

RECOVERY OF DEFENSE COSTS INCURRED UNDER A RESERVATION OF RIGHTS

[ref. Liability Insurance Principles, Para. 4.02]

Many liability insurance policies provide that the insurer will defend and indemnify its insured against claims or suits seeking damages caused by a covered occurrence. The insurer's duty to defend an insured in a lawsuit is triggered by the factual allegations of the complaint. As long as any of the allegations arguably fall within the policy's coverage the insurer has a duty to provide the insured with a defense. When a complaint contains covered and noncovered allegations, the insurer is obligated to defend the entire action.

If the insurer believes that some or all of the allegations of the complaint are not covered, the insurer should provide a defense under the protection of a reservation of rights letter. The reservation of rights letter typically states that the insurer reserves the right to contest coverage and withdraw from the insured's defense, and identifies any applicable policy language in support of its position. Some insurers also state in the reservation of rights letter that they are preserving the right to seek reimbursement of defense costs if it is determined that the lawsuit is not covered by the policy, or to recover costs incurred in connection with individual allegations that are not covered. Attempts to recover defense costs based on reimbursement language in a reservation of rights letter have resulted in litigation and there is a split of authority over the effect of such language. This article will take a look at both views and two recent court cases, one that found the insurer was entitled to reimbursement and one that concluded otherwise.

COURTS THAT ALLOW RECOVERY OF DEFENSE COSTS

Some courts that have considered whether a reservation of rights letter allows an insurer to recover the costs incurred in defending a noncovered suit from its insured have ruled in favor of the insurer. Most of the cases that have allowed reimbursement have involved situations in which there was no coverage under the policy for any of the allegations in the lawsuit. A few have involved situations of mixed coverage in which some, but not all, of the allegations were covered.

Some courts that have allowed recovery of defense costs have found that the reservation of rights letter creates an implied contract between the insured and the insurer. The contract may be implied by law or fact, depending on the view of the court. Either way, to these courts, when the insured accepts the insurer's defense under a reservation of rights, the insured accepts the conditions of that defense. The insured's silence or failure to object to the reservation of rights has been viewed as implied acceptance of its terms. What the insurer needs to prove is that it specifically reserved the

right to seek reimbursement of defense costs from the insured and that it provided the insured with adequate notice of its right to reimbursement.

In the alternative, some courts have found that there is an equitable right to reimbursement of defense costs. These courts have reasoned that the insured would be unjustly enriched by the insurer's provision of a defense when the insurer was under no duty to defend. If the insurer preserved the right to reimbursement in its reservation of rights letter, these courts have granted the insurer an equitable right of reimbursement.

In *Valley Forge Ins. Co., v. Health Care Management Partners, LTD*, 616 F3d 1086 (10th Cir. 2010), the court held that the insurer was entitled to reimbursement of defense costs incurred in a suit that was not covered by the policy. A number of insureds were sued by the government for Medicaid and Medicare fraud. The insureds reported the suit to three insurers. One insurer denied coverage. The two other insurers disputed whether there was coverage under the policies, but agreed to provide a defense under "a reservation of rights permitting them to challenge their duty to defend at a later date and, if successful in that challenge, to recoup the costs they incurred in defending." The insureds accepted the defense without objecting to the reservation of rights letters. The insurers filed a declaratory judgment action in which it was determined that the insurers had no duty to defend. The insurers were later awarded reimbursement of their defense costs in full and the insureds appealed, arguing that an insurer cannot recover its defense costs based on a reservation of rights letter when the insurance policy does not provide for reimbursement.

