clearly and unambiguously explained how those provisions were relevant to Advantage's position or how they potentially created coverage issues. They noted that the letters did "not actually analyze anything or explain what coverage issues might exist . . . ." The court ultimately concluded that the letters did not constitute an effective reservation of rights. "Thus, regardless of the Court's January 2, 2012 declaratory judgment ruling that the policy language did not explicitly cover the claims of Alsation, because Mid-Continent failed to effect a proper reservation of rights, it was prohibited from asserting only limited coverage for the claim. Therefore, Mid-Continent was estopped to deny coverage from the claim to the extent of its policy limits."

Although the Court of Appeals discussed a number of factors that may have constituted evidence of bad faith, they relied on the inadequacy of the reservations of rights letters in justifying the trial court's decision to withhold from the jury his own ruling that there was no coverage for Advantage under the Mid-Continent policy. In essence, the court found that the insurance company was already estopped from relying on its policy defenses by the time the settlement demands were made as a result of the deficient reservation of rights letter. They also determined that the bad faith failure to settle actually occurred when a settlement demand was made within the policy limits that was not accepted by Mid-Continent and that a later determination that there was no coverage was irrelevant in the bad faith portion of the proceeding.

Essentially, the court held that the insurance company's failure to settle could be deemed to be with bad faith, even though it was ultimately established that there was no coverage under the policy and that Mid-Continent was correct in its coverage position. This leads to the perplexing conclusion that an insurance company is exposed to a bad faith failure to settle judgment in situations where they can clearly establish that there is no legal liability under the policy. The reason this conclusion is so troubling in this circumstance is because the Court of Appeals did not specifically find that the trial court was wrong when it determined that the Mid-Continent policy did not cover the negligence claims against Advantage. If Mid-Continent was estopped to rely on its exclusions because of an inadequate reservation of rights letter then the claims were covered and Mid-Continent was required to pay the bench trial judgment entered in the original matter. The compensatory damages in that instance would be the $4.604 million judgment less the $2.4 million that the original co-defendants settled for or something just less than $2.2 million, not the $3 million that was found by the jury. It is possible that the $3 million compensatory judgment consisted of the amount from the bench trial along with attorney's fees and other proven actual damages, but this is not clear from the opinion.

This case becomes all the more disconcerting when you read the reservations of rights letters that are attached to the opinion. The two letters were found by the court to be completely inadequate in conveying to the insured the position of the insurance company. They certainly are not perfect, but they are far more detailed than most reservation of rights letters discussed in Missouri and other states' case law. The September 2nd letter describes the manufacturing and construction process and Advantage's part in it. The letter explains that "the claimants seek to have the panels repaired or replaced on the entire building as well as recover damages to the interior. The claimants allege damages because of 'property damage' as a result of an 'occurrence' as these terms are defined by the policy." The letter goes on to say that "Coverage A has the following exclusions that would further eliminate the potential application of Coverage A to this litigation," and then sets out those exclusions, including those related to "property damage to property on which you are working or that must be restored, repaired or replaced because your work was incorrectly performed on it," along with the standard "your work" and "your product" exclusions.

Missouri case law does not provide a great deal of guidance on what a proper reservation of rights letter should contain. But, until now, this degree of explanation would have likely been adequate. It is difficult to comprehend how someone reading this letter, particularly one represented by independent counsel, would not have understood that the majority of the damages claimed against them in the lawsuit were excluded by these provisions. Without saying what would have passed muster under the circumstances, it appears what the court wanted was an early statement by the insurance company that they intended to deny coverage for everything above $50,000.00 for the damage done to pre-existing property on the interior of the building. The court seemed to view it most damning that the insurance company's file reflected a specific belief that only the damage to the interior of the building might be covered when the reservation of rights letters were not as explicit.

At the time of this writing, the only case to mention Advantage Buildings is *Smith v. Maryland Cas. Co.*, No. SD 33341, 2015 WL 302151 (Mo. App. S.D., Jan. 23, 2015). That case involved an initial lawsuit which Maryland Casualty defended under a reservation of rights. That lawsuit was dismissed for failure to prosecute, and, when it was re-filed, the insurance company had its defense attorney continue the original defense without re-issuing a second reservation of rights letter. The insured demanded that Maryland Casualty withdraw their reservation or withdraw their defense counsel, and counsel was subsequently withdrawn. The Plaintiff in the underlying case then entered into a Section 537.065 agreement with the insured and had judgment entered by the trial court for $1,834,298.00. A garnishment action was then filed against Maryland Casualty alleging that they had "waived" their right to deny coverage by failing to issue a second reservation of rights letter when the underlying action was re-filed.

