Policyholders' Perspective

Why Insurance Companies Should Lose the Battle over Recoupment of Defense Costs

By William Gorman Passannante and Jessica Goldberg

Defense counsel's pleasure at having their client defended need not be shattered by a recoupment claim for past defense costs.

Defense counsel are often pleased that a liability insurance company is paying for the defense of their client. Conversely, defense counsel are often discomfited after a defense has been waged and the defense client is the target of a recoupment claim by the insurance company for past defense costs.

Some insurance companies recently have argued to recoup the defense expenses they incur while defending their policyholder against lawsuits. They make these attempts even in the absence of: (1) an agreement regarding such recoupment written into the insurance policy, (2) a bilateral non-waiver agreement signed by the policyholder, and (3) suitable recognition of the nature of the duty to defend.

Current Recoupment Appeals

Indeed, this recoupment argument has become so widespread that at the time of this writing, one state high court and one United States Court of Appeal have this very issue before them. *St. Paul Fire and Marine Ins. Co v. Bodell Construction Co.*, No. 20-cv-00288 DKW-WRP (Hawaii Supreme Court, argued 2023) (certified question currently *sub judice*); and *Berkley National Ins. Co. v. Atlantic-Newport Realty LLC*, No. 22-1959 (United States Court of Appeals for the First Circuit, to be argued during October 2023).

How Did Policyholder-Defendants Get Here?

Policyholders purchase liability insurance as protection from litigation and loss. Thepromise of liability insurance is in large part litigation insurance. A lawsuit naming the policyholder as a defendant including claims that might fall within the insurance policy's coverage triggers the duty to defend. *Evanston Ins. Co. v. Law Office of Michael P. Medved, P.C.*, 890 F.3d 1195, 1198 (10th Cir. 2018). The insurance company must provide a complete defense, which includes payment of the policyholder's legal fees for defending the lawsuit. *Cal. Ins. Co. v. Stimson Lumber Co.,* 325 F. App'x 496, 499 (9th Cir. 2009). Most general liability insurance policies do not mention recoupment of defense costs.

Most General Liability Insurance Policies Do Not Contain a Recoupment Clause

Since virtually all general liability insurance policies do not contain a clause indicating the policyholder's agreement to a possible recoupment of defense expenses, insurance companies are left with few options to pursue their recovery. According to Professor Stempel, "Prohibiting recoupment absent an enforceable provision in the policy itself is not a rule oppressing insurers…." Jeffrey W. Stempel, "A Deeper Dive into Nautilus: Differentiating Insurer Efforts to Recover Defense Costs and Assessing Recoupment in the Wake of the ALI Restatement," 57, 92 (2022). *Scholarly Works*. 1358. ***https://scholars.law.unlv.edu/facpub/1358*** ("*A Deeper Dive*") The professor also notes that "[i]nsurers of course are free to include such language in the policies that they draft but have consis-

William Gorman Passannante is a DRI member and co-chair of Anderson Kill's Insurance Recovery Group and is a nationally recognized authority on policyholder insurance recovery in D&O, E&O, asbestos, environmental, property, food-borne illness, and other insurance disputes. He represents global corporations and educational and governmental institutions. **Jessica Goldberg** is a Fordham Law student and was a Summer Associate at Anderson Kill. Jessica was a Judicial Intern for the New York Court of Appeals and earned her B.A. from the University of Wisconsin - Madison. Upon graduating law school this spring, she will be joining Anderson Kill's Insurance Recovery Group.

tently declined to do so despite being well aware of the issue." *A Deeper Dive* at 58.

One notable contrast to the absence of a recoupment clause in the general liability insurance policy is executive insurance – the D&O liability insurance policy. Directors and officers often are entitled to payment of defense expenses *by the corporation* and the corporation usually requires an *undertaking* signed by the director or officer promising that if the corporation is not permitted to pay the defense costs the director or officer will repay the corporation for the costs expended that the corporation was not permitted by law to pay. *See generally*, Delaware Code § 145(e), 'Indemnification of officers, directors, employees and agents; insurance;' *Marino v. Patriot Rail Co. LLC*, 131 A.3d 325, 334 (Del. Ch. 2016). Further, D&O policies do cover those defense expenses paid by the corporation on behalf of their D&Os, and some D&O insurance policies specifically call for reimbursement to the insurance company of defense costs that the corporation was not permitted by law to pay. The D&O executive liability context with its corporate indemnification and undertakings called for by statute bears no similarity to the context of a general liability policy with a duty to defend. However, the insurance policies that do contain recoupment clauses provide a marked contrast to insurance policies that do not.

