Hirschler Fleischer Construction Series

Recoupment of Defense Costs: How Insurance Companies are Leaving Policyholders to Foot the Bill on Suits and Claims

By Chandra D. Lantz

Insurance can be a proactive way to manage risk and minimize costs. Most policyholders seek to transfer risk away from their own cash flow and assets to those of a commercial insurer. Increasingly, however, insurance companies have "turned the tables" by asking their policyholders to reimburse them for costs expended to defend or indemnify claims. This process, known as "recoupment," is an accelerating trend against which policyholders need to take prompt action to minimize the likelihood of being asked to foot the bill.

How Insurers Lay the Groundwork for Reimbursement from Their Policyholders

Commercial general liability policies often contain terms, which are interpreted to place a duty to defend on the insurer. Under these terms, the insurer must pay defense costs for any claim or suit that may potentially be covered by the policy. Typically, this duty is construed broadly to extend even to potentially covered claims. As such, an insurer could pay to defend claims that ultimately are not covered and for which it has no duty to pay the damages. As a result, insurers may seek ways to recover costs they may pay to defend non-covered claims. To do so, an insurer blazes a path for possible recoupment by issuing a Reservation of Rights letter to its policyholder after a claim is submitted.

Reservation of Rights letters can take many forms, but every letter sets forth one or more reasons why an insurance company believes some or all of the claims are not covered by a policy. After setting forth reasons why a claim is not covered, the insurer then states that it will defend subject to its "reservation of rights" to deny some or all coverage under the policy at a later time. Increasingly, insurers also are adding to the reservation of rights that they will seek reimbursement of their expenses from the policyholder if the insurer later determines that the claim should not have been covered. This "new" right is rarely in the insurance policy itself.

Different States, Different Outcomes

Courts are split on whether the use of a Reservation of Rights letter entitles an insurer to later seek recoupment of defense costs for claims determined to have fallen outside the coverage terms of a policy. Some courts that allow recoupment find that a policyholder's acceptance of a defense subject to the insurer's reservation of rights "implied" in a contract by which the insured agreed to reimburse the costs if there was no coverage. Other courts look to the legal concept of unjust enrichment, reasoning that allowing the insured to obtain the benefits of a defense for uncovered claims would be unjust. Finally, some courts conclude that allowing recoupment advances public policy by encouraging insurers to provide a defense even in unclear or "close call" coverage situations.

Courts that say "no" to recoupment typically conclude that a Reservation of Rights letter cannot unilaterally modify the terms of the insurance policy setting forth the agreement between the insurer and the policyholder. Unless the policy itself includes terms allowing recoupment, these courts deny reimbursement to the insurer. Other courts have reasoned that permitting recoupment improperly encourages insurance companies to "hedge their bets" by transferring all the risk to the insured. In other words, the insurer could avoid breach of contract or bad faith claims by providing a defense, while simultaneously, leaving the door open to demand reimbursement of the costs expended should the claim fall outside the policy's coverage. Finally, some courts conclude that an insurer who pays costs without having made a conclusive coverage determination is a "volunteer" who cannot gain any rights to reimbursement of sums voluntarily paid.

Steps to Take to Avoid a Recoupment Battle With Your Insurer

Policyholders can take affirmative steps to avoid becoming swept up in the recoupment trend. First, companies should review their policies to determine whether they have terms that allow the insurer to seek recoupment. For some policies, such as directors and officers liability coverage, recoupment provisions are not uncommon. However, standard commercial general liability policies typically do not include recoupment language.

Next, a policyholder should never ignore a Reservation of Rights letter. At a minimum, the policyholder should send a prompt response acknowledging the letter but stating that it does not accept the insurer's positions. Objections should be made to coverage defenses and to any attempt to lay the groundwork for recoupment. The policyholder should be sure that it clearly understands, from the insurer's letter(s), those policy provisions by which the insurer believes it can deny coverage and those by which it believes it can recoup costs.

Insureds also need to determine whether the insurer will seek to allocate costs between covered and non-covered claims and, if so, how such an allocation would be determined. Often, a lawyer's work to defend a case relates to multiple issues raised and is not readily apportioned between different claims in a suit.

A policyholders needs to consider whether it can or should retain independent counsel. When an insurer proceeds with a defense under a reservation of rights, the interests of the insured and the insurer can begin to conflict. For instance, when a lawsuit includes claims that are both covered and non-covered under the policy, some policyholders fear that an insurer could try to steer a judgment or settlement toward the non-covered claims to minimize its exposure. Depending on the jurisdiction, a policyholder may have a right to demand independent counsel if there is a potential conflict, while other jurisdictions will require a probable or actual conflict.

Where the stakes are particularly high – such as exceptionally high anticipated defense costs or the potential for a large judgment in excess of policy limits – a policyholder needs to make the difficult call of whether to step up its response to the Reservation of Rights letter. One option is for the insured to decline the insurer's defense, pay for the defense on its own, and then seek reimbursement of those costs under the policy if the claim is determined to be within the coverage provisions. Another option is to file a declaratory judgment lawsuit seeking to have a court determine whether the insurer must provide a defense for the claim.

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Reducing the Risk of Recoupment Requires Vigilance

Businesses with robust insurance programs, such as construction companies, have learned over the past several years that tendering, overseeing and resolving claims is an increasingly complex – and uncertain – process. The Reservation of Rights letter adds yet another layer of challenge. These letters should never be tossed in a claim file or otherwise ignored. Proactive communication with the insurer and management of a claim are required to minimize the possibility that a risk believed to have been transferred to insurance bounces back to the company through a recoupment claim. ❖