

INSIGHTS

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DON'T GET BLASTED BY A NUCLEAR VERDICT

BY BRIAN DEL GATTO,
ELISE M. FARNHAM,
AND ARMAN NAFISI



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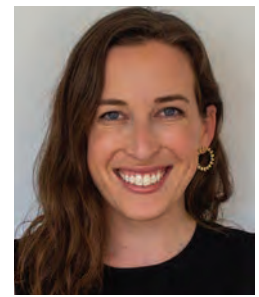
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“Yes, I Have a Reservation!”

The Dos and Don'ts of Reservation of Rights Letters

by Laura Meyer Gregory and Chantal M. Roberts



ABSTRACT

A reservation of rights letter is a carrier's notification to the insured of potential coverage issues. It prevents waiver of the insurer's rights to deny coverage under the policy at a later date. From the standpoint of the insured, these letters can be intimidating and scary; from the standpoint of the adjuster, they can be onerous. By presenting a fictitious claim, this article will dissect the reservation of rights letter to make it more palatable for both the insured and insurance company.

At 5 p.m. Central time on August 27, 2020, 50 miles south of Shreveport, Louisiana, Hurricane Laura finally slowed to a tropical storm—and in so doing took on a magnitude unlike any other in Arkansas since the unnamed September 1941 Texas hurricane.

Despite other remnants of hurricanes that have affected Arkansas, none created a tropical storm warning for the landlocked state like Laura did. In addition to contributing to record rainfalls leading to flash floods, Laura spawned eight tornadoes in northeastern Arkansas, which led to power outages from fallen trees and power lines.¹

To better understand the concept of reservation of rights letters, let's consider fictitious insureds Bill and Mary Brant, who have a vacation and retirement home in Pocahontas, Arkansas, that was damaged by a tornado.

Due to a prior engagement, the Brants were unable to immediately drive the three hours from their primary home to their second home to inspect it for damage after the tornado hit. They arrived in Pocahontas a week later to find an array of damages, and they called their agent to file a claim.

The Brants purchased a dwelling policy that contains a standard, unendorsed Section I Dwelling Property 3 – Special Form (DP 00 03 12/02) for their secondary home. Upon making contact and discussing the loss with the Brants, the adjuster, Natalie, had several coverage questions.

Natalie discovered that the Brants had spoiled food, interior water damage—which progressed to produce mold damage—and roof damage due to a fallen tree. To ensure that no waiver of these limitations on coverage exists, Natalie must send either a reservation of rights letter or a non-waiver agreement to the Brants, alerting them of the coverage issues and directing them to the applicable policy sections—and protecting the insurer's rights.

This process would be very similar even if the Brants and Natalie were located elsewhere. The discussion is not specific to one state's law. However, please check the applicable state's law before issuing a reservation of rights or non-waiver agreement to ensure compliance.

WHAT IS A RESERVATION OF RIGHTS?

A reservation of rights is a notification to the insured by the insurer regarding potential coverage issues. It prevents waiver of the insurer's rights to deny coverage under the policy at a later date.

Although serving the same purpose, a reservation of rights letter and a non-waiver agreement are different. Usually a reservation of rights letter is a one-way letter, a notification from the carrier to the insured about a coverage issue; a non-waiver agreement is signed by both the insurer and the insured and simply acknowledges the existence of a coverage question.

A reservation of rights letter protects the carrier's interests and informs the insured that some parts of a loss may not be covered. The letter states that the insurer will continue to investigate the claim but may ultimately deny all or part of it if no coverage is found.²

As reasserted in *Harleysville Grp. Ins. v. Heritage Communities, Inc.*, quoting from *New Appleman on Insurance*, the letter benefits

the policyholder “by alerting the policyholder to the potential that coverage may be inapplicable for a loss; that conflicts may exist as between the policyholder and the insurer; and that the policyholder should take steps necessary to protect its potentially uninsured interests.”³

A popular misconception is that a reservation of rights letter is only needed during a lawsuit where the carrier's and insured's interests are in conflict; however, whenever the insurer finds coverage or policy questions, it should send a reservation of rights letter.

Reservation of rights letters preserve the insurer's right to assert defenses if there is a lawsuit at a later date or if the insurer later denies coverage for the loss.⁴ And they are appropriate in both first- and third-party situations.

