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CAN AN INSURER RECOVER THE COST OF DEFENDING A NON-COVERED CLAIM?

[ref: Reservation of Rights, Para. 4.01]

Liability insurance policies require the insurer to defend its insured, or pay for its defense, against claims or suits that seek damages caused by a covered occurrence. An 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.

If the insurer is uncertain whether the allegations of the complaint are covered, the insurer will typically provide a defense under the protection of a reservation of rights letter. The reservation of rights letter usually states that the insurer reserves the right to contest coverage and withdraw from the insured's defense, and identifies applicable policy language in support of its position. Some insurers also state in the reservation of rights letter that they intend to seek reimbursement of defense costs if it is determined that the lawsuit is not covered by the policy. This reimbursement language in a reservation of rights letter has resulted in much litigation.

In *Holyoke Mutual Ins. Co. v. Vibram USA, Inc.*, 2017 Mass. Super. LEXIS 12 (Mass. Super. 2017), the insured, Vibram, sought coverage under CGL policies it had with Holyoke Mutual and Maryland Casualty. The insurers provided a defense under a reservation of rights claiming there was no coverage and specifically reserving the right to seek reimbursement of defense costs if it was determined that there was no coverage. The insurers brought a declaratory judgment action, and the court found that they had no duty to defend any allegations in the complaint. The insurers then sought reimbursement of defense costs on the strength of their reservation of rights.

The court acknowledged that jurisdictions are not in agreement on this issue. Some courts allow an insurer to seek reimbursement of defense costs and follow the rationale of the California Supreme Court's decision in *Buss v. Superior Court*, 939 P2d 766 (Cal. 1997). In that case the court held that the insurer never bargained to assume the costs of defending claims that are not even potentially covered by the policy and, therefore, to require it to do so would upset the contractual relationship between the parties. The insured paid for, and could reasonably expect, the insurer to defend it against a third party claim that at least arguably fell within the policy coverage, but it couldn't expect

more. If the insurer could not seek reimbursement for defense costs paid for a claim that lacked even the potential for coverage the insured would receive more than it bargained for. The insured, which did not bargain for a defense of non-covered claims, would receive a windfall and be unjustly enriched. The insurer would be entitled to restitution to avoid this windfall and any unjust enrichment.

The court in *Vibram*, however, rejected the *Buss* rationale and decided to join the jurisdictions that have refused to allow reimbursement of defense costs. Courts in these jurisdictions have followed the Pennsylvania Supreme Court's reasoning in *American & Foreign Ins. Co. v. Jerry's Sport Center*, 2 A3d 526 (Pa. 2010). In *Jerry's*, discussed at length later in this article, the court focused on a liability insurer's broad duty to defend and held that although a question of whether a claim is covered may be a difficult one, it is the insurer's duty to make that decision. In addition, if an insurer wanted a right to reimbursement, it could have included language to that effect in the policy.

The court in *Vibram* explained:

> In this case, if the insurers had refused to provide a defense, they would have incurred no liability to Vibram because the claims in the underlying action were not within the coverage provided. However, they determined in the exercise of their considered judgment that it was better to provide a defense and file an action for declaratory judgment. It is undisputed that the policies did not contain a provision providing for reimbursement of defense costs under any circumstances. Thus the right the insurers attempt to assert in this case, the right to reimbursement, is not a right to which they are entitled based on the policies. Knowing that there is a risk that they would decide to provide a defense in cases in which they were uncertain as to whether a claim was covered because the claim was novel or the law unclear, the insurers could have addressed the right of recoupment in their policies; they didn't. The court ought not insert a policy provision that the parties did not agree upon.

The court further explained that including the right to reimbursement in a reservation of rights letter cannot unilaterally change the insurance contract and does not create a new right of reimbursement. The court went on to say that in Massachusetts the duty to defend arises when the complaint shows even a possibility that the claim falls within the policy coverage even if the facts don't specifically and unequivocally make out a covered claim.

This article will examine the rationales, both legal and equitable, on the issue of whether an insurer is entitled to reimbursement of defense costs incurred defending a non-covered suit based on a reservation of rights letter that includes reimbursement language when the insurance policy does not include reimbursement language.

COURTS THAT HAVE ALLOWED REIMBURSEMENT OF DEFENSE COSTS

Courts that have allowed reimbursement have sometimes 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 that includes reimbursement language the insured accepts the conditions of that defense. The insured's silence or failure to object to the reservation of rights has been held to be implied acceptance. What the insurer must prove is that it specifically reserved the right to seek reimbursement from the insured, provided the insured with adequate notice of the potential for reimbursement, and informed the insured of his right to accept or reject the reservation of rights.

Some courts have found that an insurer has an equitable right to reimbursement. These courts have reasoned that the insured would be unjustly enriched by the insurer's defense if it is ultimately determined there is no coverage. When the insurer preserved the right to reimbursement in its reservation of rights letter, these courts have granted the insurer an equitable right of reimbursement.

