KAUFMAN | DOLOWICH

Can insurers be ensured repayment of defense costs without an express recoupment clause?, By Michael L. Zigelman, Esq., and Daniel H. Brody, Esq., Reuters Legal News, 4-27-2023

When an insured submits a new claim under a liability insurance policy, the insurer will frequently agree to defend the insured subject to a reservation of rights, including the right to seek recoupment of the defense costs in the event it is later determined there was no defense obligation after all.

This is done for a number of reasons. The lawsuit might be comprised of both covered and uncovered claims. Or the insurer might spot a potential defense to coverage that cannot yet be enforced, because of missing facts. Or perhaps the insurer is concerned about the unknown — a new coverage defense later revealing itself. Whatever the reason, the insurer might then, immediately or in the future, file a declaratory judgment action in court against the insured to obtain an adjudication declaring the insurer had no duty to defend or otherwise pay defense costs. And if successful, the insurer will often pursue recoupment of the defense costs it paid in the interim.

In the absence of a recoupment clause, courts in recent years have become divided on whether an insurer is entitled to recoupment. Some liability policies expressly require the insured to reimburse defense costs under these circumstances, and it is generally accepted that repayment will be enforced when there is an express recoupment clause. However, it is not always clear what will happen when there is no recoupment provision in the policy.

In the absence of a recoupment clause, courts in recent years have become divided on whether an insurer is entitled to recoupment. The majority view permits defense costs to be recouped when the insurer reserves its recoupment rights, often based on a theory of implied contract or unjust enrichment. On the other hand, the minority approach generally does not allow for recoupment without an express recoupment clause. This division has made its way to the American Law Institute, where the Restatement of the Law on Liability Insurance, in Section 21, has adopted the minority view against recoupment, stating that an insurer should not be able to seek recoupment of defense costs unless otherwise stated in the insurance policy or otherwise agreed by the insured.

Meanwhile, the Restatement of the Law of Restitution and Unjust Enrichment, in Section 35, favors recoupment with respect to contracts generally when a party performs a disputed obligation under protest or with a reservation of rights, allowing such party to preserve a restitution claim for the value of the benefit conferred.
Since the Restatement of the Law on Liability Insurance was released in 2018 with its emphasis on requiring an express recoupment clause, courts faced with this issue have continued to be split, with some courts even expressly referring to the Restatement before adopting or rejecting its approach.

In Nautilus Insurance Co. v. Access Medical, LLC, 482 P.3d 683 (Nev. 2021), for example, the Nevada Supreme Court followed the majority rule by holding that, when a court finally determines the insurer had no contractual duty to defend, the insurer may ordinarily recover in restitution if it has clearly reserved its right to do so in writing.

In favoring recoupment even where the policy has no recoupment clause, the Nevada Supreme Court explained that it was persuaded by the Restatement of Restitution and Unjust Enrichment and specifically declined to follow the other Restatement of Liability Insurance. The court further explained that such restitution did not modify the insurance policy, nor did it erode the duty to defend, thereby rejecting arguments often made in opposition to recoupment.

The Restatement of Liability Insurance was also discussed in Zurich American Insurance Co. v. Syngenta Crop Protection LLC, 2022 WL 4091260 (Del. Super. Aug. 24, 2022) where the Delaware Superior Court found that, even though the subject policy did not provide for recoupment, the insurer would have been entitled to recoupment upon a finding that there was no duty to defend. In so holding, the court distinguished the case from other circumstances where a duty to defend arises when there is doubt as to whether the risk is insured, even if only one count or theory in the lawsuit is covered.

According to the court, it is different if it is determined as a matter of law that the duty to defend "never was triggered," because under those circumstances, the policyholder did not bargain for a defense to which it was not entitled. See also Catlin Specialty Ins. Co. v. CBL v. Assocs. Properties, Inc., 2018 WL 3805868 (Del. Super. Aug. 9, 2018) (applying Tennessee law and granting recoupment under theory of quasi-contract or implied contract).

In another recent decision, Great American Fidelity Insurance Co. v. Stout Risius Ross, Inc., __ F. Supp. 3d ___, 2022 WL 16571316 (E.D. Mich. Nov. 1, 2022), the federal court sitting in Michigan recognized that reimbursement of defense costs without a recoupment clause is not a settled issue in Michigan. Nevertheless, the court was not persuaded by other state supreme courts or federal circuits to adopt the minority view. Instead, it reaffirmed the 6th U.S. Circuit Court of Appeals' previous determination that Michigan law would allow for recoupment, despite no recoupment provision in the policy. The holding was based on a theory of implied contract, and the court rejected the argument that a reservation of rights modifies the original agreement. Instead, the court explained that the insurance policy is a contract about specific claims that are covered, while the reservation of rights applies to claims that are not covered.

