

Pay Me Back! Reimbursement of Defense Costs in the CGL

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After a colossal struggle, you have finally prevailed on the commercial general liability (CGL) insurer to provide a defense for the complaint filed against your customer, albeit subject to a reservation of rights letter. You declare victory and proceed to share the good news.

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As expected, a few days later, the reservation of rights letter arrives. You take a quick look at the letter and then file it away. Later that day, you answer the phone to hear shouting on the other end. The person shouting turns out to be your customer, who has read the reservation of rights letter. Apparently, a portion of the letter that escaped your notice is a paragraph in which the insurer stated:

Subject to the foregoing, and without waiving any of its rights and defenses, *including the right to recoup any defense costs paid in the event that it is determined that the Company does not owe the Insured a defense in this matter*, the Company agrees to provide the Insured a defense in the captioned suit.¹

Your customer demands to know—does your insurer really have a right to recoup all of its defense costs if the allegations in the complaint are later determined not to be covered by your customer's CGL policy?

Duty To Defend

Virtually all states recognize the duty to defend in the CGL policy is quite broad. It is generally true that if the allegations in a suit are *potentially* covered by the CGL policy, the insurer's duty to defend is triggered. (See also [Duty To Defend in the CGL Policy](#).)

While the duty to defend is broader than the duty to pay damages on behalf of the insured (more commonly described in the courts as the "duty to indemnify"), the duty to defend is not unlimited. The duty does not begin until the suit is tendered and does not end until it can be shown that no claim can in fact be covered. If the claim is *not even potentially* covered, the insurer has no duty to defend. (See *Buss v. Superior Court*, 939 P.2d 766 (Cal. 1997).).

Declaratory Judgment

The facts in the above example may be insufficient to answer the overriding question—does the insurer have a right to reimbursement of its costs paid to defend the insured?

It is apparent from the paragraph quoted from the reservation of rights letter that the insurer disputes that it has a duty to defend in the first instance. Let's assume in our example that the insurer proceeds with defending the insured, but seeks a judicial determination—a declaratory judgment action—that the insurer had no duty to defend.

If the court determines that the insurer was correct—the claim was *not* covered and the insurer had no duty to defend the insured—will the court allow the insurer to obtain reimbursement of the defense costs it had incurred prior to the declaratory judgment?

The Supreme Court of Pennsylvania

This question was recently (August 17, 2010) decided by the Supreme Court of Pennsylvania in the case of *American and Foreign Ins. Co. v. Jerry's Sports Ctr., Inc.*, No. 88 MAP 2008. Similar to the above example, the insurer (referred to in the case as "Royal") provided defense to the insured, but in a reservation of rights letter to the insured stated it reserved the right to seek reimbursement for "any and all of the defense costs it incurs in defense of this matter."

While defending its insured, Royal sought a judicial determination that it did not owe its insured a duty to defend the complaint. Ultimately, Royal prevailed; the court granted summary judgment in favor of Royal and determined Royal was *not required* to defend the insured.

In order to recoup its defense costs, Royal argued that providing the defense to the insured amounted to "unjust enrichment"² and, on that basis, sought restitution from its insured. Jerry's Sports Center (the insured) argued that the contract that determined the rights of the parties was the CGL policy, which was silent on the issue of reimbursement of defense costs. The trial court found in favor of Royal, requiring the insured to reimburse Royal for \$309,216 of defense costs plus prejudgment interest.

The Appeals Process

The superior court overturned the trial court's award, finding instead that Royal's reservation of rights letters "amounted to an impermissible, unilateral modification of the written insurance contract." Royal was granted permission to appeal to the Supreme Court of Pennsylvania to decide whether Royal was entitled to its defense costs when (1) a court has determined that the insurer has no duty to defend the insured and (2) when insured has claimed a right of reimbursement in a reservation of rights letter.³

Royal argued that the claims against it insured were not *potentially* covered because the trial court found that Royal had *no duty to defend*. Of course, the insured argued to the contrary—Royal's duty to defend was triggered when it was faced with what Royal characterized (in its communication with the insured) as a potentially covered claim.

The insured further argued that Royal defended the insured for its own benefit—protection against Royal's possible obligation to pay damages by exercising its right to hire a law firm of the insurer's choice—a right that would have been lost if Royal had not defended.

Uncertainty Regarding Potentially Covered Claims

Here is how the court characterized Royal's argument: "According to this argument, the trial court's declaratory determination *retroactively* nullifies any consequences of Royal's initial determination that claims *may have been potentially covered*." [Emphasis added.]

The court went on to explain:

In some circumstances, an insurance company may face a difficult decision as to whether a claim falls, or potentially falls, within the scope of the insurance policy. *However, it is a decision the insurer must make*. If it believes there is no possibility of coverage, then it should deny its insured a defense because the insurer will never be liable for any settlement or judgment.

This would allow the insured to control its own defense without breaching its contractual obligation to be defended by the insurer. *If, on the other hand, the insurer is uncertain about coverage*, then it should provide a defense and seek declaratory judgment about coverage.

