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NEWSLETTERS

A Negative Trend For Insureds: Federal Courts Apply Different Standards Than State Courts When Determining Coverage

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The opinion of the Eleventh Circuit in *Wellons Inc. v. Lexington Insurance Company*, 566 Fed. Appx. 813, 2014 WL 1978412 (11th Cir. May 16, 2014) is a recent federal court decision which continues a trend of ignoring an insured's substantive rights under state law. While this frequently occurs in the construction arena because insurance is often involved in those disputes, the divide between the approaches taken by state courts as compared to federal courts continues to widen.

In *Wellons*, the Eleventh Circuit was asked to decide whether a series of prior, general reservation of rights letters by Lexington preserved Lexington's right to deny coverage after a lawsuit was filed and Lexington undertook the defense. The *Wellons* claim involved the construction of a dryer energy thermal oxidation system to produce heat for production of oriented strand board (OSB), customarily used in home construction and flooring. The system was designed to provide sufficient heat energy to power the OSB production process, incinerate pollutants expelled by the OSB process, and further produce sufficient heat to power a boiler and turbine that would serve as a co-generation unit for electricity to be sold to Georgia Power. After the initial energy system was built and placed in operation, leaks developed in the superheater where steam passes before being sent to the turbine. Testing allegedly revealed leaks in a substantial number of the joints, which were then repaired. Approximately two weeks later, one of the superheater tubes completely severed and resulted in the owner's call for a replacement of the superheater, as well as damage to most of the tubes in the energy system.

Wellons placed Lexington on notice of the claim before suit was filed. Lexington's "reservation of rights" letter advised Wellons that Lexington had no obligation to defend or indemnify Wellons for the claim, explaining that: "it is unclear exactly what Langboard's claims of injury are, beyond the demand that the superheater be replaced. As a result, at this time, Lexington has no duty to indemnify Wellons…." Thus, Lexington's initial coverage position was that it was denying coverage, yet reserving rights as well - a position inconsistent with Georgia law. *See, e.g., Hoover v. Maxum Indemnity Company*, 730 S.E. 2d 413 (Ga. 2012). After suit was filed against Wellons, it put Lexington on notice of the suit. Lexington's adjuster then orally advised Wellons' insurance agent that it was going to provide a defense under a general reservation of rights, without specifying any particular coverage defenses. The adjuster stated Lexington's prior reservation of rights letters were "in the same mode" and "the issues addressed in each of the letters are still applicable." Lexington did not issue a new reservation of rights letter after suit was filed, but instead

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assigned defense counsel to defend Wellons in the lawsuit.

After participating in discovery and completing multiple depositions, Lexington's chosen panel defense counsel were preparing for trial alongside independent counsel chosen by Wellons to assist in the trial. On the Friday before the Monday of the beginning of the jury trial, Lexington emailed a letter to Wellons denying all coverage for the lawsuit, claiming that discovery revealed that the losses sustained did not meet the definition of either "occurrence" or "property damage" under the CGL policy. Lexington referenced its earlier reservation of rights letters, noting that other exclusions referenced in those letters might otherwise be applicable. Although denying coverage outright, Lexington nevertheless continued the defense of Wellons at trial. The jury awarded $8,440,764.00 against Wellons, which timely appealed to the Georgia Court of Appeals.

Three months after the jury verdict, Wellons filed a declaratory judgment action against Lexington arguing that the verdict was a covered loss under the CGL policy (and an excess policy issued by a Lexington affiliate) because Lexington failed to adequately reserve its rights and was now estopped from asserting any coverage defenses. On cross-motions for summary judgment, the district court concluded Lexington was not estopped from denying coverage under the CGL and the excess policies and entered judgment accordingly.

Wellons appealed to the Eleventh Circuit which held that, "under Georgia law, an insurer need not inform the insured of the specific basis for the insurer's reservation of coverage." The Eleventh Circuit's decision turned on the interpretation of the Georgia Supreme Court decision in *World Harvest Church, Inc. v. GuideOne Mutual Insurance Company*, 695 S.E. 2d 6 (Ga. 2010). Interestingly, it was the Eleventh Circuit which had certified questions to the Georgia Supreme Court in World Harvest governing an insurer's requirements for reservation of rights letters. In *World Harvest*, the Georgia Supreme Court specifically held as follows: "At a minimum, the reservation of rights must fairly inform the insured that, notwithstanding the insurer's defense of the action, it disclaims liability and does not waive the defenses available to it against the insured. The reservation of rights should also inform the insured of the specific basis for the insurer's reservations about coverage…." (Quotations and citations omitted). The Eleventh Circuit in *Wellons* read the above language to mean that an insurer "must fairly inform the insured that the insurer is providing a defense under reservation of rights," but that an insurer "may" inform the insured of the specific basis for the insurer's reservation of coverage. The Eleventh Circuit interpreted the word "should" in the *World Harvest* decision to mean only "recommend." Therefore, as the Eleventh Circuit read *World Harvest*, the Georgia Supreme Court was simply making a recommendation or was providing an advisory opinion to the insurance industry about how it might treat its insureds. The Court also found that Hoover did not apply despite the fact that Lexington denied coverage outright while purportedly reserving its rights by continuing to participate in the defense of the case *at trial*.

Much of the subsequent public commentary regarding the *Wellons* decision surrounds what the current obligations of an insurer might be under Georgia law. Is the insurer required to provide specifics to its insured when it is informing the insured that it might ultimately deny coverage while still providing and managing the defense? May the insurer

deny coverage but still participate in the defense of the claim without waiving its defenses or being estopped from later denying coverage? Commentators continue to debate these issues.

As federal and state courts diverge on important insurance coverage issues such as notice, “occurrence,” “property damage” and allocation – often affecting construction industry clients disproportionately – the choice of forum becomes extremely important to insurers and insureds alike. Insurers remove coverage cases to federal court whenever possible. Insureds should look for creative ways to have state law applied to claims, regardless of whether the litigation is in state or federal court. Naming local insurance agents who are potentially liable for late notice of claims or obtaining the wrong types of coverage for the insured is one strategy for keeping the case in state court (by destroying diversity jurisdiction). State supreme court certification processes are another avenue if the federal district or appellate courts misapply state supreme court directives, as many commentators, including the authors of this article, believe the Court did in *Wellons*.

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