ALM | LAW.COM

New York Law Journal

New York Courts Reject Insurance Companies' Attempts to Recoup Defense Costs

By Raymond A. Mascia Jr. and William G. Passannante

May 24, 2024

Under a liability insurance policy, an insurance company promises to defend its policyholder and provide "litigation insurance" *Continental Casualty v. Rapid-American*, 80 N.Y.2d 640, 648 (1993). Thus, when an insurance company defends a policyholder in litigation, the policyholder does not expect the insurance company to demand that the policyholder pay it back.

In recent years, however, insurance companies have increasingly sought to "recoup" defense costs paid for their policyholder's defense, arguing retrospectively that the litigation was not actually covered by the policy. Surprisingly, the insurance companies often seek recoupment, while ignoring the purpose of the duty to defend, and when their policies do not include any contractual provision allowing for recoupment. They often base recoupment on a reservation of rights letter. These letters, which the insurance company sends in response to a policyholder's notice of a claim, acknowledge the insurance company's duty to defend, but then purportedly reserve the option to recoup defense costs if

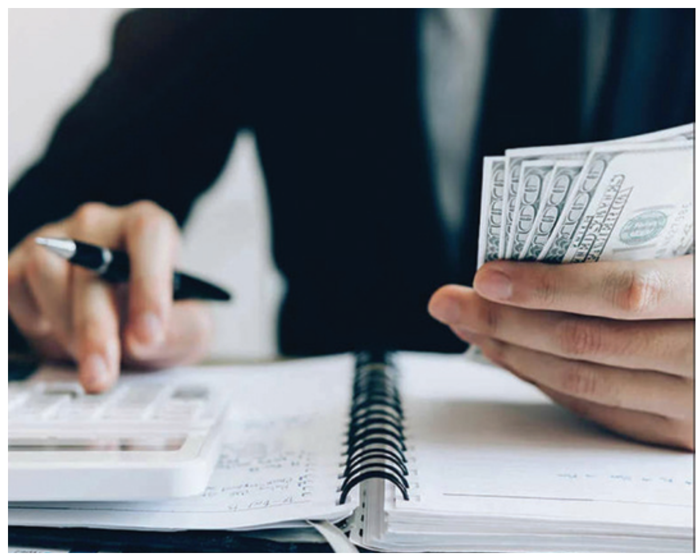

Photo: Wutzkoh via Adobe Stock

the insurance company later determines that the underlying claim was not covered.

Recently, several New York federal and state courts have held that an insurance company has no right to recoup defense costs where the insurance policy includes a duty to defend, but does not include an express contractual provision allowing for recoupment. These decisions correctly recognize that recoupment of defense costs violates New York law on contracts and the duty to defend, which is useless if the defense is not provided unequivocally at the time of litigation. Here, we discuss these recent New York decisions.

Liability Insurance Functions as Litigation Insurance

Policyholders purchase liability insurance to protect against litigation and loss. Liability policies include separate duties to defend and indemnify. Under its duty to indemnify, the insurance company must pay for a claim against the policyholder—by funding a settlement or paying a judgment against the policyholder, for example.

The duty to defend, on the other hand, protects the policyholder by providing a defense. The duty to defend is broader than the duty to indemnify. Under New York law (and universally), an insurance company must defend its policyholder "whenever the four corners of the complaint suggest—or the insurer has actual knowledge of facts establishing—a reasonable possibility of coverage." *Fitzpatrick v. American Honda Motor*, 78 N.Y.2d 61, 66-67 (1991).

Under its duty to indemnify, the insurance company must pay for a claim against the policyholder— by funding a settlement or paying a judgment against the policyholder, for example.

In other words, the insurance company must defend the entire action—even if there are uncovered aspects of that action—as long as a single claim arguably is covered by the policy. *Town of Massena v. Healthcare Underwriters Mutual Insurance*, 98 N.Y.2d 435, 443 (2002).

This "litigation insurance" includes the payment of the policyholder's defense costs in defending the litigation. Most general liability policies provide defense coverage in addition to the policy's limit of liability and do not contain any mention of recoupment of defense costs. *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").

NY Courts Recently Rejected Insurance Companies' Attempts To Recoup Defense Costs

In New York and nationally, policyholders are winning the battle on recoupment of defense costs. Several New York courts have joined the growing trend of decisions rejecting recoupment. *See, e.g.*, *Crescent Beach Club v. Indian Harbor Insurance*, 468 F. Supp. 3d 515 (E.D.N.Y. 2020); *Century Surety v. Vas & Sons*, No. 17-CV-5392 (DLI), 2018 WL 6164724 (E.D.N.Y. 2018), *report and recommendation adopted by*, 2018 WL 4804656 (E.D.N.Y. 2018); *General Star Indemnity v. Driven Sports*, 80 F. Supp. 3d 442 (E.D.N.Y. 2015); *American Western Home Insurance v. Gjonaj Realty & Management*, 138 N.Y.S.3d 626 (2d Dep't 2020).

These decisions hold that an insurance company has no right to recoup defense costs for the reasons outlined below.

