Breaking Down Insurers' Improper Recoupment Efforts

By **William Passannante and Nicholas Bradley** (November 3, 2023)

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When an insurance company defends a policyholder in litigation, the client or its counsel does not expect the insurance company to demand defense expenses back.

In a recent trend, however, insurance companies have sought to recoup defense costs from their policyholders, arguing retrospectively that the underlying litigation was not eligible for coverage. Shockingly, insurance companies bring recoupment actions despite the absence of a recoupment agreement written into the policy or a bilateral nonwaiver agreement agreed to by the policyholder.

Even worse, insurance companies sometimes argue that a policyholder's acceptance of a defense under a reservation of rights somehow amounts to an implied contract favoring recoupment.

Efforts at recoupment are contrary to an insurance company's duty to defend and constitute an improper attempt to have their cake and eat it too by choosing to collect premiums for an insurance policy without a recoupment clause and then seeking repayment of defense costs.

Below, we analyze insurance companies' arguments favoring recoupment and identify counterarguments that policyholders can deploy to fend off these improper recoupment efforts.

The law may be improving for policyholders in recoupment cases.

A matter recently argued before the Supreme Court of Hawaii illustrates a typical recoupment fact pattern.

In the litigation underlying St. Paul Fire and Marine Insurance Co. v. Bodell Construction Co., a homeowner's association sued a realty company, Sunstone Realty Partners Inc., for construction defects in a new apartment building. Sunstone tendered defense to its insurance company, St. Paul Fire and Marine Insurance Co., under its own general liability insurance policy and as a named insured under the policies for Bodell Construction Co.

St. Paul accepted the defense, issued a reservation of rights letter, and secured settlements through arbitration.

Once the underlying case was closed, St. Paul sued Bodell and Sunstone, claiming that it owed no duty to defend and seeking reimbursement of the defense costs. Although the disputed policies contained no right to recoup those costs, St. Paul contended that Bodell and Sunstone had been unjustly enriched by its defense of uncovered claims.

The U.S. District Court for the District of Hawaii certified four questions on equitable reimbursement to the Hawaii Supreme Court, which heard argument in July. The court's decision remains pending.

The U.S. Court of Appeals for the First Circuit heard a similar appeal in October in Berkley National Insurance Co. v. Granite Telecommunications LLC, which arose from a summary judgment decision in the District of Massachusetts and found that the plaintiff insurance company is entitled to reimbursement for the costs of defending claims falling within policy exclusions.

As in St. Paul Fire and Marine, the insurance company argued that the policyholder was unjustly enriched by its defense of uncovered claims, which argument betrays a certain cynicism when one sells insurance policies that define the relationship between the insurance company and the policyholder.

Most general liability policies do not contain a recoupment clause.

Perhaps the most concerning theme of St. Paul Fire and Marine and Berkley National is that the insurance companies' equitable recoupment arguments did not arise from any language contained in the insurance policies.

Indeed, most general liability policies do not contain a clause by which the policyholder agrees that the insurance company may recoup the costs of defending underlying claims later determined to be outside the policy coverage.

While it is common for some policies, like executive or directors and officers liability, to contain recoupment clauses that parallel corporate indemnification obligations under state corporate law, insurance companies typically choose not to include those terms in general liability policies.[1]

In the unique context of D&O policies, a recoupment provision typically provides that, if the corporation is not permitted by law to pay the defense costs, the director or officer will repay the insurance company for any defense costs the corporation could not pay.[2]

However, since those policies frequently do not cover defense costs that the corporation pays on behalf of its directors or officers, or they require reimbursement to the insurance company of costs the corporation was not permitted to pay, D&O policies do not provide a useful analogy for examining recoupment arguments under CGL policies.

The unilateral reservation of rights is not a nonwaiver agreement.

The reservation of rights letter is a legal device on which insurance companies frequently base their arguments for recoupment.

These letters, issued in response to a policyholder's tender of a claim, acknowledge the insurance company's duty to defend and purport to reserve the company's right to recoup defense costs if it later determines that the claim was not eligible for coverage — as well as any other rights and defenses purported to exist under the policy.

