Reservation of Rights - a worrying trend

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A survey conducted by AIRMIC (the Association of Insurance and Risk Managers in Industry and Commerce) of its members in 2012 revealed a worrying trend in the use of ‘reservation of rights’ letters by insurers in response to claims notifications.

65% of respondents had received a ‘reservation of rights’ letter from their insurer, which they believed had been issued unfairly, and 57% indicated that the matter had not been resolved to their satisfaction. The scale of the problem is also of concern, with 35% of respondents receiving at least one reservation of rights letter in the past two years.

AIMIC’s survey results suggest that certain insurers are reserving rights routinely, and often in inappropriate circumstances. This situation comes as no surprise to those of us involved in dealing with insurers in relation to claims notifications. In our experience, there is a trend of insurers reserving rights far too readily; some even appearing to adopt it as the default response in relation to any high-value or complex claim notification, and this situation is being exacerbated by the ongoing economic conditions.

What is a reservation of rights?

A reservation of rights letter is a device by which insurers seek to preserve any coverage defences, by informing the insured that a notified claim or claim circumstance may not be covered under their policy.

In some situations, for instance where an insured appears at the outset to be in breach of a key policy condition, such a response from insurers is perfectly justified for a short time while the insurer investigates and formulates a definitive view of the validity of the claim.

On the other hand, a knee-jerk and/or long-term reservation of rights in the face of a valid claim notification, where there is no indication of breach of policy terms by the insured, can be extremely counterproductive and unsettling for the insured.
Why do insurers reserve their rights?

Traditionally, the insurance market has had a pervasive fear of inadvertently confirming coverage where a valid defence may have existed. This fear arose from an historic body of case law which, in effect, led insurers to believe that any equivocal behaviour in their response to a claim; any reliance upon policy terms; or any positive engagement with an insured in relation to a claim, might amount to a waiver by the insurers of its policy defence and/or a confirmation of coverage. The safest option therefore was thought to be a full reservation of rights letter issued to the insured upon receipt of a claims notification.

In recent years however, the law in this area has been clarified. In the case of Kosmar Villa Holidays v. Trustees of Syndicate 12431, the Court of Appeal made it clear that an insurer would need to make a truly unequivocal representation that it was waiving a policy defence in order for it to be lost. Indeed, Lord Justice Rix went as far as to suggest that, during the period of the insurer’s investigation, there was no need for the insurer to reserve its rights:

“It would not be good practice for insurers to rush to repudiate a claim for late notification, or even to destabilise their relationship with their insured by immediately reserving their position - at a time when they were in any event asking pertinent questions about a claim arising out of an occurrence about which they had long been ignorant in the absence of prompt notification. Insurers traditionally armour themselves with all kinds of conditions precedent, but, in a relationship where there is trust, they are just as likely to forgo their strict rights. If they did not, the conduct of the insurance market might very well undergo considerable adaptation. Legal doctrine should not push insurers into over-hasty reliance on their procedural rights.”

In December 2008, following the decision in Kosmar, AIRMIC published a statement of principles intended to provide insureds with clarity regarding when and where insurers should or could reserve their rights. That statement of principles was negotiated with, and endorsed by a number of prominent insurers. The main principle agreed was that in relation to large claims (i.e. those expected to exceed £2.5million), insurers would not reserve their rights for a period of 90 days from receipt of the claim, instead they would correspond on a “without prejudice” basis in order to determine coverage, with any subsequent reservation of rights being explained properly to the insured.

In light of these developments, one might be forgiven for expecting insurers to feel rather more comfortable in engaging fully with insureds at an early stage of a claims notification, and to reserve their rights in far fewer instances. The anecdotal evidence however, both from AIRMIC’s members and from claims professionals in the London insurance market, is that certain insurers continue to resort to a reservation of rights as the default option, whenever they are faced with a complex or high-value claim notification.

Why does it matter?

A complex or high-value claim is likely to be enough of an unwelcome distraction for a commercial enterprise. In these instances insureds should be entitled to expect, in the absence of a breach of key policy conditions, that their insurers will stand behind them; assisting them with the disposition of the claim; and ultimately pay any element of the claim which is indemnifiable under the policy. Insureds should not have to endure their insurers sitting on the fence for protracted periods, reserving their position, equivocating as to coverage and leaving the insured to deal with the claim without any confidence that their insurance will respond.

In our experience, inappropriate reservations of rights by insurers often create unnecessary inconvenience, stress and commercial tension. Sometimes the result is that claims are resolved on far less satisfactory terms for all concerned than had the insurer worked collaboratively with the insured from the outset.

What can be done?

AIRMIC’s announcement that it will seek to re-engage with the insurance market to try and secure greater commitment to the appropriate use of reservations or rights letters is both timely and welcome. However, this renewed engagement is unlikely to bring immediate change to insurers’ behaviour, which has often become entrenched over years. In the meantime, and until market practice has been improved uniformly in this area, skillful presentation of claims; access to experienced claims advisers who can assist in the management of the claims process; and swift and decisive resolution of potential coverage issues before they become entrenched will continue to be crucial.

The Draft Clause

To address the issue further, AIRMIC has suggested adding a specific clause to insurance contracts and it suggests a model wording for that clause. This is a positive step as the proposed clause helps the parties to deal with reservations of rights in a more structured way and clients will have greater certainty around the reservation process. It should also help speed the claims negotiation process as it facilitates the flow of essential information the insurers require to evaluate a claim, but does not stop them issuing a reservation of rights if that is ultimately required.

The suggested clause has been drafted for Airmic by Herbert Smith Freehills and, in our view, is fair and reasonable. Insureds and their representatives should therefore seek to add such a clause to their policy, irrespective of the limit of indemnity. It will be interesting to see how insurers respond to this development and we expect that in some cases a degree of negotiation will be required before a final wording is agreed.