Recoupment Claims Violate Duty To Defend

Allowing recoupment of defense costs would make the duty to defend coextensive with the duty to indemnify, even though New York law clearly holds that the duty to defend is broader than the duty to indemnify. The duty to defend arises even if the underlying claims are false or meritless. Thus, when an insurance company sells a policy with a duty to defend, it contracts "to defend more than the policy obligates the insurer to ultimately pay." *Driven Sports,* 80 F. Supp. 3d at 462.

Recent New York decisions have held that an insurance company may not recoup defense costs because it would "erod[e] this well-established doctrine and effectively would make the duty to defend merely coextensive with the duty to indemnify." *Gjonaj*, 138 N.Y.S.3d at 632.

> The insurance industry generally has chosen not to include recoupment provisions in general liability policies providing a duty to defend.

Indeed, allowing recoupment would make the duty to defend useless and meaningless to policyholders who contracted for and purchased litigation insurance. As one court explained:

[I]f insurers can threaten the later collection of costs, an insured's incentives would change drastically, and he would be faced with a "Hobson's choice" in any close case. In other words, an insured whose claim might be covered could be dissuaded from seeking coverage out of concern that the legal costs would be so prohibitive that the insured could never pay them if a court later disagreed. Thus, the insured would lose the benefit of his bargain with the insurer, which the insured struck believing that the insurer was obligated to defend him, at least initially, even in the most borderline cases.

Driven Sports, 80 F. Supp. 3d at 462.

Unilateral Reservation of Rights Letters Do Not Form Binding Contracts

Insurance companies typically base purported recoupment arguments on reservation of rights letters. Insurance companies argue that a policyholder's acceptance of a defense without a specific objection to the reservation of rights creates an implied contract. New York courts have held that this argument violates basic contract law.

In one recent example, the Second Department Appellate Division rejected this argument, because allowing recoupment based on a reservation of rights "despite the lack of any language in the policy at issue permitting" recoupment "flies in the face of basic contract principles and allows an insurer to impose a condition on its defense that was not bargained for." *Gjonaj*, 138 N.Y.S.3d at 635.

As a matter of contract law, a reservation of rights neither imposes new obligations on the insurance company, nor grants any new benefits to the policyholder, because the preexisting contract cannot serve as new consideration. At most, a reservation of rights letter is a notice of the insurance company's position, but it cannot create new contractual provisions that limit the duty to defend.

Unjust Enrichment Also Inapplicable

Insurance companies sometimes depict their argument for recoupment as an unjust enrichment claim. New York courts recently have rejected this argument as well. Unjust enrichment is a quasi-contractual claim that only applies "in the absence of an actual agreement between the parties." *Crescent Beach Club*, 468 F. Supp. 3d at 554.

However, an insurance policy "is an extensive, detailed contract governing the particular subject matter of coverage for claims". Thus, insurance companies cannot use unjust enrichment to recoup defense costs. *Crescent Beach Club*, 468 F. Supp. 3d at 554-55 ("Since the Policy is an extensive, detailed contract governing the particular subject matter of coverage for claims against [the policyholder], [the insurance company] cannot recover on a quasi-contractual claim for unjust enrichment").

Decisions Recognizing Recoupment Claims Incorrectly Based on Policies that Do Not Provide Duty To Defend

The insurance industry generally has chosen not to include recoupment provisions in general liability policies providing a duty to defend. Thus, the most concerning aspect of this issue is that the insurance industry has based recoupment claims, not on any language actually contained in general liability policies, but on policies that include recoupment provisions or provide a duty to *advance* defense costs, as opposed to a duty to defend.

For example, directors and officers (D&O) liability policies typically provide a duty to pay or advance defense costs and include recoupment provisions because they are intended to mimic corporate indemnification obligations under state corporations laws. This includes the undertakings often required from the individual directors or officers to repay amounts advanced by the corporation in defense costs if it is ultimately determined that they are not entitled to indemnification because of a failure to meet the required standard of conduct under state corporate indemnification law.

In other words, the limited recoupment provisions in D&O policies are aimed at the funds reimbursed via an undertaking if such reimbursement takes place. These D&O policies are not analogous to general liability policies and cannot serve as a basis for recoupment of defense costs paid pursuant to a duty to defend.

As one court explained, "in allowing recoupment, [prior decisions] have ignored the distinction between the duty to defend and the narrower duty to advance defense costs; it is in connection with the latter that recoupment has been authorized under New York law." *Vas & Sons*, 2018 WL 6164724, at *8.

Conclusion

Insurance companies should not be permitted to recoup defense cost paid pursuant to their duty to defend. The recent trend of New York cases recognize that the duty to defend is a promise to provide litigation insurance and that allowing recoupment of defense costs would violate this promise and basic principles of contract law. Policyholders should resist improper attempts to recoup defense costs.

Raymond A. Mascia Jr. *is a shareholder in Anderson Kill's insurance recovery group and co-chair of the firm's Financial Services group.* **William G. Passannante** *is co-chair of the firm's insurance recovery group.*