The Unilateral Reservation of Rights – Not a Non-Waiver Agreement

Some insurance companies have attempted to recoup defense costs already paid by sending a reservation of rights letter in which they acknowledge their defense obligation to the policyholder under a reservation of rights.

Insurance companies have always had a different legal device available, the bilateral "non-waiver agreement," which if it were agreed to would be signed by the policyholder as an indication of agreement even if not supported by additional considerations. *See Shelby Steel Fabricators, Inc. v. United States Fid. & Guar. Ins. Co.,* 569 So.2d 309, 311 (Ala. 1990). "A nonwaiver agreement is one in which the insured and the insurance company agree in writing that neither party will waive any of its rights under the policy as a result of the investigation or defense of an action brought against the insured." Magarick & Brownlee, 1 *Casualty Insurance Claims* § 19:7, "Nonwaiver Agreements" (4th ed. June 2023 Update); *6A Couch on Insurance* § 97:34, "Nonwaiver agreement" (3d ed. June 2023 Update). In our experience, policyholders usually decline to enter nonwaiver agreements.

By contrast, policyholders would argue that unilateral reservation of rights letters attempt to create a right not contained in the policy (because policyholders likely would not buy and regulators might object to such policies) and not in any non-waiver agreement (because policyholders often won't sign them). Still, insurance companies send unilateral reservation of rights letters containing clauses such as: "[Insurance company] specifically reserves its right to seek reimbursement of defense costs incurred on [the policyholder's] behalf for all claims which are not potentially covered by the [Insurance] Policy." *Cont'l Cas. Co. v. Winder Labs., LLC,* 73 F.4th 934, 939 (11th Cir. 2023).

Insurance companies' use of reservations of rights in this way have led to considerable litigation on the question: Should insurance companies be able to recoup defense costs after a court finds that the policyholder is not entitled to coverage, where the right to do so was never stated in the insurance policy but was later asserted by the insurance company in a reservation of rights letter?

Reservation of Rights Letters Are Not Binding Contracts Because They Are Not Supported by Consideration

Insurance companies sometimes argue that accepting the insurance company's defense under a reservation of rights without specifically objecting forms an implied contract. *United Nat'l Ins. Co. v. SST Fitness Corp.*, 309 F.3d 914, 916 (6th Cir. 2002). In an Eleventh Circuit case, *Continental Casualty Co. v. Winder Laboratories, LLC,* the court rejected the insurance company's argument that a reservation of rights letter, which included a recoupment clause, was a contract. *Winder*, 73 F.4th at 946. The Eleventh Circuit found that because the reservation of rights letter was not supported by any consideration, it was not a contract

binding on the policyholder. The reservation of rights was not supported by consideration because it neither imposed any new obligations on the insurance company, nor provided the policyholder with any new benefits. *Winder*, 73 F.4th at 946. Pre-existing contract obligations cannot serve as consideration, as they were not bargained for in a new agreement. In this case, the original insurance policy already provided the policyholder with the benefit of the insurance company's defense. *Winder*, 73 F.4th at 946.

Therefore, because the recoupment provision in the reservation of rights is not supported by any new consideration, the reservation of rights does not constitute a new binding contract and is unenforceable against the policyholder. *Winder*, 73 F.4th at 946.

