

Who Pays Defense Costs While Insurer And Policyholder Fight About Coverage?

Defense costs are a significant factor in any claim. The question of who pays defense costs is often as important and contentious as the claim itself. It is settled law that an insurer must defend its insured whenever the facts alleged in the complaint bring the claim

GERALD G. SALTARELLI
STEVEN A. BLOCK

potentially within the scope of the coverage provided by the policy. An insurer that believes that the claim tendered by its insured is not even potentially covered by the policy may refuse to defend. If a court later determines that there was no potential for coverage, the insurer is home free. But if a court later determines that the facts alleged potentially fall within the coverage provided, the insurer will be found to have breached its duty to defend. The consequence in many states is that the insurer will then be estopped to assert any policy defenses to coverage. Thus, the price of guessing wrong on its duty to defend is the loss of any exclusions, conditions, or terms that would have excused the insurer from the obligation to indemnify the policyholder for any settlement or judgment that results from the claim.

Faced with the prospect of such a harsh result, insurers often opt to defend under a reservation of rights. A properly drafted reservation of rights preserves the insurer's ability to contest later its alleged obligation to indemnify the insured for any settlement or judgment that results from the claim. But if it turns out that the insurer was right - there was no coverage, and, in fact, not even a potential for coverage - can the insurer recoup its defense costs from the policyholder? The answer generally is "no" since the insurer that defends under a reservation of rights is merely discharging its obligation under the policy. But what if the insurer explicitly reserves the "right" to recoup defense from the

policyholder should a court determine that the insurer has, in fact, no obligation to defend? The answer depends on the particular state law that applies to the dispute.

The majority of courts that have considered the question have held that the insurer is entitled to recoup defense costs when a court subsequently finds that the insured never had an obligation to defend. These courts reach the common sense conclusion that the insurer should not be saddled with defense costs when it turns out that there was no coverage to start with. Surprisingly, a decision of the California Supreme Court - a court that is notoriously favorable to policyholders - is the leading case for the right of an insurer to recoup defense costs from the policyholder. *Buss v. Superior Court*, 939 P.2d 766 (Cal. 1997).

The majority courts reach this result by one of two legal routes. The first is by holding that the insured is unjustly enriched when an insurer provides a defense for a claim that is not covered. The second is by finding an implied agreement by the policyholder to reimburse the insurer in the event there is no coverage. Courts will find such an implied agreement even if the policyholder objects to the insurer's reservation of rights to recoup defense costs, provided that the policyholder actually accepts the defense tendered by the insurer. Under these cases, the policyholder would have to reject the insurer's defense, and provide its own, in order to avoid the risk that it would have to reimburse the insurer for defense costs. But since fronting the money is hardly attractive, not many policyholders will reject the insurer's defense merely because the policyholder may some day be obligated to reimburse the insurer for costs incurred.

A minority of courts reach the contrary conclusion. These courts, now led by an opinion of the Illinois Supreme Court, *General Agents Ins. Co. of American Inc. v. Midwest Sporting Goods Company*, 828 N.E. 2d 1092 (Ill. 2005), insist that the insurer may not be relieved of its

Hobson's choice of defending under a reservation of rights or being estopped to raise policy defenses if it turns out that its refusal to defend is wrong. In *General Agents*, the Illinois court cited approvingly another court that had noted that insurers are in the business of making decisions as to whether their policies must respond to claims. That choice may well be difficult, and substantial costs attend either option. If it elects to defend, the insurer must pay defense costs. If it refuses, the insurer risks estoppel if a court later finds coverage. The Illinois court concluded that permitting the insurer essentially a third option - defending under a reservation but with the right to recoup defense costs from the insured - places on the policyholder the burden of defense costs that the insurer otherwise would bear. The right to recoup defense costs, the court stated, was not contained in the policy at issue and so could not be reserved by the insurer. Further, the court held that the policyholder was not unjustly enriched by the insurer's defense since that defense was offered as much for the insurer's protection as the policyholder's benefit.

Legal reasoning aside, the result is unfair. In the Illinois case, an insurer that had no duty to defend under its policy ends up obligated to pay defense costs. If there is a legitimate dispute as to whether the insurer is obligated to defend, allowing the insurer to defend while the coverage question is determined, without a loss of the ability to recover defense costs expended if the coverage court agrees with the insurer, hardly seems inequitable.

Both insurer and corporate counsel must be aware of the split in authority on the recoupment of defense costs. To make an intelligent decision about defending or accepting the defense, both need to determine what state law is likely to apply to the insurance questions raised by the underlying claim. That in itself is often difficult, but the state in which the claim is pending, or the state in which the insured is located, are likely candidates.

Policyholder's counsel must review any reservation of rights letters carefully. They may not be safely disregarded. At a minimum, counsel must advise the policyholder of the exposure for defense costs if coverage issues are determined by a court following the majority rule. In addition, counsel must understand that merely objecting to the insurer's reservation of the right to recoup likely will not be sufficient. Moreover, even in a state following the minority rule, an insurer may be able to recoup defense costs pursuant to a reservation of rights if the

insurance contract contains an express provision providing that right to the insurer. Therefore, counsel must also carefully review the policy language even if it is determined that the applicable law follows the minority rule in *Midwest Sporting Goods*. Finally, depending on counsel's view of the strength of the policyholder's coverage position, the policyholder may wish to reject a defense offered by the insurer. In other words, if the policyholder is likely to be ultimately obligated for defense costs, it may want to provide its own defense.

The insurer's counsel also needs to be aware of whether the right to recoup will be recognized, if only because his or her client surely needs to understand whether it may be able to recoup defense costs. Moreover, routine inclusion of the right to recoup in reservation letters may not be wise. If the insured rejects the insurer's defense because the insurer sought to reserve the right to recoup defense costs, a court following the minority view might conclude that the insurer did not properly offer a defense to the insured, and thereby breached its duty to defend. That would land the insurer back in the briar patch, with loss of any policy defenses.

Gerald G. Saltarelli is a partner and Steven A. Block is an associate with Butler Ruben Saltarelli & Boyd LLP, a Chicago litigation boutique. They specialize in complex commercial litigation, including insurance coverage disputes. The views expressed are personal to the authors.