REIMBURSEMENT OF DEFENSE COSTS

AN INSURER'S DUTY TO DEFEND OR DUTY TO LEND

Summary: This article discusses the duty of the insurer to defend its insured and the subsequent possibility that the insurer will seek reimbursement of those defense costs from the insured. The article analyzes several court decisions from around the country that have dealt with the right of the insurer to reimbursement, with an even-handed presentation of those courts that have sided with the insurer and those that have sided with the insured when disputes have arisen between the two parties.

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Introduction

If coverage issues were stocks, the duty to defend would be Blue Chip. Like the returns characteristic of stocks in this category, the duty to defend has been consistent and predictable. Just as it's not a surprise when General Electric declares a dividend (as it has done every quarter for over 100 years), it also doesn't raise any eyebrows when a court somewhere declares that the duty to defend is—get ready—broader than the duty to indemnify.

Unlike flash-in-the-pan coverage issues, such as Y2K; emerging issues, such as junk faxes; fickle ones, like the absolute pollution exclusion; or the many coverage issues that develop slowly, but are at least subject to *some* incremental change, the duty to defend just keeps plodding along, as the Steady Eddie of the coverage world. Indeed, its general principles haven't changed since the days of Woodrow Wilson's administration. See *Greer-Robbins Company v. Pacific Surety Company*, 174 P. 110 (Cal. App. 1918). (The insurer argued that the duty to defend depends upon the outcome of the action against the insured. The court disagreed: "If the position of the appellant [insurer] were adhered to in all cases, it would work an alteration in the very language of the policy. It would change its terms from those imposing an obligation evidenced by the words 'will defend' to terms laying a duty indicated by some such words as 'should have defended.'")

It is perhaps because the breadth of the duty to defend has achieved taken-for-granted status that policyholders cry foul anytime they perceive an insurer straying from what they believe to be such a sacrosanct principle. And at no time does the shrill get louder than when an insurer, following a determination that the duty to defend did not in fact arise, attempts to recover defense costs from an insured to whom it provided a defense.

Insureds typically respond, vocally, that reimbursement of defense costs is simply not a right that exists for insurers, and any attempt to do so is the coverage equivalent of trying to put the toothpaste back into the tube.

The duty to defend has been the subject of litigation for decades. But litigation surrounding an insurer's right to reimbursement of defense costs has a much shorter history. While there are certainly some older cases that address the issue, the vast majority of decisions have come within the past ten years, with a significant spike witnessed in just the past two. In general, insurers have been winning a few more of these cases than they've been losing. The score is close. But even when insurers succeed in establishing that the right to reimbursement exists, they sometimes find that practical problems associated with the implementation of this right diminish its actual value. Thus, in some cases, an insurer's right to reimbursement of defense costs has more bark than bite.

What follows is a discussion of how several courts around the country have addressed reimbursement of defense costs and the rationales employed for permitting or rejecting it. In general, an insurer's right to reimbursement of defense costs is beginning to evolve into a two-schools-of-thought issue, with a body of case law emerging that permits reimbursement and a similar-size body that rejects it. Just as with other coverage issues that are the subject of competing schools, such as the absolute pollution exclusion (is it limited to so-called traditional environmental pollution?) and allocation of multiple triggered policies (pro-rata time on the risk versus joint and several liability), courts confronting the reimbursement issue for the first time will usually take note of the absence of binding precedent, turn to the competing schools for guidance and then decide in which one to enroll.

Insurers' Magic Buss

Any discussion of an insurer's right to reimbursement of defense costs must begin with the best known case in this area—*Jerry Buss v. Superior Court of Los Angeles County (Transamerica Ins. Co.)*, 939 P.2d 766 (Cal. 1997). Yes, *that* Jerry Buss. The one that brought us Laker Girls. Buss owned the Los Angeles Lakers as well as other sports teams in L.A., the Great Western Forum indoor arena and various cable television broadcasting networks. A dispute arose between Buss and H&H Sports over the provision of advertising for Buss. H&H filed a 27 count complaint against Buss. Buss sought coverage from Transamerica under CGL policies. Transamerica agreed to defend Buss on the basis of a defamation cause of action—the only cause of action out of 27 that Transamerica believed was potentially covered.