A RESERVATION OF RIGHTS IS A NOTIFICATION TO THE INSURED BY THE INSURER REGARDING POTENTIAL COVERAGE ISSUES

To continue to investigate a first-party loss without potentially waiving coverage limitations, an insurer needs to send a reservation of rights letter. In a third-party claim, an insurer might cover portions of the allegations against the insured, but not all. To maintain its defenses to coverage, the insurer must then issue a reservation of rights and defend the insured “under a reservation of rights.”

In *Western Heritage Ins. Co. v. Asphalt Wizards*⁵, the court stated that even if the summary of the claim was detailed, if it was not tied to the policy language, the reservation of rights letter would be ineffective. The *Western Heritage* court, discussing reservation of rights letters under Missouri law, outlined items contained in a typical reservation of rights letter, finding that it:

- (1) identifies the policy at issue; (2) quotes, or at least refers to, the relevant policy provisions and identifies any terms, conditions, or exclusions which may bar coverage;
- (3) refers to specific, relevant allegations in the complaint;
- (4) identifies which claims may not be covered; (5) explains in detail the basis for the insurer's coverage position;

(6) sets forth the proposed arrangement for providing a defense and, depending on the law of the jurisdiction, advises the insured of its right to independent defense counsel; (7) advises the insured of any actual or potential conflicts of interest between the insurer and the insured; (8) reserves the right to withdraw from the defense; (9) contains a general reservation of rights, including the right to assert other defenses the insurer may subsequently learn to exist during further investigation; and (10) uses the words “reservation of rights.” ... [and] it must be timely.⁶

State law varies regarding what elements a reservation of rights letter must contain to be effective and preserve the rights of the carrier. Generally, it must clearly notify the insured of the rights that are being reserved based on the claim at issue (the insurer’s position) and be done in a reasonable time (under the circumstances at issue).

A POPULAR MISCONCEPTION IS THAT A RESERVATION OF RIGHTS LETTER IS ONLY NEEDED DURING A **LAW SUIT WHERE THE CARRIER’S AND INSURED’S INTERESTS ARE IN CONFLICT**

ENSURING TIMELINESS AND SPECIFICITY

Back to our fictitious case, as soon as Natalie recognizes that the Brants’ policy may not cover certain aspects of their claim, she must issue a reservation of rights letter.

While there is no specific timeline for sending this letter, courts in most states will look to whether an insured is prejudiced, or relied on coverage due to the lack of a reservation of rights letter. This could prevent the insurer’s loss of defenses.

With this in mind, an insurer should strive to issue or update a reservation of rights as soon as it is aware of a potential coverage issue.

If Natalie dallies in notifying the Brants of the coverage issues, she may waive the limitations on coverage and/or estop the carrier from asserting its rights to later deny coverage. This is the process she should follow:

1. Use the phrase

Natalie’s reservation of rights letter should notify the Brants that the letter they are reading is, in fact, a reservation of the carrier’s rights by using the words “reservation of rights.”⁷ Placing this phrase near the top and on the first page will avoid any confusion regarding the reason for the letter.

2. Identify the policy

Like the phrase “reservation of rights,” the policy number and type should be immediately identified to avoid any confusion.

3. Summarize the facts and tie them to the policy

A reservation of rights letter may not protect the carrier if it does not adequately inform the insured of the coverage issue. States’ laws on this issue vary, so adjusters must know their jurisdiction.

For example, in *Hoover v. Maxum Indem. Co.*, 730 S.E.2d 413 (Ga. 2012), the court held that “A reservation of rights is not valid if it does not fairly inform the insured of the insurer’s position.” It further stipulated that a reservation of rights letter must be specific. Otherwise, a court generally has to interpret the reservation in the insured’s favor.

All too often the reservation of rights letter gives a brief summary of the claim followed immediately by pages of the policy that allegedly correspond to the loss facts. Or the letter does not specifically quote the policy language, but instead quotes the sections, assuming the insured has a copy of the policy to review.