Despite the popularity of reservation of rights letters, insurance companies have always had a different device available to the policyholder's agreement: the bilateral nonwaiver agreement.

A nonwaiver agreement provides 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."[3] At least one court has held that a nonwaiver agreement will be enforceable if signed by the policyholder.[4] In our experience, policyholders usually decline to enter

nonwaiver agreements.

The reservation of rights letter is problematic because it attempts to create a right not contained in the policy. Insurance companies understand that customers are unlikely to purchase a policy containing a reimbursement provision and that regulators would likely object to its inclusion.

Nevertheless, insurance companies persist in sending unilateral reservation of rights letters stating that "[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."[5] These letters constitute an after-the-fact attempt by insurance companies to insert a right to recoup into the insurance policy which does not appear in the language of the policy sold.

Known as post-claim underwriting, this conduct may be treated by a court as per se evidence of bad faith.[6]

Unilateral reservation of rights letters are not binding agreements because they are not supported by consideration.

Insurance companies sometimes argue that a policyholder's acceptance of the defense under a reservation of rights without specific objection forms an implied contract.[7]

That argument flies in the face of reality.

In one recent example from July, Continental Casualty Co. v. Winder Laboratories LLC, the U.S. Court of Appeals for the Eleventh Circuit rejected such an argument because the reservation of rights was not supported by any consideration and, therefore, was not a contract.[8]

Specifically, the reservation of rights neither imposed new obligations on the insurance company nor provided the policyholder with any new benefits, since preexisting contract obligations cannot serve as new consideration.[9]

At most, a reservation of rights letter is a notice to the policyholder of asserted defenses and exclusions contained in the insurance policy.[10] A reservation of rights cannot create new provisions that were not contained in the original insurance policy, as doing so would force policyholders to choose between accepting the additional conditions or losing the right to the insurance company's defense.[11]

Insurance company recoupment arguments contradict their obligations under the duty to defend.

The duty to defend arises from the liability insurance policy and provides that an insurer must defend claims, even where it disputes coverage for that claim.[12] The duty is triggered when there is even the potential for coverage. In other words, the duty to defend is broader than the duty to indemnify.

While it may seem self-evident to the casual observer that an insurance company should not be able to rewrite the insurance policy once it is sold, courts are split on the application of this principle to the issue of recoupment. Some have permitted recoupment after determining that the claim was not covered under the disputed policy, finding retroactively that there was no duty to defend.[13] In those cases, the courts reasoned that the

insurance company's reservation of rights when providing a defense was sufficient to permit recoupment once the court determined no coverage existed.[14]

Courts declining insurance company requests for recoupment typically recognize that a subsequent finding of no coverage only relieves the insurance company of its duty to defend going forward and does not create a right to reimbursement after the fact.[15]

Avoid insurance company overreach — they may not have their cake and eat it too.

An insurance company enjoys considerable benefits from its choice to defend a policyholder in litigation. These benefits include control over defense costs and the direction of litigation, access to privileged defense-related materials, and the ability to participate in settlement discussions.[16]

By providing the policyholder with a defense, an insurance company can use its elevated position of control to protect its own interests.

In that context, an insurance company's pursuit of recoupment after providing its policyholder with a complete defense — controlled by the insurance company itself — whiffs of double-dipping.

Policyholders rejecting an insurance company demand for recoupment of defense costs may take the position that there is no right to recoupment in the underlying policy and that a reservation letter does not create one. Indeed, the insurance company's attempt to create such a right after the fact may bear indicia of post-claim underwriting, a practice disfavored by many courts.[17]

Moreover, a policyholder's acceptance of defense under a reservation of rights does not create an implied contract in favor of recoupment because there is no consideration.[18] Finally, counsel should remind the court of the breadth of an insurance company's duty to defend and, where possible, argue that the duty cannot be relieved retroactively.[19]

Having chosen to collect premiums for liability insurance policies without a recoupment clause, insurance companies have had their cake. One slice will suffice.