Courts that permit reimbursement hold that since an insurer is obligated to defend the insured when the allegations in the complaint even potentially fall within the policy coverage, the insurer, in fairness, should not be saddled with defense costs if it is later determined that there was never any coverage in the first place. It's a matter of balancing the interests of the insurer and insured. On one hand, the insurer must defend if there is a possibility of coverage, but on the other hand it should not be required to pay defense costs if ultimately it is determined there was no coverage. These courts have held that an insurer's right to reimbursement does not depend on whether there is language in the policy permitting reimbursement.

Most courts that allow reimbursement require specific reimbursement language in the reservation of rights and the absence of evidence that the insured expressly refused to consent. If the insured objects to the reimbursement language in the reservation of rights, the insurer cannot simply continue to defend without jeopardizing its right to reimbursement. In *Westchester Fire Ins. Co. v. Wallerich*, 563 F3d 707 (8th Cir. 2009), for example, the insurer sent a reservation of rights letter that reserved the insurer's right to seek reimbursement of defense costs. While the insured accepted the insurer's defense under the reservation of rights, it rejected that part of it that reserved the insurer's right to reimbursement. The court held that when the insurer continued with the defense despite the insured's objection to the insurer's reservation of the right to reimbursement, the insurer waived that right.

In addition, most courts that allow reimbursement do so only after a judicial determination that the insurer never had a duty to defend. For these courts, if there never was a duty to defend, despite the absence of policy language that permits reimbursement, a properly worded reservation of rights can be viewed as a new implied contract between the insurer and insured, or it can give rise to the equitable remedy of restitution.

If, on the other hand, a claim was potentially within the policy coverage at the outset, then there was a duty to defend and no right to reimbursement even if a court later determined that the claim was not, in fact, within the policy coverage. Defense of such a claim is within the agreement of the parties in the policy and cannot be altered by different terms in a reservation of rights.

Court decisions on this issue depend heavily on the particular facts of the underlying claim, and it's difficult to generalize. With that in mind, the following courts are among those that have permitted insurers to recover defense costs from insureds, on the basis of a reservation of rights that specifically reserved the right to reimbursement of defense costs, when it was later determined that there was no coverage for any of the allegations in the complaint:

California	*Buss v. Superior Court*, 939 P2d 766 (Cal. 1997)
Colorado	*Valley Forge Ins. Co. v. Health Care Management Partners*, 616 F3d 1086 (10th Cir. 2010)
Delaware	*Nationwide Mutual Ins. Co. v. Flagg*, 789 A2d 586 (Del. Super. Ct. 2001)
Florida	*James River Ins. Co. v. Arlington Pebble Creek*, 188 F. Supp. 3d 1246 (N.D. Fla. 2016)
Hawaii	*Scottsdale Ins. Co. v. Sullivan Properties, Inc.*, 2007 U.S. Dist. LEXIS 57021 (D. Haw. 2007)
Kentucky	*Travelers Property Casualty Co. v. Hillerich & Bradsby Co.*, 598 F3d 257 (6th Cir. 2010)

Montana	*Travelers Casualty and Surety Co. v. Ribi Immunochem Research, Inc.*, 108 P3d 469 (Mont. 2005)
Nevada	*Probuilders Specialty Ins. Co. v. Double M. Construction*, 116 F. Supp. 3d 1173 (D. Nev. 2015)
New Mexico	*Resure, Inc. v. Chemical Distributors, Inc.*, 927 F. Supp. 190 (M.D. La. 1996) (applying New Mexico law)
Ohio	*Chiquita Brands International, Inc. v. National Union Fire Insurance Co.*, 57 NE3d 97 (Ohio App. 2015)
Tennessee	*Cincinnati Ins. Co. v. Grand Pointe, LLC*, 501 F. Supp. 2d 1145 (E.D. Tenn. 2007)

COURTS THAT HAVE NOT ALLOWED REIMBURSEMENT

A number of courts do not permit reimbursement of defense costs based solely on language in an insurer's reservation of rights letter. The rationale of some of these courts is that to permit reimbursement would amount to asking the insured to pay for an action the insurer took to protect its own interests rather than the insured's. The insurer that is uncertain about its duty to defend and indemnify, will offer a defense under a reservation of rights to avoid the risk that a court will later find that it did, in fact, have a duty to defend and, perhaps, that it acted in bad faith by refusing to defend. The reservation of rights, then, is at least as much for the insurer's benefit as it is for the insured's. If the insurer could recover its defense costs, the insured would be required to pay for the insurer's act of protecting itself. In the absence of a policy provision or the insured's actual consent to the terms of the reservation of rights, the reservation of rights letter is not enough to require reimbursement.