The federal appeals court, basing its decision on Colorado law, considered two prior decisions of the Colorado Supreme Court. In *Hecla Mining Co. v. New Hampshire Ins. Co.*, 811 P2d 1083 (Colo. 1991), the court stated that an insurer is obligated to defend the insured when the allegations in the complaint potentially fall within the policy coverage and that if the insurer believes that it has no obligation to defend, its appropriate course of action is to defend under a reservation of rights to preserve its defenses and seek reimbursement if it is later determined that there was in fact no coverage. The *Hecla* court was silent on the need for policy language permitting reimbursement. In *Cotter Corp. v. American Empire Surplus Lines Ins. Co.*, 90 P3d 814 (Colo. 2004), the Colorado Supreme Court explained its earlier decision in *Hecla*. The court said that in its prior decision it was attempting to balance the interests of insurers and insureds. On the one hand, the insurer must defend if there is a possibility of coverage but on the other hand, it is not required to pay defense costs if ultimately there is no coverage. The federal appeals court found that this balancing of interests did not depend on whether there was any language in the policy permitting reimbursement and decided that the Colorado Supreme Court would allow reimbursement on the basis of a reservation of rights letter.

The federal appeals court did not see the need to identify the legal theory, be it equitable or contractual, for allowing reimbursement, stating:

Finally, the parties expend considerable time and effort debating what doctrinal label best describes Colorado's rule permitting insurers to recoup their costs when they reserved the right to do so by letter. Is the rule best viewed as an equitable one, based on the fact that allowing an insured to retain the benefits of an unbargained-for defense would constitute unjust enrichment, as some courts elsewhere have suggested? ... Or is the rule better viewed as a legal one, based on the fact that the insurer's reservation of rights letter and the insured's acceptance of the defense without objection created a new contract between the parties, or at least an implied-in-fact contract, as courts in other states have suggested? ... Or might the rule simply be a matter of Colorado public policy? Or something else still? *Hecla* and *Cotter* do not answer these questions. A future case might. But for our purposes none of this matters. Regardless whether the Colorado courts situate the rule in equity,

contract, policy, rule of court, or someplace else – whatever doctrinal pigeonhole best fits – one thing is clear: Colorado permits insurers to recoup defense costs in the circumstances before us. We need not venture more than that to decide this case.

Other courts that have permitted insurers to recover defense costs from insureds when it was determined that there was no coverage under the policy include:

Alaska	<i>Union America Ins. Co. Ltd. v. General Star Indemnity Co.</i> , 2005 U.S. Dist. LEXIS 46337 (D. Alaska 2005)
California	<i>Buss v. Superior Court</i> , 939 P2d 766 (Cal. 1997)
Florida	<i>Jim Black & Associates, Inc. v. Transcontinental Ins. Co.</i> , 932 So2d 516 (Fla. App. 2006)
Hawaii	<i>Scottsdale Ins. Co. v. Sullivan Properties, Inc.</i> , 2007 U.S. Dist. LEXIS 57021 (D. Hawaii 2007)
Montana	<i>Travelers Casualty and Surety Co. v. Ribl Immunochem Research, Inc.</i> , 108 P3d 469 (Mont. 2005)
Nevada	<i>Forum Ins. Co. v. County of Nye, Nevada</i> , 1994 U.S. App. LEXIS 13374 (9th Cir. 1994)
New York	<i>Gotham Insurance Co. v. GLNX, Inc.</i> , 1993 U.S. Dist. LEXIS 10891 (S.D. N.Y. 1993)
Ohio	<i>United National Ins. Co. v. SST Fitness Corp.</i> , 309 F3d 914 (6th Cir. 2002)
Tennessee	<i>Cincinnati Ins. Co. v. Grand Pointe, LLC</i> , 501 F.Supp.2d 1145 (E.D. Tenn. 2007)

Some of these cases dealt with situations of mixed coverage in which some counts in the complaint fell within coverage while others did not. Regardless whether the cases involved no coverage or mixed coverage, the rationale used by the courts appears to be the same. The only difference in mixed coverage cases is that the insurer must be able to separate the expenses incurred solely in defense of the allegations that are not covered from those incurred in defending the covered allegations.

COURTS THAT HAVE REFUSED TO ALLOW RECOVERY OF DEFENSE COSTS

Most of the courts that have held that the insurer has no right to seek reimbursement, despite having reserved the right to do so, have based their decisions on a strict interpretation of the insurance policy. These courts have found that a reservation of rights cannot create rights that do not exist under the policy. Put another way, a reservation of rights cannot unilaterally modify the contract of insurance.