The trial court in the garnishment action entered summary judgment on the entire amount against Maryland Casualty finding that the insurance company had waived its right to deny coverage. On appeal, the Court of Appeals for the Southern District of Missouri reversed the trial court, saying that summary judgment was not appropriate because fact issues were still in dispute as to whether the insurance company intended a "knowing waiver" of its right to deny coverage by failing to send a second reservation letter. The court acknowledged *Advantage Buildings*, but found that the cases were distinguishable in that *Advantage Buildings* was not a

waiver case. According to the court in *Smith*, *Advantage Buildings* was based on an estoppel theory because the insurance carrier had performed an "affirmative act" and had not merely failed to act as in the present case.

Also of interest in *Smith* is the Southern District's recitation and discussion of the elements of a "proper" reservation of rights letter as proposed by the judgment creditor in that matter. It was alleged that for a reservation of rights letter to be effective there were requirements that must be met. Such a letter must "(1) be sent directly to the alleged insured; (2) be sent prior to the insurer's taking action in the defense of the lawsuit; (3) be in writing; (4) identify the specific lawsuit at issue: (5) notify the alleged insured that the insurance company's interests may be in conflict with the alleged insured's interests; and (6) notify the alleged insured of his right to employ independent counsel." Although the *Smith* court pointed out that *Advantage Buildings* only requires that the insured be "fully informed," and no case specifically imposes the requirements alleged by the judgment creditor in the case, it did go on to state that "these formalities are not legally required." This case further exacerbates the confusion of *Advantage Buildings*, because this list of "formalities" does not even include an explanation by the insurance carrier as to what is or is not covered and why as was required in *Advantage Buildings*.

The requirements presumptively imposed by the court in *Advantage Building* concerning the content of reservation of rights letters are both impossible to meet and unwise as a practical matter. A reservation of rights letter must be issued to the insured prior to undertaking the insured's defense or the insurance company runs the risk of being estopped to later deny coverage if the insured relies to their detriment in accepting the defense. At this very early stage in litigation, it is impossible to know how the facts will play out in sufficient detail to allow the insurance company to outright deny questionable claims. Later discovery of additional facts that may eliminate coverage may cause the insurance company to withdraw their defense at that time, but that is exactly the purpose of reserving their rights to deny coverage in the first place. In many instances, a reservation of rights is advisable based on the possible existence of yet unknown facts that may only become clear at the time of trial. For instance, a plaintiff can plead a physical injury inflicted by a defendant based on the alternative theories of intentional assault (which would be excluded by the "expected or intended injury exclusion in the policy) or negligently inflicted (which might be covered). Only when the plaintiff decides at trial to submit his claim to the jury as an intentional assault rather than a negligently inflicted injury can coverage be definitively determined.

As a practical matter, the courts should want to encourage insurance companies to provide a defense to their insureds on questionable cases. The cost of providing a defense is often greater than the exposure of the damages. If the insured's case ultimately wins, then the coverage reservation never becomes an issue. If the insurance company is forced to decide whether or not a matter is covered from the outset, then they are potentially forced to abandon their insured to go it alone while at the same time subjecting their company to exposure for bad faith in a failure to defend the claim. It is axiomatic that the duty to defend is broader than the duty to indemnify, but *Advantage Buildings* makes that obligation almost impossible to meet by placing all the risk of assuming the defense of their insured on the insurance company.

Certainly, the facts of the case suggest that the defense attorney in this case should have been having a discussion about uncovered exposure with the insured; but, in reality, he probably was. The timing of the involvement of the insured's personal attorney and the two "hammer letters" that were sent demanding that the case be settled within policy limits are indicative of an insured who knew exactly what was going on. Why the insured would not be told about the mediation in a matter like this, a fact referenced by the court, appears to lack explanation. If the insured was in fact not informed about the mediation, then it represents a big problem in claims handling and lawyering. Both the insured's lawyer and his insurance carrier have an obligation to make sure that the insured is aware of proceeding that would so directly affect his or her interests. However, it is almost certainly the case that more was happening behind the scenes than the court's opinion reflects. However, the facts that are included in the case history are consistent with scenarios like those in *Schmitz v. Great Am. Assur. Co.*, 337 S.W.3d 700 (Mo. banc 2011) and *Columbia Cas. Co. v. Hiar Holdings, LLC*, 411 S.W.3d 258 (Mo. banc 2013) where the Missouri Supreme Court has inadvertently created a blueprint for plaintiffs to set up insurance companies, who might otherwise have legitimate coverage positions, for bad faith failure to settle.

What is concerning for the insurance industry in Missouri is that the majority of reservation of rights letters that are currently out there likely could not pass muster under the rationale set forth by the Western District Court of Appeals. Arguments will be made that insurance companies now defending their insureds under a reservation of rights should be estopped to deny coverage because the letters they sent at the beginning of the case did not supply unknowable facts in an injudicious format. *Schmitz* and *HIAR* already instruct insurance companies that it is never a good idea to deny coverage and as a result fail to defend an insured. *Advantage Buildings* now cautions insurers that it is also unwise to undertake a defense of their insured when they have any doubts about coverage under their policy.