A reservation of rights letter is not a contract. Rather, a reservation of rights letter provides notice of asserted defenses and exclusions contained in the insurance policy. *Am. W. Home Ins. Co. v. Gjonaj Realty & Mgmt. Co.*, 192 A.D.3d 28, 40 (2d Dep't 2020) (no recoupment of defense costs based on reservation of rights letter). An insurance company cannot unilaterally create rights by including new provisions in the reservation of rights letter that were not contemplated in the insurance policy. *Gjonaj*, 192 A.D.3d at 40. Such a setting places policyholders in the unfair position of making a Hobson's Choice, where the policyholder must either accept the insurance company's additional conditions or lose its right to a defense provided for and paid for by the insurance company. *Gen. Agents Ins. Co. of Am., Inc. v. Midwest Sporting Goods Co.*, 828 N.E.2d 1092, 1102 (Ill. 2005).

The sequential performance leads to insurance companies defending, while purportedly reserving the right to recoup defense costs, potentially leads to bad faith post-claim underwriting.

In *Buss v. Superior Court,* 939 P.2d 766, 776-77 (Cal. 1997) the California Supreme Court did not find a contractual right, but instead found that the insurance companies in that case had a "quasi-contractual" right to recoupment of defense costs in the defense of "claims that are not even potentially covered." *Buss*, 939 P2d at 776-77.

Does Implying a Recoupment Right Amount to Post-Claim Underwriting?

Scholars have explained that insurance companies have a distinct advantage in bargaining power over policyholders—from taking advantage of the "sequential character of contractual performance" embodied in insurance policies. *See* Thomas C. Cady & Georgia Lee Gates, *Post Claim Underwriting*, 102 W. Va. L. Rev. 809, 826 (2000) (citing Richard A. Posner, *Economic Analysis of Law* § 4.1, at 103 (5th ed. 1998)) (hereinafter "Post Claim Underwriting"). Sequential performance under an aleatory agreement creates a delay in the insurance company's performance of its duty in paying under the policy.

> *An insurer engaged in post claim underwriting tries to take advantage of the postponement in fulfilling its promise, made possible by sequential performance, by waiting until after a claim has been filed to determine [a policyholder's] eligibility. It takes advantage of the [policyholder] because it continues to accept premiums from the [policyholder], knowing that it will later challenge the [policyholder]'s eligibility for coverage to avoid contract performance. As a consequence, the law of contracts should protect the [policyholder] from an insurer's efforts to implement post claim underwriting as a means of taking advantage of the vulnerabilities created by sequential performance.*

Post Claim Underwriting at 827. Post-loss underwriting harms policyholders because "it culminates in either an irresponsible decision not to pay, or an unwarranted delay in payment." *Post Claim Underwriting* at 830.

The same aleatory nature of the insurance policy – the policyholder has paid premiums up front and must rely upon the good faith performance of the insurance company to obtain the benefit of its bargain – leads also to the opportunity to assert after-the-fact reservations regarding performance under the policy. Thus, the sequential performance leads to insurance companies defending, while purportedly reserving the right to recoup defense costs, potentially leads to bad faith post-claim underwriting. Post-claim underwriting occurs where an insurance company attempts to avoid indemnifying their policyholder for a claim because they failed to adequately assess the risk of such a claim when they originally sold the insurance policy. *Post Claim Underwriting* at 829-30. Many policyholders contend that insurance companies engage in post-claim underwriting by playing on the aleatory nature of insurance contracts. *RESTATEMENT (FIRST) OF CONTRACTS* §291. Insurance companies, some argue, exploit this characteristic by continuing to accept premiums from the policyholder, knowing that they will later challenge the policyholder's entitlement to coverage under the policy if the uncertain event comes to fruition. *Post Claim Underwriting* at 827. If determined, post-claim underwriting has been called per se bad faith. *Anderson v. Cont'l Ins. Co.*, 271 N.W.2d 368 (Wis. 1978).

By asserting a recoupment clause in a reservation of rights when such clause was not contained in the insurance policy sold to the policyholder, insurance companies may be exposed to arguments by policyholders of post-claim underwriting.