"I don't care how much it costs. (Buss. Magic Buss.)." With apologies to The Who's Pete Townshend, Transamerica did care how much it cost.

Transamerica reserved all of its rights, "including the right to deny that any cause of action was actually covered, and, '[w]ith respect to defense costs incurred or to be incurred in the future, . . . to be reimbursed and/or [to obtain] an allocation of attorney's fees and expenses in this action if it is determined that there is no coverage . . . . '" *Buss* at 770.

Buss paid H&H Sports $8.5 million to settle the dispute. Transamerica paid Buss' *Cumis* counsel approximately $1,000,000 and a Transamerica expert concluded that the amount to defend the defamation cause of action was between $21,000 and $55,000. ("*Cumis* counsel" comes from *San Diego Federal Credit Union v. Cumis Ins. Society, Inc.*, 162 Cal. App. 3d 358 (1984), codified at *Cal. Civ. Code* §2860, which generally provides that, under certain circumstances, when an insurer defends its insured under a reservation of rights, the insured is entitled to select its own counsel, paid for by the insurer.)

Besides all of the other reasons for his fame, Mr. Buss is also the namesake behind the landmark California Supreme Court decision that, in a so-called "mixed" action, in which some claims are potentially covered and others are not—thereby triggering a duty to defend the action in its entirety—an insurer may seek reimbursement of defense costs for claims that are not potentially covered. The *Buss* Court rested its decision on the following rationale:

> Under the policy, the insurer does not have a duty to defend the insured as to the claims that are not even potentially covered. With regard to defense costs for these claims, the insurer has not been paid premiums by the insured. It did not bargain to bear these costs. To attempt to shift them would not upset the arrangement. The insurer therefore has a right of reimbursement that is implied in law as quasi-contractual, whether or not it has one that is implied in fact in the policy as contractual. As stated, under the law of restitution such a right runs against the person who benefits from unjust enrichment and in favor of the person who suffers loss thereby. The enrichment of the insured

> by the insurer through the insurer's bearing of unbargained-for defense costs is inconsistent with the insurer's freedom under the policy and therefore must be deemed unjust. *Buss* at 776-777 (citation omitted).

Of course, the *Buss* rule is more valuable in theory than practice. The court held that "an insurer is only entitled to recover those defense expenses which can be fairly and reasonably allocated *solely* to non-covered claims for which there never was any potential for coverage." *Buss* at 778, n.15, quoting the Court of Appeal's decision in the case (emphasis in original). Thus, defense costs incurred to defend actually or potentially covered claims, as well as non-covered claims, cannot be recovered. *Id*.

It is no secret that, by limiting reimbursement of defense costs to those that can be allocated *solely* to non-covered claims, insurers have been handed a right that is sometimes more theoretical than tangible. After all, in a mixed action, the majority of the defense costs will likely have been incurred for claims that are both potentially covered and not covered. Translation: such costs can not be recovered. As the *Buss* Court itself noted, the task of allocating defense costs solely to claims that are not even potentially covered is at best extremely difficult and may never be feasible. *Buss* at 781, discussing *Hogan v. Midland National Ins. Co.*, 476 P.2d 825 (Cal. 1970).

It is for this reason—the practical problem of allocating defense costs in a mixed action—that a more important California decision for insurers in the context of defense cost reimbursement is *Scottsdale Insurance Company v. MV Transportation*, 115 P.3d 460 (Calif. 2005). In *MV Transportation*, Scottsdale was confronted with a request for a defense to an underlying action alleging contractual breaches, unlawful business practices and misappropriation of trade secrets. Scottsdale responded to the tender by noting that, while one Ninth Circuit case had concluded that certain trade secret misappropriation claims fall within the scope of a CGL policy's coverage for advertising injury, that case was distinguishable. Therefore, according to Scottsdale, its defense obligation was not triggered. Nonetheless, Scottsdale agreed to provide a defense under a reservation of rights, including the right to seek a declaration of its rights and duties under the policy and "[t]he right to seek reimbursement of defense fees paid toward defending causes of action which raise no potential for coverage, as authorized by the California Supreme Court in *Buss*." *MV Transportation* at 463–464.

