

What Does a Reservation of Rights Letter from an Insurance Company Mean?

A university hires an architect and general contractor for a multi-million dollar project involving the erection of a new state-of-the-art building containing multimedia-capable lecture halls. After three years of planning and construction, the university unveils the new facility to great fanfare. Within a few months, however, problems start to arise. Rain and melting snow fail to drain properly. Water seeps in through new cracks in the masonry walls. Mold forms on walls and ceilings, spoiling the appearance and causing allergic reactions among students and staff. Investigators for the university conclude that the building has significant design and construction flaws. As a result, the university files a number of lawsuits against the architect and the contractors who performed the work, alleging that their incompetence caused the problems.

The architectural firm notifies its professional liability insurance company of the allegations. Within a few weeks, the firm receives a letter from the insurance company stating that the company is reserving its rights to deny parts or all of the claim, pending its own investigation. The architect, already faced with a hit to its reputation and a potential loss of business because of the suit, reacts badly to the letter. The chief partner calls the firm's insurance broker and demands to know why he has received this threatening letter after he has paid thousands of dollars in premiums for the insurance policy. The broker explains that the letter, known as a "reservation of rights letter," is a normal part of the insurance claims process. Not entirely reassured, the partner wants to know what the letter is all about.

A reservation of rights letter is a notice which states that, while the insurance company is handling the claim, the insurance policy may not cover the claim entirely. In the early stages of the claim process, the company has limited information about what happened. It may take time for the company to investigate and gather all the facts. However, many states have laws requiring insurance companies to promptly notify clients and claimants that coverage may not apply. By giving the insured an early notice, the reservation of rights letter preserves the company's legal ability to deny some or all of the claim at a later date.

Insurance companies may deny claims for several reasons, such as:

- The policy excludes coverage for the activity or event in question. For example, if the company's investigation reveals that one of the firm's architects intentionally designed a poor drainage system, the policy's intentional acts exclusion will apply and preclude coverage. Likewise, the policy does not cover losses arising from faulty workmanship. If the company finds that faulty workmanship was responsible for the building's problems, it will deny payment.
- Even if an exclusion does not apply, the company will deny the claim if the policy does not apply to the particular loss. There may be some question as to when the loss occurred, particularly with problems that appear over time. The company will deny the claim if it determines that the loss occurred before the policy took effect.

While the insured may be alarmed to receive a reservation of rights letter, the letter does not necessarily mean that the company and the insurer must be adversaries. It merely means that the insurer has concerns about some of the allegations. With complex insurance coverages like professional liability, it is not unusual for the insurer to issue such a letter. Clients should work closely with their brokers and their insurers' claim departments to ensure that all relevant information is available, ensuring a prompt and fair claims settlement.