The South Carolina Supreme Court stated that to be effective, a reservation of rights must provide an insured with “sufficient information to understand the reasons the insurer believes the policy may not provide coverage. ... [G]eneric denials of coverage coupled with furnishing the insured with a copy of all or most of the policy provisions (through a cut-and-paste method) is not sufficient.”⁸

For example, a court could find Natalie’s letter ineffective if the only statement regarding the rights reserved were as follows:

There is a coverage question on your policy, and there may not be coverage under your DP 00 03 12/02 for mold, spoiled food, and trees due to the following policy language: A. 2. c. (8) (c); A. 4.; 5.

A court is much more likely to find Natalie’s letter effective if it reads like this:

There is a coverage question on your policy with regard to this loss. A tree fell through your roof, and you experienced interior water damage, which has now resulted in mold in

your home. Mold may not be a covered loss under the DP 00 03 12/02 as found on pages 1, 5-6 of 13 of your policy. The corresponding language is as follows:

PERILS INSURED AGAINST

A. Coverage A – Dwelling And Coverage B – Other Structures

...

2. We do not insure, however, for loss:

...

c. Caused by:

...

(8) Any of the following:

...

(c) Smog, rust or other corrosion, mold, wet or dry rot;

The following terms are defined in the policy:

DEFINITIONS

In this policy, “you” and “your” refer to the “named insured” shown in the Declarations and the spouse if a resident of the same household. “We,” “us,” and “our” refer to the Company providing this insurance. In addition, certain words and phrases are defined as follows:

...

3. “Fungi” means any type or form of fungus, including mold or mildew, and any mycotoxins, spores, scents or by-products produced or released by “fungi”.

Natalie would then move to the next coverage issue, the power outage and spoiled food, followed by the downed trees, separating coverage questions into individual paragraphs with the specific, relevant policy language used. If coverage is excluded over several



sections in the policy, this should also be broken down into bite-size sections:

While there is coverage for trees under your dwelling policy, they are only covered for six specific perils. These perils are: fire/lightning; explosion; riot/civil commotion; aircraft; vehicles; and vandalism/malicious mischief. It is our understanding that the tree that damaged your structure fell due to windstorm. Windstorm may not be one of the covered perils; therefore, there is a third question regarding coverage under your policy. I draw your attention to the following policy language on page 3 of 13 of the DP 00 03 12/02 form, which states:

Section I

OTHER COVERAGES

...

5. Trees, Shrubs, And Other Plants

We cover trees, shrubs, plants, and lawns, on the "Described Location" for loss caused by the following Perils Insured Against:

- a. Fire or lightning;
- b. Explosion;
- c. Riot or civil commotion;
- d. Aircraft;
- e. Vehicles not owned or operated by you or a resident of the "Described Location"; or
- f. Vandalism or malicious mischief, including damage during a burglary or attempted burglary, but not theft of property.

You do have Debris Removal for damage to your covered property. Unfortunately, the tree may not be covered, and there may not be any Debris Removal coverage for the expenses to detach the tree from your property. I draw your attention to the following policy language of the DP 00 03 12/02, page 3 of 13, which states:

Section I

OTHER COVERAGES

1. Debris Removal

We will pay your reasonable expense for the removal of:

- a. Debris of covered property if a Peril Insured Against causes the loss

Unlike some reservation of rights letters that attempt to bury the relevant policy language, an effective reservation of rights letter

cuts out the extraneous policy provisions. If Natalie had a concern about omitting the exclusions that precede the ones quoted, enclosing a copy of the policy and highlighting the relevant areas would be helpful for the Brants:

D. Coverage D – Fair Rental Value

1. If a loss to property described in Coverage A, B or C by a Peril Insured Against under this policy makes that part of the "Described Location" rented to others or held for rental by you unfit for its normal use, we cover the fair rental value of that part of the "Described Location" rented to others or held for rental by you less any expenses that do not continue while that part of the "Described Location" rented or held for rental is not fit to live in.

Payment will be for the shortest time required to repair or replace that part of the "Described Location" rented or held for rental.

2. If a civil authority prohibits you from use of the "Described Location" as a result of direct damage to a neighboring location by a Peril Insured Against in this policy, we cover the Fair Rental Value loss for no more than two weeks.

3. The periods of time referenced above are not limited by the expiration of this policy.

4. We do not cover loss or expense due to cancellation of a lease or agreement.

Use of this coverage reduces the Coverage C limit of liability for the same loss.

