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How to Defeat an Insurance Company's Demand That the Policyholder Pay Back Defense Costs

Insurance companies often assert a right to recoup advanced defense costs in their reservation of rights letters. Policyholders leave such claims uncontested at their peril.

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Insurance companies routinely send reservation of rights letters in response to a policyholder's demand for coverage. Policyholders, for their part, routinely ignore those reservations. That's a mistake. While it may be tempting to let reading and responding to a reservation of rights letter slide to the bottom of the endless to-do list, policyholders who do so may find themselves on the receiving end of an enforceable obligation to repay their own insurance company for amounts the insurance company paid in defense of a claim.

An insurance company's request that the policyholder pay money to the insurance company is antithetical to the insurance company's promise to defend the policyholder and pay, on the policyholder's behalf, a settlement or judgment entered. While there is a growing trend for courts to refuse an insurance company's request for reimbursement of defense costs, there still remain a number of states that have upheld such requests. Given the tension and conflict of interest that exist when an insurance company provides a defense, controls the defense, and simultaneously asserts a right to be reimbursed for sums paid in that defense, it is important for policyholders to understand how to forestall an insurance company's ability to seek—and obtain—reimbursement of defense costs.

The following discussion is intended to assist policyholders in understanding the import of an insurance company's request for reimbursement of defense costs, how to respond to it, and what action to take in order to protect policyholder rights.

Given the purpose of commercial general liability (CGL) insurance, which is sometimes referred to as "litigation insurance," it is alarming that so many policyholders have been presented with demands by insurance companies seeking to take back the defense promise. In some cases, courts have enabled this recoupment, and in some cases, the policyholder's response to a reservation of rights—or lack thereof—has been dispositive.

Courts Split on Insurance Company Recoupment

When an insurance company asserts a right to seek reimbursement of defense costs from a policyholder, it is important for the policyholder to understand whether that reservation is valid and enforceable according to the terms and conditions of the insurance policy and the applicable

law. Answering these threshold questions is the first step in forestalling an eventual demand for reimbursement of defense costs. As the cases discussed below suggest, knowing how a court may view an insurance company's right to reimbursement can help a policyholder counteract an insurance company's reservation of rights.

In a CGL insurance policy, insurance companies generally have a duty to defend the policyholder. The standard form of the CGL policy issued by the Insurance Services Office (ISO) promises the following:

We will pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies. *We will have the right and duty to defend the insured against any "suit" seeking those damages*. However, we will have no duty to defend the insured against any "suit" seeking damages for "bodily injury" or "property damage" to which this insurance does not apply. . . .

That standard form policy language does not contain any provision that obligates a policyholder to repay its insurance company for amounts the insurance company paid in defense of a claim. However, insurance companies have attempted to insert a "right of recoupment"—a statement that they may seek reimbursement of any amounts incurred in the defense of a policyholder—into their CGL insurance policies by including it in their reservation of rights letters. A policyholder's response (or failure to respond) to those reservations may affect whether courts will allow the insurance company to recoup from its policyholder amounts paid in the defense of a claim.

Courts have generally honored a policyholder's objection to an insurance company's unilateral reservation and claim that it has a right to recoup defense costs.[1] There is a growing trend in U.S. courts to prevent insurance companies from seeking reimbursement from their policyholders, but the courts remain divided.[2] Five states have decided that an insurance company does not have a right to recoup defense costs. Alaska refused to enforce an insurance policy provision that would allow the insurance company to seek recoupment of defense costs even if it defended under a reservation of rights.[3] The Eighth Circuit, applying Missouri law, held that an insurance company that defends its policyholder under a reservation rights is not entitled to reimbursement of defense costs even if there is no duty to defend.[4] Courts applying Arizona, Arkansas, and Maryland law have also decided that an insurance company may not recoup defense costs if its right to do so is based up a unilateral reservation of rights.[5]