The court's role in the declaratory judgment action is to *resolve the question of coverage to eliminate uncertainty*. If the insurer is successful in the declaratory judgment action, it is relieved of the continuing obligation to defend. *The court's resolution of the question of coverage does not, however, retroactively eliminate the insurer's duty to defend the insured during the period of uncertainty*. [Emphasis added.]

In other words, the determination of whether a claim is potentially covered is made *by the insurer* at the time the complaint is presented. If the insurer is uncertain as to whether a defense should be provided, the insurer should provide a defense and *then seek judicial determination* as to coverage. However, the court's determination that there was no duty to defend only resolved the *uncertainty* in the matter. It did not *retroactively* relieve the insurer of its initial duty to defend its insured.

As respects the specific arguments made in this case, the court opined:

Facing uncertainty about coverage, Royal appropriately activated its right and met *its duty to defend* under the policy when it was presented with a claim that *may or may not have been covered*. At the same time, Royal appropriately exercised its right to seek a declaration that it had no duty to defend.

The trial court's subsequent declaratory judgment determination that the claim was not covered relieved Royal of having to defend the case going forward, *but did not somehow nullify its initial determination that the claim was potentially covered*. [Emphasis added.]

The role of the court is to resolve the uncertainty prospectively and does eliminate the insurer's duty to defend a claim that the insurer determined was potentially covered.

As is now obvious, the court rejected Royal's attempt to "define its duty to defend based on the outcome of the declaratory judgment action" and ruled that Royal could not recover its defense costs, despite the express reservation in its letters to the insured.

We therefore hold that an insurer *may not obtain reimbursement of defense costs* for a claim for which a court later determines there was no duty to defend, *even where the insurer attempted to claim a right to reimbursement*

in a series of reservation of rights letters. Accordingly, we affirm the order of the Superior Court. [Emphasis added.]

Supporting Reasons

Several reasons were set forth by the court as to why Royal's defense costs were not reimbursable:

1. Allowing such reimbursement would amount to an erosion of the broad duty to defend in that the duty to defend would be contingent upon a court's determination that a complaint was covered;
2. The CGL policy was silent on the insurer's right to reimbursement and the reservation of rights letter did not create a new contract with the insured;
3. A reservation of rights letter can only assert defenses and exclusions that are found in the CGL policy—permitting reimbursement by reservation of rights is tantamount to allowing the insurer to unilaterally change the insurance policy;
4. Royal exercised its right to defend and thus benefited from the arrangement, eliminating the "unjust enrichment" theory argued by Royal.

Minority View

It should be noted that the court characterized those jurisdictions as having *rejected* the insurer's right to reimbursement of defense cost as the so-called minority view. This is important as the Supreme Court of Pennsylvania's decision is based on a very specific set of facts. In particular, the case involved claims that were *potentially* covered by the policy. The controversy turned in part on whether the judicial determination meant the claims were not potentially covered. What if the insurer defended claims that were never potentially covered? Would reimbursement of defense costs still be prohibited?

Mixed Actions

In *Buss v. Superior Court*, 939 P.2d 766 (1997), the Supreme Court of California considered an insurer's right to reimbursement of defense costs paid when defending claims in a "mixed action." A "mixed action" is a complaint against an insured in which some of the allegations are potentially covered and some of the allegations are *not* potentially covered. In the case of *Buss*, 27 causes of action were brought against the insured, 26 of which were *not* ever potentially covered. The insurer was required to defend the complaint in its entirety, including the causes of action that were not potentially covered.

Duty To Defend Covered and Uncovered Causes of Action

The *Buss* court explained why the insurer was required to defend all causes of action in the complaint, including those for which no coverage was possible:

... we can, and do, justify the insurer's duty to defend the entire "mixed" action prophylactically, as an obligation imposed by law in support of the policy.

To defend meaningfully, the insurer *must defend immediately*. To *defend immediately*, it *must defend entirely*. It cannot parse the claims, dividing those that are at least potentially covered from those that are not. To do so would be time consuming. It might also be futile. [Emphasis added.]

Insurer's Right to Reimbursement for Defense of Uncovered Claims

Given this set of facts, the *Buss* court concluded "as to the claims that are not even potentially covered, however, the insurer may indeed seek reimbursement for defenses costs." As the insurer did not receive premium for the cost of defending claims not potentially covered by the policy, such defense costs were not the insurer's obligation under the policy. The insurer's right of reimbursement of the defense costs incurred for the uncovered claims was implied in law as a quasi-contractual right.

However, the *Buss* court restricted the insurer's right to defense costs reimbursement to only those situations in which the insurer expressly reserved its right to recover defense costs paid on claims not potentially covered. Further, the insurer was allowed to recover only those defense costs that could be allocated *solely* to the claims not potentially covered, with the burden on the insurer to demonstrate the required allocation.