On the other end of the spectrum, some courts have since adopted the minority approach against recoupment. In Hayes v. Wisconsin & Southern Railroad, LLC, 514 F. Supp. 3d 1055 (E.D. Wis. 2021), for example, the court, after mentioning both Restatements, concluded that Wisconsin law would not permit an insurer to recoup under a theory of unjust enrichment, explaining that insurers could instead add recoupment provisions to their policies. The court also found it was not unjust for an insured to accept the benefit of an insurer-paid defense.

According to the court, an insurer that decides to provide a defense when coverage is questionable does so not out of benevolence or by mistake, but instead as the result of a cost-benefit determination motivated by the insurer's self-interest in avoiding the consequences under Wisconsin law in the event the insurer's belief as to coverage proves wrong.

Similarly, in American Family Insurance Co. v. Almassud, 522 F. Supp. 3d 1263 (N.D. Ga. 2021), the court also adopted the minority approach from the Restatement of Liability Insurance, holding that, absent a recoupment provision or some other express agreement, an insurer that issued a unilateral reservation of rights cannot recoup defense costs. See also Chemical Equipment Labs, Inc. v. Travelers Property Casualty Co. of America, 595 F. Supp. 3d 365 (E.D. Pa. 2022).

In addition, in Hanover Insurance Co. v. Blue Ridge Property Management, LLC, 490 F. Supp. 3d 904 (M.D.N.C. 2020), the federal court sitting in North Carolina recognized the lack of North Carolina cases on point, and then ruled against recoupment. Specifically, the court expressed concern about narrowing the duty to defend and rejected the theory of unjust enrichment in the face of an explicit insurance contract.

Although some decisions addressing this issue might be viewed as adopting a hard-and-fast rule for or against recoupment in the absence of a recoupment clause, the determination of which approach applies could potentially vary based on the circumstances. For example, the result may depend on how the coverage defense is applied.

In John Moriarty & Associates, Inc. v. Zurich American Insurance Co., ___ N.E.3d ___, 102 Mass. App. Ct. 474 (2023), a Massachusetts state appellate court remanded the case to the trial court for a determination on the right to recoup, while acknowledging that recoupment — without a recoupment clause — is an open issue in Massachusetts and provided guidance to the parties on remand. In doing so, the court distinguished circumstances where the insurer defended the claim based on a factual uncertainty that may place a claim outside the policy's coverage, as opposed to a legal uncertainty.

Whether recoupment is permitted might also depend on the insured's conduct. In Berkley National Ins. Co. v. Granite Telecommunications LLC, 617 F. Supp. 3d 77 (D. Mass. 2022), the federal court sitting in Massachusetts recognized that the Massachusetts Supreme Judicial Court has not squarely addressed such recoupment, but the court held in favor of recoupment, given the insureds' "unfair behavior" in forcing the insurer to defend at the threat of litigation, which the court characterized as "bearing the flavor of extortion."

As litigation costs continue to rise, insurer recoupment issues are likely to appear in more and more locations. It will be interesting to see how these jurisdictions ultimately side, and whether the Restatement of the Law on Liability Insurance and/or the Restatement of the Law of Restitution and Unjust Enrichment will further amend their respective provisions.

About the authors

Michael L. Zigelman is co-managing partner of the New York City office of Kaufman Dolowich & Voluck LLP and chair of its general liability coverage practice group. He concentrates his practice on all aspects of insurance coverage — including directors and officers

liability, professional liability, ERISA/fiduciary-related claims, commercial general liability (CGL), admiralty and maritime, toxic/mass tort and environmental coverage. He can be reached at mzigelman@kaufmandolowich.com. Daniel H. Brody is a partner in the New York City office of the firm. He concentrates his practice in insurance coverage matters representing insurance carriers, primarily with respect to liability policies for corporate directors and officers and other professionals. He can be reached at dbrody@kaufmandolowich.com.

This article was first published on Reuters Legal News and Westlaw Today on April 27, 2023. Thomson Reuters is a commercial publisher of content that is general and educational in nature, may not reflect all recent legal developments and may not apply to the specific facts and circumstances of individual transactions and cases.