Of those states that do permit an insurance company to recoup defense costs (if the tally includes federal courts interpreting or predicting state law), 12 appear to assess the insurance company's ability to seek reimbursement based on whether the insurance policy contains a specific provision that allows the insurance company to do so.[6] By a similar tally, 14 states permit an insurance company to recoup defense costs by asserting that possibility in a reservation of rights letter.[7]

In Georgia, a state where an insurance company has a right to recoupment provided that it reserves that right either through the insurance policy itself or in a reservation of rights, the courts have noted that even though an insurance company may, in certain circumstances, be

permitted to recoup defense costs, that right is not without limitations. In one case, the court noted that there is no right of reimbursement unless an express policy provision allows reimbursement or unless the insurance company expressly reserved its right of reimbursement—and the policyholder accepted that reservation.[8]

As the cases above illustrate, where the insurance policy does not expressly permit an insurance company to recoup defense costs, the insurance company may attempt to create an implied-in-fact contract that does allow recoupment via a reservation of rights. For an implied-in-fact contract to exist, the insurance company must show that an agreement to allow recoupment may be inferred based on the understanding of the parties, i.e., the policyholder and insurance company.[9] For an insurance company to prevail in its claim for recoupment, it must do more than simply point to a reservation of rights. Indeed, "even implied-in-fact contracts must have all the elements of an express contract. These include 'an offer, an acceptance, contractual capacity, consideration (the bargained-for legal benefit or detriment), a manifestation of mutual assent, and legality of object and of consideration.'"[10] "In implied-in-fact contracts, 'a plaintiff must demonstrate that the circumstances surrounding the parties' transaction make it reasonably certain that an agreement was intended.'"[11]

Reading and Responding to a Reservation of Rights

What does this mean for policyholders?

While reading a reservation of rights letter that appears to be a recitation of every exclusion in the insurance policy may feel like time wasted, reading that letter and discerning what rights the insurance company believes it can reserve can in fact make the difference between coverage and no coverage.

Consider independent counsel to defend the third-party claims. When an insurance company agrees to defend a third-party claim but provides that defense subject to a reservation of rights, the policyholder may be able to obtain independent counsel to defend the suit.[12] The central issue in determining whether a policyholder is entitled to independent counsel has been captured as whether there is "a question as to the loyalty of the insurer's counsel to that insured"; where there is, the insured is entitled to select its counsel, whose reasonable fee is to be paid by the insurer.[13] With respect to the appointment of independent counsel, New Jersey courts have held that "[a]n insurer owes a fiduciary duty to its insured, and the relationship carries with it affirmative duties toward the insured. Where there is a clear conflict of interest between an insurer and an insured, a carrier may not, in the insured's name, so defend as to exculpate the carrier alone."[14]

Determining whether an insurance company's reservation of rights necessarily creates an irreconcilable conflict of interest that can only be cured through independent counsel depends on the specific facts, the nature of the reservation of rights, and the applicable law. While it is not definitive that a reservation of rights to seek reimbursement of defense costs creates a fatal conflict of interest that warrants independent counsel, consideration of this issue in consultation with coverage counsel may be warranted to ensure that the policyholder's interests are being adequately protected by the defense counsel appointed by the insurance company.

A policyholder may be inclined to conclude that, each time an insurance company provides a defense subject to a reservation of rights, there is necessarily a fatal conflict of interest between the policyholder and the insurance company. However, courts have not always found this to be the case. For example, a California appellate court observed that "not every reservation of rights entitles an insured to select *Cumis* counsel."[15] Furthermore, "[a] mere possibility of an unspecified conflict does not require independent counsel. The conflict must be significant, not merely theoretical, actual, not merely potential."[16] The court noted that the language of California Civil Code section 2860 "specifically provides that 'a conflict of interest does not exist as to allegations or facts in the litigation for which the insurer denies coverage.' It further uses the permissive 'conflict of interest *may* exist,' rather than the mandatory 'shall.'"[17] Accordingly, the court rejected the policyholder's contention that either a "global reservation of rights" or a reservation of the right to reimbursement for uncovered claims always triggers a duty to provide independent counsel.[18] The court offered the following guidelines for determining when such a duty arises:

[T]he potential for conflict requires a careful analysis of the parties' respective interests to determine whether they can be reconciled (such as by a defense based on total nonliability) or whether an actual conflict of interest precludes insurer-appointed defense counsel from presenting a quality defense for the insured.[19]

The court also noted that any potential conflict of interest could be obviated so long as insurer-appointed counsel *actually* litigated diligently on the insured's behalf. The court also rejected the notion that simply because an attorney is appointed by an insurance company, the attorney will attempt to manipulate any litigation against the insured.

Courts do not reflexively permit policyholders to obtain independent counsel any time that an insurance company sends a reservation of rights letter. However, policyholders would be wise, when reviewing a reservation of rights, to consider whether the reservation creates a conflict with defense counsel and how to address that conflict. Requesting independent counsel is one of the options that is available.

Practice Pointers

It is important that policyholders read and respond to reservation of rights letters. While the focus of this discussion has been on the specific reservation of a right to seek reimbursement of defense costs, policyholders should be attentive to all reservations that the insurance company raises. Consulting with a broker and trusted counsel can assist the policyholder in determining how and whether to respond to the reservation and also aid in understanding insurance policy.

Understanding the insurance policy with the help of a broker and coverage counsel can arm the policyholder with tools to challenge a reservation of rights. Reading and understanding an insurance policy, particularly the provisions regarding an insurance company's defense obligation, is a critical first step in understanding how to respond to an insurance company's reservation of a right to seek reimbursement of defense costs.

Equally important is understanding how a court is likely to evaluate an insurance company's demand for reimbursement of defense costs; even more important is understanding how a policyholder's response to a reservation may affect the court's decision. Armed with such knowledge, the policyholder may be able to respond to the reservation of rights letter in a way that forestalls an attempted recoupment—or defeats such an attempt in court.

Responding to an insurance company's request for reimbursement is one of the key factors that courts have considered in deciding whether an insurance company is entitled to reimbursement. For this reason, when an insurance company reserves a right to seek reimbursement, the policyholder should take notice and respond. A policyholder's rejection of the insurance company's request or reservation to seek reimbursement has been a critical component in some courts' analysis of whether the insurance company is entitled to obtain reimbursement from the policyholder.

Policyholders who receive reservations of rights letters from their insurance companies should consider the following recommendations in formulating their next steps:

1. Respond early; do not remain silent.
2. Make clear that you do not agree with the insurance company's reservation of rights and, in turn, reserve all of your own rights.
3. Cooperate with the insurance company's reasonable requests and its claim investigation, but beware of potential pitfalls, including waivers of privilege, revealing too much of your defense strategy, and complying with burdensome or costly requests.
4. Request reconsideration of the insurance company's position, including as to any denials that might be intermingled within the reservation of rights letter.
5. Consult coverage counsel.

The key for policyholders is to respond proactively, challenge the insurance company's self-serving statements and reservations, and be aware of the strong rights afforded under the policies purchased.

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[1] *See Excess Underwriters at Lloyd's v. Frank's Casing Crew & Rental Tools, Inc.*, 246 S.W.3d 42, 48–51 (Tex. 2008) (rejecting excess carriers' claims for reimbursement under implied-in-fact and quasi-contract theories); *Tex. Ass'n of Counties Cty. Gov't Risk Mgmt. Pool v. Matagorda County*, 52 S.W.3d 128, 131, 134–35 (Tex. 2000) (rejecting insurance company's implied-in-fact and quasi-contractual claims for recoupment and stating that "a unilateral reservation-of-rights letter cannot create rights not contained in the insurance policy").

[2] *See, e.g., Utica Mut. Ins. Co. v. Rohm & Haas Co.*, 683 F. Supp. 2d 368, 372 (E.D. Pa. 2010); *Gen. Star Indem. Co. v. V.I. Port Auth.*, 564 F. Supp. 2d 473, 476 (D.V.I. 2008).