The Pennsylvania Supreme Court addressed whether an insurer that prevailed in a declaratory judgment action had a right to reimbursement of defense costs from its insured in *American and Foreign Ins. Co. v. Jerry's Sport Center, Inc.*, 2 A3d 526 (Pa. 2010). Jerry's Sport Center and other firearms dealers were sued by the NAACP and the National Spinal Cord Injury Association (NSCIA) for negligently creating a public nuisance by distributing firearms in an unreasonable and unsafe manner. The suit sought injunctive relief and money damages to be used to establish a fund for the education, supervision, and regulation of gun dealers. Although the suit stated that the dealers' conduct resulted in injury and death to the plaintiff associations' members, the suit did not seek damages to compensate those members. Jerry's reported the suit to its insurer, Royal Ins. Co., under its commercial liability and commercial umbrella policies. Royal advised Jerry's that it was providing a defense through counsel of its choice under a full reservation of rights, which expressly

reserved the right “to seek reimbursement for any and all defense costs ultimately determined not to be covered.”

Royal filed a declaratory judgment action in which it was determined that since the complaint sought only equitable relief it did not state an injury that was actually or potentially covered by the policy. As such, Royal had no duty to defend the insured. Royal sought reimbursement of the defense costs it incurred. The lower court awarded reimbursement to the insurer, the award was reversed on appeal, and the dispute proceeded to the state supreme court.

Royal argued that the declaratory judgment action proved the claim was not potentially within the scope of coverage and there was never a duty to defend. It further argued that whether it initially provided a defense because it believed the claim could potentially be covered was irrelevant because only a court could resolve whether the claim was covered. According to Royal, the court’s determination in the declaratory judgment action “retroactively nullified any consequence of Royal’s initial determination... .” Royal argued that the supreme court was precluded from finding that the claim was potentially covered based on the declaratory judgment. Royal went on to argue that when there is no duty to defend, both the law of contracts (referring to the reservation of rights) and equitable principles support the insurer’s right of reimbursement.

Jerry’s disagreed, arguing that Royal’s duty to defend was triggered when Royal recognized that there was the potential for coverage. As such, there was a real question of coverage before the declaratory judgment action was resolved. Jerry’s further argued that “if an insurer needed a court determination before it knew whether to provide a defense for claims that may or may not be covered, then every questionable claim tendered to an insurer would require a declaratory judgment action prior to the provision of a defense.” The insured also argued that when an insurer is uncertain, “it should provide a defense while seeking a declaratory judgment as to its coverage obligations under the policy, but it is not entitled to reimbursement during any period of uncertainty.” The insured then disputed the right to reimbursement because there was no language in the insurance policy granting that right and the reservation of rights letter was an “impermissible, unilateral modification of the written insurance contract.” Further, the insured disputed that there was an equitable right to reimbursement because Royal provided a defense, at least in part, to protect its own interests as much as Jerry’s.

After considering the arguments on both sides and the cases cited by the parties, the Pennsylvania Supreme Court noted that a growing number of courts have refused to allow an insurer to obtain reimbursement of defense costs incurred for claims that are not covered. The rationale is that allowing reimbursement is contrary to the broad duty to defend. The court found these cases to be more persuasive than those that allowed reimbursement, stating:

Carefully considering the competing views espoused in these two lines of cases, we conclude that the reasoning of the courts refusing to allow reimbursement is more consistent with the broad duty to defend under Pennsylvania law, discussed below, when viewed in light of the policy language of the parties’ insurance contract. Insurance policies are contracts, and the rules of contract interpretation provide that the mutual intention of the parties at the time they formed the contract governs its interpretation. Such intent is to be inferred from the written provisions of the contract. If doubt or ambiguity exists it should be resolved in the insured’s favor.

An insurer’s duty to defend is broader than its duty to indemnify. It is a distinct obligation, separate and apart from the insurer’s duty to provide coverage. An insurer is obligated to defend its insured if the factual allegations of the complaint on its face encompass an injury that is actually or potentially within the scope of the policy. As long as the complaint “might or might not” fall within the policy’s coverage, the

insurance company is obligated to defend. Accordingly, it is the potential, rather than the certainty, of a claim falling within the insurance policy that triggers the insurer's duty to defend.