3. Reasonable Repairs

a. In the event that covered property is damaged by a Peril Insured Against, we will pay the reasonable cost incurred by you for necessary measures taken solely to protect against further damage.

b. If the measures taken involve repair to other damaged property, we will pay for those measures only if that property is covered under this policy and the damage to that property is caused by a Peril Insured Against. This coverage does not:

- (1) Increase the limit of liability that applies to the covered property; or
- (2) Relieve you of your duties, in case of a loss to covered property, as set forth in Condition D.2.

4. Property Removed

We insure covered property against direct loss from any cause while being removed from a premises endangered by a Peril Insured Against and for no more than 30 days while removed.

This coverage does not change the limit of liability that applies to the property being removed.

5. Trees, Shrubs And Other Plants

We cover trees, shrubs, plants or lawns, on the "Described Location" for loss caused by the following Perils Insured Against:

- a. Fire or lightning;
- b. Explosion;
- c. Riot or civil commotion;
- d. Aircraft;
- e. Vehicles not owned or operated by you or a resident of the "Described Location"; or
- f. Vandalism or malicious mischief, including damage during a burglary or attempted burglary, but not theft of property.

The limit of liability for this coverage will not be more than 5% of the Coverage A limit of liability, or more than \$500 for any one tree, shrub or plant. We do not cover property grown for commercial purposes.

This coverage is additional insurance.

Section I

OTHER COVERAGES

1. Debris Removal

We will pay your reasonable expense for the removal of:

- a. Debris of covered property if a Peril Insured Against causes the loss; or
- b. Ash, dust or particles from a volcanic eruption that has caused direct loss to a building or property contained in a building.

However, we will not pay any expenses incurred by you or anyone acting on your behalf to:

- (1) extract pollutants from land or "water"; or
- (2) remove, restore or replace polluted land or "water".

This expense is included in the limit of liability that applies to the damaged property.

2. World-Wide Coverage

You may use up to 10% of the Coverage C limit of liability for loss by a Peril Insured Against to property covered under Coverage C except rowboats and canoes, while anywhere in the world.

DP 00 03 12 02 Includes copyrighted material of Insurance Services Office, With its Permission Copyright, Insurance Services Offices, Inc., 2002 Page 3 of 13

Some states do not enforce general language in a reservation of rights, while others actually require that the rights reserved be specifically described. Again, know your jurisdiction.

As noted in the above examples, Natalie's reservation of rights letter must have specific policy language and be in bite-size pieces to fully inform the Brants of the carrier's concerns about coverage. However, insurers in most states also opt to add a general reservation of rights at the end of their letters. This notes the right to claim other policy provisions as the loss is investigated.

OTHER CONSIDERATIONS

Defense, including the right to withdraw—If a claim had been asserted by a third party against the Brants, then there would've been a liability claim as well as the property loss claim. If a coverage question arises regarding the liability claim on the Brants' dwelling liability policy, Natalie should include in the reservation of rights that the insurer will defend the Brants but is doing so pursuant to a complete reservation of rights, including the specific policy terms indicated in the reservation.

In these circumstances, the insurer usually appoints defense counsel, although in some states the insured has the right to independent—or so-called Cumis or Moeller—counsel, due to the reservation of rights. Natalie may need to inform the Brants of their right to independent defense counsel, depending on the jurisdiction.

Also, Natalie should assert the carrier's right to withdraw a defense in the event that there is no duty to defend the claim against the Brants. In some jurisdictions, the insurer may be able to recoup defense costs expended prior to withdrawing the defense or for defense costs limited to uncovered claims if the carrier asserts the right to do so in the reservation of rights letter.

BECAUSE MANY INSURED DO NOT UNDERSTAND WHAT A RESERVATION OF RIGHTS LETTER IS, THEY MAY BE UPSET IF THEY RECEIVE ONE WITHOUT PRIOR EXPLANATION

Letter recipients—The Brants should receive the reservation of rights letter at the address on the policy, or as updated with the insurer. Since the property in question is a vacation home, Natalie should make sure the letter is directed to the primary mailing address. If this is unclear, she should err on the side of sending additional notices. If there is more than one insured, such as an additional named insured, both parties should receive a copy of the letter.⁹

Natalie should send all letters by U.S. Postal Service certified mail, return receipt requested. Since the majority of insureds have electronic mail, sending the letter and highlighted policy copy via email may also be helpful. However, the insurer should also always send the letter through the postal service, and the return postcard should be kept in the claim file.