Mixed Action—No Right of Defense Cost Reimbursement

Compare the *Buss* case to a later case in Illinois. In *General Agents Ins. Co. v. Midwest Sporting Goods Co.*, 828 N.E.2d 1092 (2005), the Supreme Court of Illinois considered a *similar* set of facts. First, the complaint was a "mixed action" against the insured. Second, the insurer flatly denied coverage for all but one of the allegations. Third, the insurer paid

for a defense⁴ of the complaint *in its entirety*. Fourth, the insurer defended under a reservation of rights letter that expressly reserved its right to recoup any defense costs not covered. The insurer, General Agents Insurance Company or "Gainsco," obtained summary judgment in its favor (confirmed on appeal) that ultimately Gainsco had no duty to defend its insured.

As part of its summary judgment action, the insurer argued for reimbursement of its defense costs. The trial court ordered the insured to pay Gainsco its defense costs; this order was upheld by the appellate court. The Supreme Court of Illinois allowed the insured's petition to appeal.

Unlike *Buss*, which was cited by Gainsco, the *General Agents* court recognized but did not appear to make a meaningful distinction between defense costs incurred for claims not potentially covered and defenses costs incurred for claims potentially covered by the policy. The reason may be that it appears from the record that Gainsco was demanding reimbursement of *all of its defense costs*; its demand was not limited to the defense costs it incurred to defend the claims not potentially covered. Put another way, Gainsco did not attempt to allocate defense costs to claims not potentially covered as was required for reimbursement in *Buss*.

Gainsco maintains that because it had no duty to defend, it follows that there is no contract governing the relationship between the parties. The problem with this argument is that Gainsco is *attempting to define its duty to defend based upon the outcome of the declaratory judgment action.* Although an insurer's duty to indemnify arises only after damages are fixed, the duty to defend arises as soon as damages are sought. [Emphasis added.]

The General Agents court ruled in favor of the insured, primarily because the CGL policy did not include any provision that provided for the reimbursement of defense.

We choose, however, to follow the minority rule and refuse to permit an insurer to recover defense costs pursuant to a reservation of rights *absent an express provision to that effect in the insurance contract between the parties.* [Emphasis added.]

Conclusion

Whether an insurer has a right to seek reimbursement of defense costs after a judicial determination that it had no duty to defend is both dependent on the specific facts as well as the jurisdiction in which the question is raised. At best, an insurer may have a right to reimbursement of defense costs when expressly reserving its right to reimbursement of defense costs, but only when defending claims that were never potentially covered, and then only if the costs of defending the noncovered claims can be sufficiently allocated to such claims. Even the *Buss* court does not allow reimbursement of defense costs for claims that were *potentially covered*, even if it is subsequently adjudicated that the insurer ultimately had no duty to defend the potentially covered claims.

... the insurer's duty to defend runs to claims that are *merely potentially covered*, in light of facts alleged or otherwise disclosed. *It arises as soon as tender is made.* It is discharged when the action is concluded. It may be extinguished earlier, if it is shown that no claim can in fact be covered. If it is so extinguished, however, it is extinguished only prospectively and *not retroactively*: before, the insurer had a duty to defend; after, it does not have a duty to defend further. [Emphasis added.]

As an example of allowing no reimbursement for defense costs paid for noncovered claims, consider a recent ruling of the Tenth Circuit Court of Appeals applying Wyoming law. In *Employers Mut. Cas. Co. v. Bartile Roofs, Inc.*, Nos. 08-8064, 08-8068 (10th Cir. Sept. 7, 2010), the insurer (EMC) agreed to defend the insured even after EMC had informed the insured the claims "were not covered by the policy."

EMC explains that it seeks to recover defense costs in a case involving only *noncovered claims*. In this action, EMC has no right to recoup its costs of defending Bartile. *As an initial matter, the CGL policies contain no provisions reserving EMC's right to recoup defense costs from Bartile.* Although EMC subsequently issued a reservation-of-rights letter, this letter constituted a unilateral attempt either to modify the existing CGL policies or to create a new contract authorizing recoupment. Neither attempt succeeds. As Shoshone First Bank instructs, EMC should have denied Bartile a defense at the outset of the underlying action instead of defending against the action for several years and only now attempting to recoup its defense costs. [Emphasis added.]

In the above, the Tenth Circuit appeared to look no further than the CGL policy itself—as CGL does not provide for the reimbursement of defense costs, no right of reimbursement was recognized, even for noncovered claims.

¹*General Agents Ins. Co. v. Midwest Sporting Goods*, 828 N.E.2d 1092 (Ill. 2005). [Emphasis in original.]

²Unjust enrichment is the retention of a benefit conferred by another, without offering compensation, in circumstances where compensation is reasonably expected, for which the beneficiary must make restitution. *Black's Law Dictionary* (8th ed. 2004). [Footnote in original.]

³Royal actually sent a series of reservation of rights letters, all reserving its right to reimbursement of defense costs.

⁴Because of the "competing interests" between the company and the insured, Gainsco agreed to pay defense counsel selected by the insured.

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