[3] *Attorneys Liab. Prot. Soc'y, Inc. v. Ingaldson Fitzgerald, P.C.*, 370 P.3d 1101, 1103 (Alaska 2016).

[4] *See Liberty Mut. Ins. Co. v. FAG Bearings Corp.*, 153 F.3d 919, 924 (8th Cir. 1998).

[5] *See Great Am. Assurance Co. v. PCR Venture of Phoenix LLC*, 161 F. Supp. 3d 778, 787 (D. Ariz. 2015); *Med. Liab. Mut. Ins. Co. v. Alan Curtis Enters., Inc.*, 285 S.W.3d 233, 238 (Ark. 2008); *Perdue Farms, Inc. v. Travelers Cas. & Sur. Co. of Am.*, 448 F.3d 252, 258 (4th Cir. 2006).

[6] *See, e.g.*, *Gen. Agents Ins. Co. of Am. v. Midwest Sporting Goods Co.*, 828 N.E.2d 1092, 1103–4 (Ill. 2005); *Westchester Fire Ins. Co. v. Wallerich*, 563 F.3d 707, 719 (8th Cir. 2009).

[7] *See, e.g.*, *Horace Mann Ins. Co. v. Hanke*, 312 P.3d 429, 436 (Mont. 2013); *Travelers Prop. Cas. Co. of Am. v. Hillerich & Bradsby Co.*, 589 F.3d 257, 268 (6th Cir. 2010).

[8] *See Transp. Ins. Co. v. Freedom Elecs. Inc.*, 264 F. Supp. 2d 1214, 1221 (N.D. Ga. 2003); *see also Ill. Union Ins. Co. v. NRI Const. Inc.*, 846 F. Supp. 2d 1366, 1377 (N.D. Ga. 2012).

[9] *See, e.g.*, *Lawyers Title Co., LLC v. Kingdom Title Sols., Inc.*, 592 F. App'x 345, 351 (6th Cir. 2014) (citing *Legros v. Tarr*, 44 Ohio St. 3d 1, 540 N.E.2d 257, 263 (Ohio 1989) (an implied-in-fact contract "is shown by the surrounding circumstances which made it inferable that the contract exists as a matter of tacit understanding")).

[10] *Lawyers Title Co.*, 592 F. App'x at 351 (quoting *Lake Land Emp. Grp. of Akron, LLC v. Columber*, 101 Ohio St. 3d 242, 2004 Ohio 786, 804 N.E.2d 27, 31 (Ohio 2004)).

[11] *Lawyers Title Co.*, 592 F. App'x at 351 (citing *Stepp v. Freeman*, 119 Ohio App. 3d 68, 694 N.E.2d 510, 514 (Ohio Ct. App. 1997)).

[12] *PhotoMedex, Inc. v. St. Paul Fire & Marine Ins. Co.*, No. 07-0025, 2008 U.S. Dist. LEXIS 8526, at *67 (E.D. Pa. Feb. 6, 2008) (insurer obligated to pay for independent counsel under Pennsylvania law, following insurance company reservation of rights).

[13] *PhotoMedex, Inc*, 2008 U.S. Dist. LEXIS 8526, at *67.

[14] *Webb v. Witt*, 379 N.J. Super. 18, 35 (App. Div. 2005).

[15] *Dynamic Concepts, Inc. v. Truck Ins. Exch.*, 61 Cal. App. 4th 999, 1006 (Ct. App. 1998).

[16] *Dynamic Concepts*, 61 Cal. App. 4th at 1007.

[17] *Dynamic Concepts*, 61 Cal. App. 4th at 1007 (emphasis in original).

[18] *Dynamic Concepts*, 61 Cal. App. 4th at 1007.

[19] *Dynamic Concepts*, 61 Cal. App. 4th at 1008.
