

## Reservation of Rights Requirements Adopted by South Carolina Supreme Court

The South Carolina Supreme Court's recent decision in *Harleysville Group Insurance v. Heritage Communities, Inc.*, Appellate Case Nos. 2013-001281 and 2013-001291, 2017 WL 105021 (S.C. Jan. 11, 2017) affirms what is and is not covered "property damage" under commercial general liability (CGL) policies in the construction defect context, affirms that the scope of an insurer's duty to indemnify is limited to damages that accrued during the insurer's time on risk, and provides guidance on how to perform time-on-risk calculations. These topics alone make the opinion required reading for insurance and legal practitioners involved in South Carolina construction defect claims.

The most newsworthy aspect of the opinion, however, is its adoption of strict requirements for effective reservation of rights letters. Citing no South Carolina authority and relying on cases from other jurisdictions, the opinion finds that Harleysville's reservations were "too imprecise" to preserve Harleysville's right to contest liability for millions of dollars in actual damages awarded in underlying cases by way of subsequently filed declaratory judgment actions. 2017 WL 105021 \*5-7. The opinion also provides detailed guidance as to what must now be included in an insurer's reservation of rights letter in order to effectively protect the insurer's interests under South Carolina law. *Id.* This guidance on effective reservations from South Carolina's highest court seemingly applies to all insurers regardless of the type of coverage at issue. Accordingly, this opinion will likely have reverberations throughout the entire South Carolina insurance coverage community, impacting both pending and future claims.

The opinion addresses two separate insurance coverage cases involving damages stemming from the defective construction of two condominium complexes in Myrtle Beach: Magnolia North Horizontal Property Regime (Magnolia North) and Riverwalk at Arrowhead Country Club Horizontal Property Regime (Riverwalk). *Id.* \*1. Magnolia North and Riverwalk were constructed between 1997 and 2000. During the construction period the various developer and construction entities involved in the projects, collectively referred to as Heritage, maintained CGL policies with Harleysville. After construction was complete and the units were sold, the purchasers became aware of significant construction problems, including building code violations, structural deficiencies, and water intrusion issues. In 2003, the property owners' associations (the POAs) for the complexes filed suit against Heritage seeking actual and punitive damages for the construction defects under theories of negligent construction, breach of fiduciary duty, and breach of warranty. Individual homeowners in Riverwalk also filed a class action seeking damages for the loss of use of their property during the repair period. *Id.*

After receiving notice of the underlying lawsuits, Harleysville informed Heritage that it would provide for Heritage's defense subject to a full reservation of rights.

The underlying lawsuits proceeded to trial. The defense counsel retained by Harleysville for Heritage limited the issues at the trials to damages. *Id.* \*2. The juries returned general verdicts for actual damages in the amounts of \$6.5 million for Magnolia North's POA, \$4.25 million for Riverwalk's POA, and \$250,000 for Riverwalk's homeowners in the loss of use case, and also awarded punitive damages in the amounts of \$2 million for Magnolia North's POA, \$250,000 for Riverwalk's POA, and \$750,000 for Riverwalk's homeowners in the loss of use case. *Id.*

Following the jury verdicts, Harleysville filed the two declaratory judgment actions addressed by the South Carolina Supreme Court. *Id.*

South Carolina's Supreme Court recognized that the general verdicts in the underlying actions at least likely included some covered and some non-covered actual damages, because costs



Tracy L. Eggleston

**Member**

teggleston@cozen.com  
Phone: (704) 348-3409  
Fax: (704) 334-3351

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associated with removing, repairing, or replacing faulty workmanship itself do not constitute covered property damage under South Carolina law. *Id.* \*3-5. The court, however, found that Harleysville had waived the right to contest its liability for actual damages because Harleysville's reservations in this regard were too generic and insufficient to preserve its rights to do so. The court stated:

... [Harleysville's] letters explained that Harleysville would provide a defense in the underlying suits and listed the name and contact information for the defense attorney Harleysville had selected to represent Heritage in each matter. These letters identify the particular insured entity and lawsuit at issue, summarize the allegations in the complaint, and identify the policy numbers and policy periods for policies that potentially provide coverage. Additionally, each of these letters (through a cut-and-paste approach) incorporated a nine- or ten-page excerpt of various policy terms, including the provisions relating to the insuring agreement, Harleysville's duty to defend, and numerous policy exclusions and definitions. **Despite these policy references, the letters included no discussion of Harleysville's position as to the various provisions or explanations of its reasons for relying thereon. With the exception of the claim for punitive damages, the letters fail to specify the particular grounds upon which Harleysville did, or might thereafter, dispute coverage.**

... These letters further advised Heritage of the possibility it may face an uninsured exposure or interest to the extent that any damages ultimately awarded exceeded the policy limits. Harleysville therefore recommended that Heritage and its principals consider employing personal counsel to represent any uninsured exposure or interest ... **Importantly, however, none of the reservation letters advised Heritage of the need for the allocation of damages between covered and non-covered losses or referenced a possible conflict of interest or Harleysville's intent to pursue a declaratory judgment action following any adverse jury verdicts in the underlying lawsuits.**

*Id.* \*5-7 (emphasis added). The court noted that without this information in the reservation, an insured is placed at a disadvantage because it does not know the specific grounds on which the insurer may contest coverage and it loses the opportunity to investigate and prepare a defense on its own. An insured may have no reason to act to protect its rights if it is unaware that a conflict of interest exists between itself and the insurer. *Id.* \*6.

It is now clear that merely providing an insured with the relevant policy language and making general denials of coverage based on such language is no longer sufficient to reserve an insurer's rights under South Carolina law. Reservations must now: (1) unambiguously specify the particular grounds, based on a discussion and application of the relevant facts to the relevant policy language, that an insurer will or may subsequently contest coverage, (2) advise the insured of the need for an allocation of damages between covered and non-covered losses by way of special interrogatories or a special verdict form at the trial of the underlying lawsuit and that it is in the insured's interests to request the same, (3) advise the insured that it will or at least may pursue a declaratory judgment action following any adverse jury verdict in the underlying lawsuit, and (4) advise the insured of the conflicts of interest that exist because of the need to seek an allocation of damages, the potential need for a declaratory judgment action, and any potential excess exposure that the insured may face. It is incumbent upon insurers to expressly indicate the specific portions or types of damages for which it may contest coverage and to advise insureds of any conflicts of interest that may arise, as well as to avoid using boilerplate language and generic denials.

These requirements are not limited in applicability to reservations for construction defect claims. Liability insurers that fail to comply with them going forward do so at their own peril. Additionally, although it is not clear that these requirements should apply retroactively, insurers that have issued reservation of rights letters in pending claims should review their previously issued reservations and consider issuing an amended or supplemental reservation if their prior communications do not sufficiently comply with *Heritage's* requirements.

Notably, it is now incumbent upon an insurer to not only advise the insured of the need for an allocation of damages in reservation of rights letters, but also to follow through and insist upon an actual allocation between covered and non-covered damages by the jury during the underlying trial. Harleysville failed to do so, and the South Carolina Supreme Court found that a court has no basis

upon which to make an assessment of a jury's purpose when the jury awards a general verdict and should not engage in unguided speculation with respect to the issue of allocating losses that have been generally awarded. *Id.* \*n. 11.

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