

Insurance Alert: Insurer's "Reservation of Rights" Creates a Conflict of Interest, Entitling the Insured to Independent Defense Counsel

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In case that has been widely watched by Minnesota insureds and insurers alike, a federal district court ruled on Tuesday that an insurer's "reservation of rights" letter created a conflict of interest, thereby permitting the policyholder to retain independent counsel, whose fees must be paid for by the insurer *Select Comfort Corp. v. Arrowood Indemnity Co.*, File No. 13-2795 (D. Minn., Aug. 26, 2014). This decision may have broad implications for insureds' rights to select their own defense counsel in situations where the insurer has not unqualifiedly accepted coverage for the claim.

Most liability insurance policies require the insurer to both defend and indemnify the insured for covered claims. In such situations, the insurer not only pays for the defense, but largely controls how defense counsel handles the case. When an insured tenders a claim for defense, the insurer has three options: (1) accept coverage and defend the claim; (2) disclaim all coverage; or (3) defend the claim under a "reservation of rights" to later disclaim coverage for some or all of the claims. The third alternative, issuing a reservation of rights letter, is by far the most common. Where the insurer defends under a reservation of rights, it typically takes the position that it may unilaterally select defense counsel (usually from its "panel list"), often rejecting the insured's request that it be defended by counsel of its choosing. Insurers do this primarily because they have negotiated favorable hourly rates with panel counsel. Further, since panel counsel receive so much of their work from insurers, they typically do not represent insureds in coverage claims against insurers.

Select Comfort was named a defendant in a class action lawsuit alleging that the defendants' products "had a propensity to develop and incubate mold, leading to adverse health consequences for users." The class action complaint included allegations that Select Comfort "had taken knowing, fraudulent, and intentional actions with respect to the defective beds that formed the basis for the claims." Select Comfort tendered the defense to Arrowood, its liability insurer, which agreed to defend the action under a "reservation of rights," through panel counsel it selected. Arrowood reserved its right to contest coverage on several grounds, including whether Select Comfort's conduct was intentional and thereby excluded from coverage. Select Comfort rejected that offer, taking the position that the "reservation of rights" created a conflict of interest,



entitling it to retain independent counsel.

In the coverage litigation, the court noted that a "conflict exists when the underlying action will involve trial of a fact issue on which the insured and insurer would be on opposing sides in a coverage dispute that the insurer reserved its right to raise." Applying this principle, the court held that Arrowood's reserving its right to contest coverage for "intentional conduct" created a conflict of interest such that Select Comfort could retain independent counsel. The court was unpersuaded by Arrowood's argument that allowing the insured to select independent counsel created a potential for abuse "because such counsel often charge more than panel counsel regularly retained by the insurer." In particular, the court noted that the insured would be limited to recovering only its "reasonable" attorneys' fees and observing that insurers could manage this risk by setting forth parameters for hiring independent counsel in the insurance policy.

The *Select Comfort* decision has broad implications for Minnesota insureds in the all too common situation where the insurer has reserved its rights to deny coverage for some or all of the claims but still wants to control the defense. This decision will provide insureds in those situations with added ammunition to reject insurer-appointed "panel counsel," defend the through its own counsel, and then seek reimbursement of defense costs.