Allowing Recoupment of Defense Costs Ignores the Nature of the Duty to Defend

Some courts having determined no coverage for a particular claim under an insurance policy find that insurance companies can therefore recoup defense costs previously expended. *Nautilus Ins. Co. v. Access Med., LLC*, 482 P.3d 683, 688 (Nev. 2021). However, this argument is at odds with the broad duty to defend which specifically is designed to eliminate uncertainty and protect policyholders against any possible covered claim. Some other courts have noted that allowing recoupment of defense costs

is contrary to the long-held principle that the duty to defend is broader than the duty to indemnify. *Gjonaj*, 192 A.D.3d at 34. The duty to defend is triggered when there is even potential for coverage, and the court further explains that, "an insurer may be contractually bound to defend even though it may not ultimately be bound to pay." *Id.* at 34-35. *Fluor Corp. v. Zurich Am. Ins. Co.,* No. 4:16CV00429 ERW, 2021 WL 3021973, at *22 (E.D. Mo. July 16, 2021) (resolution of question of coverage would not retroactively eliminate insurance company's duty to defend policyholder).

Recoupment of Defense Costs Forces Policyholders to Shoulder All Risks Inherent in the Insurance Company-Policyholder Relationship

When insurance companies choose to defend policyholders in underlying litigation, they are doing so for their own self-interest. Section 21 of the Restatement of the Law of Liability Insurance titled "Insurer Recoupment of the Costs of Defense" states that there are profound benefits for an insurance company choosing to defend a policyholder in underlying litigation. *RESTATEMENT OF THE LAW OF LIABILITY INSURANCE* §21 (AM. LAW INST. 2019) ("RLLI"). These benefits include maintaining control over the costs, quality and direction of defense, obtaining access to privileged defense-related materials, and participating in settlement discussions. RLLI at §21. In turn, insurance companies know that if a claim against their policyholder is within the scope of coverage, the insurance company's interests in the resolution of litigation are protected.

However, at the same time, the policyholder is put into a difficult position when considering whether to accept the insurance company's defense. The policyholder must evaluate how vigorous the defense is that the insurance company is providing while also considering that they may need to reimburse the insurance company for the entire cost of the defense. *John Moriarty & Assocs. v. Zurich Am. Ins. Co.*, 207 N.E.3d 542, 551 (Mass. App. Ct. 2023). A Massachusetts appeals court saw this concern to be so grave for policyholders that the court found that a policyholder had standing to seek a declaratory judgment regarding the scope of the insurance company's duty to defend before the insurance company even attempted to recoup defense costs. *Moriarty*, 207 N.E.3d at 551. The court explained, "…[the insurance company]'s reservation of the right to recoup 'has an immediate impact on [the policyholder]'s defense strategy (and ability to defend itself) in the [u]nderlying [a]ction.'" *Moriarty*, 207 N.E.3d at 552.

Case Law on Recoupment in Various Fact Patterns

A number of state high courts and courts of appeal have expressly rejected insurance companies' attempt to imply a recoupment provision not contained in the insurance policy:

Continental Cas. Co. v. Winder Labs., LLC, 73 F.4th 934, 946 (11th Cir. 2023) (since reservation of rights was not supported by consideration, no contract binding policyholder was formed);

Attorneys Liab. Prot. Soc'y, Inc. v. Ingaldson Fitzgerald, P.C., 370 P.3d 1101 (Alaska 2016) (prohibiting enforcement of a policy provision permitting reimbursement of fees and costs incurred by insurance company defending under reservation of rights);

Nat'l Sur. Corp. v. Immunex Corp., 297 P.3d 688, 695 (Wash. 2013) (reimbursement predicated on unilateral reservation of rights is inconsistent with principles of Washington law);

United States Fid. & Guar. Co. v. United States Sports Specialty Ass'n, 270 P.3d 464 (Utah 2012) (Insurance company may not seek recoupment based on theory of unjust enrichment where no provision in insurance policy);

American and Foreign Ins. Co. v. Jerry's Sport Ctr., Inc., 2 A.3d 526, 539 (Pa. 2010) (reimbursement to insurance company is inconsistent with duty to defend and unilateral reservation of rights letter cannot create rights not contained in insurance policy);

Med. Liab. Mut. Ins. Co. v. Alan Curtis Enters. Inc., 285 S.W.3d 233, 235-237 (Ark. 2008) (insurance company may not rely on unilateral reservation of rights letter to recoup attorney fees and costs expended in defense);