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[1] See 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 Tort Trial & Ins. Practice L. J. 57, 58 (2022) ("Insurers of course are free to include such language in the policies that they draft but have consistently declined to do so despite being well aware of the issue.").

[2] See generally, Del. Code § 145(e) ("Indemnification of officers, directors, employees and agents; insurance"); and Marino v. Patriot Rail Co., 131 A.3d 325, 334 (Del. Ch. 2016).

[3] Magarick & Brownlee, 1 Casualty Insurance Claims § 19:7, "Nonwaiver Agreements" (4th ed. June 2023); 6A Couch on Insurance § 97:34, "Nonwaiver agreement" (3d ed. June 2023).

[4] See Shelby Steel Fabricators, Inc. v. U.S. Fid. & Guar. Ins. Co., 569 So.2d 309, 311 (Ala. 1990).

[5] Cont'l Cas. Co. v. Winder Labs. LLC, 73 F.4th 934, 939 (11th Cir. 2023).

[6] See, e.g., Anderson v. Cont'l Ins. Co., 271 N.W.2d 368 (Wis. 1978). See generally Thomas C. Cady & Georgia Lee Gates, Post Claim Underwriting, 102 W. Va. L. Rev. 809, 826 (2000).

[7] See, e.g., United Nat'l Ins. Co. v. SST Fitness Corp., 309 F.3d 914, 916 (6th Cir. 2002); and Cont. Cas. Co. v. Winder Labs. LLC, 73 F.4th 934, 946 (11th Cir. 2023).

[8] See 73 F.4th at 946.

[9] See id.

[10] See Am. W. Home Ins. Co. v. Gjonaj Realty & Mgmt. Co., 192 A.D.3d 29, 40 (2d Dep't 2020) (rejecting recoupment argument based on a reservation of rights).

[11] See Gjonaj, 192 A.D.3d at 40; and Gen. Agents Ins. Co. v. Midwest Sporting Goods Co., 828 N.E.2d 1092, 1102 (Ill. 2005). But see Buss v. Superior Court, 939 P.2d 766, 776-77 (Cal. 1997) (finding that the insurance company had a "quasi-contractual right" to recoupment where the defended claims were "not even potentially covered.").

[12] See Gjonaj, 192 A.D.3d at 34-35.

[13] See, e.g., Nautilus Ins. Co. v. Access Med. LLC, 482 P.3d 683, 688 (Nev. 2021) (no duty to defend arose because the claim was not even potentially covered); and Makarka v. Great Am. Ins. Co., 14 P.3d 964, 969 (Ala. 2000) (no duty to defend where claim was outside the policy period).

[14] See Nautilus Ins. Co., 482 P.3d at 691.

[15] See, e.g., Am. and Foreign Ins. Co. v. Jerry's Sport Center, Inc., 2 A.3d 526, 613-14 (Pa. 2010); and Fluor Corp. v. Zurich Am. Ins. Co., 2021 WL 3021973 at *22-23 (E.D. Mo. 2021) ("Under Missouri law, any resolution of the question of coverage only relieves the defending insurer of its duty to defend going forward and will not retroactively eliminate the insurer's duty to defend the insured.").

[16] See Restatement of Liability Ins. § 21 (Am. Law Inst. 2019) ("Insurer Recoupment of the Costs of Defense").

[17] See, e.g., Anderson v. Cont'l Ins. Co., 271 N.W.2d 368 (Wis. 1978).

[18] See Am. W. Home Ins. Co. v. Gjonaj Realty & Mgmt. Co., 192 A.D.3d 29, 40 (2d Dep't 2020).

[19] See, e.g., Am. and Foreign Ins. Co. v. Jerry's Sport Center, Inc., 2 A.3d 526, 613-14

(Pa. 2010); and Fluor Corp. v. Zurich Am. Ins. Co., 2021 WL 3021973 at *22-23 (E.D. Mo. 2021).