Other courts that hold the insurer has no right to seek reimbursement, despite reserving the right to do so, have focused more on the insurance policy. These courts disregard the language of the reservation of rights if there is no reimbursement language in the insurance policy. They hold that absent language in the insurance policy that gives the insurer the right to recover defense costs, there is no such right. The rationale is that a reservation of rights cannot create rights that are not found in the policy. A reservation of rights cannot unilaterally change the contract of insurance.

Some more recent court decisions have refused to permit insurer reimbursement without either a policy provision that requires reimbursement or a bilateral agreement between the parties, such as a nonwaiver agreement signed by the insured. The rationale for this position was explained by the Pennsylvania Supreme Court in *American and Foreign Ins. Co. v. Jerry's Sport Center, Inc.*, referred to previously.

In *Jerry's,* the court addressed whether an insurer that prevailed in a declaratory judgment action had a right to reimbursement of defense costs from its insured. Jerry's Sport Center and other firearms dealers were sued by the NAACP and the National Spinal Cord Injury Association 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 Insurance Company, that provided coverage under 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 and it was determined that since the complaint sought only equitable relief it did not state a claim 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 had incurred.

Royal argued that the fact the court in the declaratory judgment action determined the claim was not within the scope of coverage proved the claim was not potentially covered and there was never a duty to defend. Royal contended 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." Further, 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, the law of contracts, referring to the reservation of rights, and equitable principles both 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 also 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 continued 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 also 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." 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.

The state supreme court observed that a growing number of courts have refused to allow an insurer to obtain reimbursement of defense costs for non-covered claims. 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.
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> An insurer's duty to defend is broader than its duty to indemnify. An insurer is obligated to defend its insured if the factual allegations of the complaint, on its face, encompass a claim 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 explain 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 found 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 a reservation of rights 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 held that the reservation of rights letter could not be used 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 denied a defense to its insured. The court concluded that the insurer could not obtain reimbursement.

Courts that have held that an insurer is not entitled to reimbursement of defense costs solely on the basis of a unilateral reservation of rights include:

Arkansas	*Medical Liability Mutual Ins. Co. v. Alan Curtis Enterprises, Inc.*, 285 SW3d 233 (Ark. 2008)
Connecticut	*Nationwide Mutual Ins. Co. v. Mortenson, et al*, 2009 U.S. Dist. LEXIS 74870 (D. Conn. 2009)
Idaho	*St. Paul Fire & Marine Ins. Co. v. Holland Realty, Inc.*, 2008 U.S. Dist. LEXIS 59431 (D. Idaho 2008)
Illinois	*General Agents Ins. Co. of America, Inc. v. Midwest Sporting Goods Co., et al*., 828 NE2d 1092 (Ill. 2005)
Iowa	*Pekin Ins. Co. v. Tysa, Inc.*, 2006 U.S. Dist. LEXIS 93525 (S.D. Iowa 2006)
Maryland	*Perdue Farms, Inc. v. Travelers Casualty and Surety Co.*, 448 F3d 252 (4th Cir. 2006)
Massachusetts	*Holyoke Mutual Ins. Co. v. Vibram USA, Inc.*, 217 Mass. Super. Lexis 12 (Mass. Super. 2017)
Minnesota	*Westchester Fire Ins. Co. v. Wallerich*, 563 F3d 707 (8th Cir. 2009)
Mississippi	*Mobile Tel. Tech. v. Aetna Casualty & Surety*, 962 F. Supp. 952 (S.D. Miss. 1997)
Missouri	*Liberty Mutual v. FAG Bearings*, 153 F3d 919 (8th Cir. 1998)
New York	*Century Surety Co. v. Vas & Sons Corp.*, 2018 U.S. Dist. LEXIS 151209 (E.D. N.Y. 2018)
Pennsylvania	*American & Foreign Ins. Co. v. Jerry's Sport Center*, 2 A3d 526 (Pa. 2010)
Texas	*Texas Association of Counties v. Matagorda*, 52 SW3d 128 (Tex. 2000)

Washington	*National Surety Corp. v. Immunex Corp.*, 297 P3d 688 (Wash. 2013)
Wyoming	*Shoshone First Bank v. Pacific Employers Ins. Co.,* 2 P3d 510 (Wyo. 2000)

CONCLUSION

When considering the issue of an insurer's right to reimbursement, the following guidelines will be helpful:

- If the insurer reserves its right to reimbursement and the insured expressly agrees – most states permit reimbursement, at least if there was never any potential coverage for the claim.
- If the insurer reserves its right to reimbursement and the insured remains silent and does nothing to reject the insurer's defense – some states permit reimbursement, at least if there was never any potential coverage for the claim, but other states do not permit reimbursement.
- If the insurer reserves its right to reimbursement, but the insured specifically rejects the right to reimbursement – most states do not permit reimbursement because the insurer, if it proceeds with the defense despite the insured's rejection of the reimbursement language, waives its right to rely on the reimbursement provision.