Further, the Brants' insurance agent should be copied on the reservation of rights letter.

Required notices—Some states require a reservation of rights (and possibly all communications with the insured following the making of a claim) to include specific information and/or language. For example, the reservation of rights may need to notify the insured of its right to independent counsel at the expense of the insurer or need to provide contact information for the state's commissioner of insurance.

CONTINUED STEPS

Because many insureds do not understand what a reservation of rights letter is, they may be upset if they receive one without prior explanation. Indeed, many insureds believe a reservation of rights letter is a letter of declination. Natalie should be prepared to speak with the Brants and explain to them what a reservation of rights is, its purpose, and the basis for the company's reservations with regard to this claim.

The National Association of Insurance Commissioners Unfair Claims Practices Model Rules and Regulations instruct carriers to explain coverages to insureds. The best time to do this is upon first contact, and the best time to alert the insured to the possibility of a coverage issue is during this first call. However, if Natalie is unaware of coverage issues until after she receives the appraiser report, then she should call the Brants and their agent to explain these issues before writing the letter.

As Natalie continues her investigation, the reservation of rights should either be updated, converted into a denial, or withdrawn. Some states require an insurer to periodically update the insured on the status of the reservation of rights with regard to each of the claims at issue. For example, the notice requirements may be different for the first-party property damage claim than for the third-party liability claim.

Not all jurisdictions have decided on the issue of recouping defense costs. Those that have differ widely in their treatment of it, as noted in *Couch on Insurance*:

Some jurisdictions hold to the view that there is no right to reimbursement where neither the policy nor any other agreement provides for reimbursement in the event that it is later determined that the insurer had no duty to defend, some take the view that litigation costs are reimbursable only if there is no duty to defend, and others take the view that litigation costs are reimbursable if it is ultimately determined that there was no coverage under the policy, even though the insurer did have a duty to defend until that lack of coverage was finally determined, assuming that the insurer has proceeded under a reservation of rights.¹⁰

To recap, a reservation of rights letter that fairly and adequately informs the insured of coverage questions should:

1. Be timely.
2. State that it is a reservation of rights.
3. Identify the applicable policy.
4. Specifically discuss the claim and how it relates to the policy in question.

5. Take the coverage issues and place them into bite-size, easy-to-understand language accompanied by the relevant policy language.
6. Include a general reservation of rights for other defenses as the investigation continues.
7. Advise the insured of its right to independent counsel if necessary.
8. Be sent to all insureds.
9. Include a right to recoup defense costs, if allowed in the jurisdiction.
10. Provide all notices required in the jurisdiction, if any.
11. Be updated to provide that the reservations continue or either change to a denial of coverage or be withdrawn.

After receiving clear communication and a well-written letter that follows these protocols, the Brants are not alarmed by the insurer's reservation of rights. And Natalie can rest assured, knowing that she best served her customer and the insurer. ■

For more information on this topic, please contact Laura Meyer Gregory at LGregory@SloaneWalsh.com or Chantal M. Roberts at CMRoberts@CMRConsulting.net.

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 2. IRMI, *Reservation of Rights*, [IRMI.com/term/insurance-definitions/reservation-of-rights](https://www.irmi.com/term/insurance-definitions/reservation-of-rights) (accessed January 25, 2021).
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 5. *W. Heritage Ins. Co. v. Love*, 24 F. Supp. 3d 866, 878 (W.D. Mo. 2014), affirmed, *W. Heritage Ins. Co. v. Asphalt Wizards*, 795 F.3d 832 (8th Cir. 2015).
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9. Veronica Bates and Renee Callantine, "Reservation of Rights Letters," *Claims Journal*, July 28, 2008, <https://www.claimsjournal.com/news/national/2008/07/28/92273.htm> (accessed January 25, 2021).
10. Daniel Moldanado et al., *Couch on Insurance*, § 226:123, Clark Boardman Callaghan, 2020.

NOT ALL JURISDICTIONS HAVE DECIDED ON THE ISSUE OF **RECOUPING** DEFENSE COSTS