Excess Underwriters at Lloyd's, London v. Frank's Casing Crew & Rental Tools, Inc., 246 S.W.3d 42, 54 (Tex. 2008) (policyholder did not impliedly consent to reimburse insurance companies and no right to reimbursement under equitable theories of quantum meruit and assumpsit);

General Agents Ins. Co. of Am., Inc. v. Midwest Sporting Goods Co., 828 N.E.2d 1092, 1100-1101 (Ill. 2005) (insurance companies may not seek reimbursement of defense costs); and

Shoshone First Bank v. Pac. Emp'rs Ins. Co., 2 P.3d 510, 514 (Wyo. 2000).

A number of trial courts have found that no right to recoup defense costs should be implied into standard-form insurance policies. *Selective Ins. Co. of Am. v. Smiley Body Shop, Inc.*, 260 F. Supp. 3d 1023 (S.D. Ind. 2017) (rejected insurance company attempt to recoup under standard liability insurance policy); *Hayes v. Wisconsin & Southern Railroad, LLC*, 514 F. Supp. 3d 1055 (E.D. Wis. 2021) (Wisconsin law did not permit insurance company to pursue claim of unjust enrichment to recover costs of defense); *Twin City Fire Ins. Co. v. Hartman, Simons & Wood, LLP*, No. 13-CV-1608-SCJ, 2017 WL 11497779 (N.D. Ga. Feb. 28, 2017) (no claim for "recoupment" for unjust enrichment under Georgia law, and party may not assert unjust enrichment claim where express contract governs relationship between parties).

Similarly, commentators have reached the same conclusion at the time of the last restatement of the law of liability insurance. *Restatement of the Law of Liability Insurance* (2018). The pro-policyholder view is soundly reasoned and consistent with public policy. Restatement of the Law of Liability Insurance § 21.

Other state high courts have reached the opposite conclusion and permitted attempts to recoup in distinct fact patterns:

Nautilus Ins. Co. v. Access Med., LLC, 482 P.3d 683 (Nev. 2021) (4-3 decision, and insurance company immediately commenced declaratory judgment action as it sent reservation of rights letter);

Travelers Cas. & Sur. Co. v. Ribi Immunochem Research, Inc., 108 P.3d 469, 480 (Mont. 2005);

Sec. Ins. Co. of Hartford v. Lumbermens Mut. Cas. Co., 826 A.2d 107, 125 (Conn. 2003) ("implied in law" and "quasi-contractual" recoupment);

Buss v. Super. Ct., 939 P.2d 766 (Cal. 1997) (only one of twenty-seven claims at issue potentially was covered); and

Hecla Mining Co. v. New Hampshire Ins. Co., 811 P.2d 1083, 1089 (Colo. 1991) (finding ability to recoup in dicta).

A number of trial courts have permitted insurance companies to attempt to recoup in certain circumstances. *Marcus v. Allied World Ins. Co.*, 384 F. Supp. 3d 115, 126 n.22 (D. Me. 2019) (recoupment allowed under claims-made professional liability policy where policyholder did not reject reservation of rights to seek recoupment of defense costs). *Catlin Specialty Ins. Co. v. CBL & Assocs. Props., Inc.*, 2018 WL 3805868 (Del. Super. Ct. Aug. 9, 2018) (permitting recoupment under Tennessee law and Contractor's Protective, Professional, and Pollution Liability Insurance Policy); *GGA, Inc. v. Kiewit Infrastructure West Co.*, 611 F. Supp. 3d 1000, 1003 (D. Haw. 2020) (noting conflicting Hawaii law on the recoupment issue and differentiating case from typical insurance duty to defend because defense was pursuant to indemnity clause but permitting recoupment of fee expenditures).

Conclusion

Defense counsel's pleasure at having their client defended need not be shattered by a recoupment claim for past defense costs.

The recent trend in authority shows without an agreement in the insurance policy or a bilateral non-waiver agreement signed by the policyholder, recoupment claims are extraordinarily difficult for insurance companies. Defense counsel may take some comfort that suitable recognition of the nature of the duty to defend will protect against recoupment claims.