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Fourth Circuit Finds Insurer Reservation of Rights Letters Inadequate to Preserve Coverage Defenses Under South Carolina Law

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In *Stoneledge at Lake Keowee Owners Ass'n v. Cincinnati Ins. Co.*, 2022 U.S. App. LEXIS 34292 (D.S.C. Dec. 13, 2022), the Fourth Circuit Court of Appeals addressed the adequacy of reservation of rights letters issued by Builders Mutual Insurance Company ("Builders Mutual") and Cincinnati Insurance Company ("Cincinnati") to their insureds, Marick Home Builders, LLC ("Marick") and Rick Thoennes ("Thoennes"), Marick's managing member, for an underlying construction defect lawsuit. In short, the Fourth Circuit found that the reservation letters were inadequate to preserve the insurers' coverage defenses because they did not sufficiently explain the basis of the carriers' position.

Stoneledge, a homeowners association, managed a community of 80 townhomes on South Carolina's Lake Keowee. In 2009, Stoneledge brought suit against Marick and Thoennes, among other defendants, alleging construction defects in the townhomes that resulted in water intrusion and other physical damage. Marick and Thoennes held commercial general-liability policies through Cincinnati and Builders Mutual covering, in relevant part, "property damage" as defined by the policies. Builders Mutual issued policies covering the period from January 2004 to October 2007, and Cincinnati issued policies covering the period from April 2008 to April 2012. After Marick notified the insurers of the underlying action, Builders Mutual sent Marick two reservation of rights letters, one in May 2009 and one in July 2009. Cincinnati sent Marick one reservation of rights letter in March 2010.

In March 2014, Stoneledge brought a declaratory-judgment action against Cincinnati seeking coverage for a judgment entered in the underlying action. The insurers removed the case to federal court, and in September 2016, Stoneledge amended its complaint, adding Builders Mutual as a defendant and seeking coverage for additional damages pursuant to a settlement agreement entered into by Stoneledge, Marick, Thoennes. The district court granted Stoneledge's motion for summary judgment, primarily on the ground that the insurers failed to reserve the right to contest coverage. The insurers appealed to the Fourth Circuit, which affirmed.

The Fourth Circuit set the stage for appeal by framing the reservation of rights issues under the Supreme Court of South Carolina's decision in *Harleysville Group Insurance v. Heritage Communities, Inc.*, 803 S.E.2d 288 (S.C. 2017). In *Harleysville*, the Court relied on the "axiomatic" principle that an insured "must be provided sufficient information to understand the reasons the insurer believes the policy may not provide coverage," and held that "generic denials of coverage coupled with furnishing the insured with a copy of all or most of the policy provisions is not sufficient."

Builders Mutual and Cincinnati attempted to limit the scope of the *Harleysville* decision by arguing it was limited to the particular context and facts of the case, that it was improper to retroactively apply *Harleysville* to reservation of rights letters that were issued before its holding, and that subsequent decisions dilute the duties of notice laid out in *Harleysville*. The Fourth Circuit found all three arguments unpersuasive. Indeed, subsequent cases applying the precedent of *Harleysvill*e show its principles apply broadly to cases assessing the adequacy of an insurer's reservation of rights, and the holding is not to be narrowly tailored. Moreover, the insurers' challenge to retroactive application of *Harleysville* was already settled in *Harleysville* itself when the court found a reservation of rights letter issued years before their decision was inadequate. Finally, the Fourth Circuit concluded the case cited by the insurers, *Ex Parte Builders Mutual*, did not dilute *Harleysville's* holding on reservation of rights, but rather reaffirmed them.

Builders Mutual and Cincinnati next argued they issued sufficient reservation of rights letters that can be distinguished from the inadequate letters discussed in *Harleysville*. In *Harleysville*, the court found the reservation of rights letter insufficient because it failed to inform the insureds of their intent to litigate coverage issues and did not apprise the insureds of potential conflicts of interest. There, the insurer "merely identified the policy numbers and policy periods for policies that potentially provided coverage" and "incorporated a nine or ten page excerpt of various policy terms, including … numerous policy exclusions and definitions."

Similarly here, the Fourth Circuit determined the reservation of rights letters from Builders Mutual and Cincinnati were inadequate. Builders Mutual's reservation of rights letters merely referred the insured to policy exclusions and summarized them, and generally referred to coverage issues again directing the insured to consult exclusions within the policy. The Fourth Circuit found Builders Mutual's reservation of rights letter was precisely the kind of general reservation of rights letter *Harleysville* deemed insufficient. Cincinnati's reservation of rights letter was slightly stronger in that they acknowledged "coverage may be limited by several other exclusions and endorsements." Cincinnati's reservation of rights went a bit further, stating "it is doubtful the claim alleges the happening of 'an occurrence'" or that the "claim alleges 'property damage' within the policy definition," and if there is no "occurrence" or "property damage" as defined by the policy, there is "no coverage." The Fourth Circuit, however, determined that language too was insufficient because the insurer never explained why they found it "doubtful" that there was an "occurrence" or "property damage" under the terms of the policy.

As Builders Mutual and Cincinnati neither discussed their position on the policy provisions nor explained any reasons for potentially denying coverage, the Fourth Circuit found their reservation of rights letters inadequate, and thus, insufficient to support a denial of coverage. Accordingly, the Fourth Circuit found there was no reversible error in the district court's application of *Harleysville* to the insurers' reservation of rights letters, and affirmed the district court's judgment.

The lesson of *Stonledge* is simple: to adequately preserve the insurer's right to contest coverage, a reservation of rights letter must do more than summarily cut and paste portions of the policy and underlying facts. Generic denials of coverage and a copy of all or most of the policy provisions is not enough, and simply stating a policy exclusion—without more—does not constitute a sufficient reservation of rights. At the very least, an insurer should discuss its position as to the various provisions and explain its reasons for potentially denying coverage. The letter should provide the insured with sufficient information to understand the reasons the insurer believes the policy many not provide coverage. Moreover, the reservation of rights should inform the insured, if appropriate, that the insurers intend to litigate coverage issues and apprise the insureds of potential conflicts of interest. Failure to do so could result in an "ambiguous" reservation of rights and resulting inability to rely on those coverage defenses to limit or preclude coverage.