The court went on to state that the duty to defend is determined by comparing the four corners of the complaint with the four corners of the insurance policy. An insurer cannot justifiably refuse to defend unless it is clear, based on the allegations in the complaint and the policy language, that there is no potential for coverage. The court agreed with the insured's argument that the insurer is the one to initially determine whether a complaint against an insured contains any allegations that are potentially covered. The court in a declaratory judgment action resolves the question of coverage, but that decision does not retroactively eliminate the insurer's duty to defend for the time period in which coverage was uncertain. The effect of the declaratory judgment was to relieve Royal of the duty to continue defending the case.

As for reimbursement, the court stated that since there was uncertainty about coverage when Royal initially provided a defense, it properly defended a potentially covered claim and was not entitled to reimbursement. There was no right to reimbursement provided in the policy and the reservation of rights letter did not create a contractual right to reimbursement. The court took note of Black's Law Dictionary's definition of a reservation of rights letter, which states that the letter is "notice of an insurer's intention not to waive its contractual rights to contest coverage or to apply an exclusion that negates an insured's claim." The court stated that the reservation of rights letter could not be employed to reserve a right that did not exist in the insurance policy. To do so would be to allow the insurer to unilaterally amend the policy. The court also dismissed Royal's unjust enrichment argument because it had the right and duty to defend under the policy. Both parties benefitted by the insurer's defense. The insured was protected from the cost of a defense and the insurer controlled the defense through its selection of counsel. In addition, given the question of coverage, the insurer protected itself from the possibility of bad faith liability that could have resulted had it improperly denied a defense to its insured. The court concluded that the insurer could not obtain reimbursement.

Other courts that have found that the insurer is not entitled to reimbursement of defense costs include:

Arkansas	<i>Medical Liability Mutual Ins. Co. v. Alan Curtis Enterprises, Inc.</i> , 285 SW3d 233 (Ark. 2008)
Idaho	<i>Blue Cross of Idaho Health Services v. Atlantic Mutual Ins. Co.</i> , 734 F. Supp. 2d 1107 (D. Idaho 2010)
Illinois	<i>General Agents Ins. Co. of America, Inc. v. Midwest Sporting Goods Co., et al.</i> , 828 NE2d 1092 (Ill. 2005)
Iowa	<i>Pekin Ins. Co. v. Tysa, Inc.</i> , 2006 U.S. Dist. LEXIS 93525 (S.D. Iowa, Davenport Div. 2006)
Maryland	<i>Perdue Farms, Inc. v. Travelers Cas. and Surety Co. of America</i> , 448 F3d 252 (4th Cir. 2006)
Minnesota	<i>Westchester Fire Ins. Co. v. Wallerich</i> , 563 F3d 707 (8th Cir. 2009)
Wyoming	<i>Shoshone First Bank v. Pacific Employers Ins. Co.</i> , 2 P3d 510 (Wyo. 2000)

Although a reservation of rights does not create a right of reimbursement in these states, some of these courts have offered the opinion that an insurer is free to insert a right of reimbursement into the insurance policy. In the alternative, some courts have said that a right of reimbursement could be created with the insured's express agreement. In these courts, the insured's silent acceptance of a

defense under a reservation of rights does not create an implied agreement between the insurer and the insured to allow the insurer to recover defense costs.

CONCLUSION

In some states an insurer, through an appropriate provision in its reservation of rights letter, is entitled to reimbursement of defense costs when it turns out that the claim wasn't covered. And this is true even if there is no provision in the policy to that effect. In other states, however, courts will not allow reimbursement based only on the reservation of rights letter. The courts that have not allowed reimbursement have looked to the policy language to determine the rights of the insurer. These courts have not allowed reimbursement absent appropriate policy language or an express agreement between the insured and the insurer. This is an evolving area of insurance law and familiarity with the rule of law in your jurisdiction is important.