Scottsdale incurred $340,000 in defense costs and sought a declaration that it owed no defense and was entitled to reimbursement of the costs paid. The California Court of Appeal ultimately concluded that the Scottsdale policies did not provide advertising injury coverage for the underlying trade secret claims at issue. However, the Court of Appeal also ruled that Scottsdale could not recover defense costs previously advanced: "[I]f the insurer wishes to limit its liability for defense costs, it either must adopt the 'risky strategy' of refusing a defense outright, thus exposing itself to a bad faith suit by the insured, or must seek, during the pendency of the third party action, to terminate its defense duty *from that time forward* by proving no potential for coverage." *MV Transportation* at 467 (italics in original).

Notwithstanding that *Buss* involved a mixed action, the California Supreme Court in *MV Transportation* viewed the present situation as indistinguishable from *Buss* and reversed the decision of the Court of Appeal: "[W]here the insurer, acting under a reservation of rights, has prophylactically financed the defense of claims as to which it owed no duty of defense, it is entitled to restitution. Otherwise, the insured, who did not bargain for a defense of non-covered claims, would receive a windfall and would be unjustly enriched." *MV Transportation* at 469.

Thus, the *MV Transportation* Court held:

> [W]e conclude that an insurer under a standard CGL policy, having properly reserved its rights, may advance sums to defend its insured against a third party lawsuit, and may thereafter recoup such costs from the insured if it is determined, as a matter of law, that no duty to defend ever arose because the third party suit never suggested the possibility of a covered claim. *MV Transportation* at 471.

Thus, just as in *Buss*, the *MV Transportation* Court's decision was grounded in contract principles, or the lack thereof: "The insured pays for, and can reasonably expect, a defense against third party claims that are potentially covered by its policy, but no more." *MV Transportation* at 469.

Buss made this point clearly by pointing out that an insurer's duty to defend an entire mixed action cannot be justified contractually. "To purport to make such a justification would be to hold what we cannot—that the duty to defend exists, as it were, in the air, without regard to whether or not the claims are at least potentially covered." *Buss* at 775. Nonetheless, the *Buss* Court stated, "[W]e 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[.]" *Buss* at 775 (citation omitted).

Reimbursement of Defense Costs—Post-*Buss*

Defense cost reimbursement was the subject of an expansive article in the Spring 2000 issue of the *Arizona Law Review* by Professor Robert H. Jerry, II, then Professor of Law at the University of Missouri-Columbia (now Dean of the University of Florida School of Law). *See* "The Insurer's Right to Reimbursement of Defense Costs," 42 *Ariz. L. Rev.* 13 (hereinafter "*the Jerry Article*"). In this article, written at a time when the issue was less developed than it is now, Professor Jerry advocated that the rationale typically asserted in support of an insurer's right to reimbursement—the law of restitution (as was the case in *Buss*)—was problematic. Professor Jerry noted that, as a result, "[W]hen the existence of the right is a question of first impression, as it will be in almost every jurisdiction in the United States, predicting whether a particular court will recognize the right is difficult." *Jerry Article* at 28. "If restitution law remains the framework for deciding the issue, one can anticipate courts in jurisdictions that have not yet considered the question reaching inconsistent results." *Jerry Article* at 73.

As the following information shows, Professor Jerry must have been staring into a crystal ball when he penned his reimbursement article in 2000. An insurer's right to reimbursement of defense costs is beginning to evolve into two schools of thought—one that permits it and another that rejects it. Each path is discussed below.

Courts Permitting Reimbursement of Defense Costs

In *Colony Insurance Company v. G & E Tires and Service, Inc.,* 777 So.2d 1034 (Fla. App. 2000), the insurer was requested to provide a defense to its insured for claims by an employee for battery, sexual harassment, invasion of privacy and intentional infliction of emotional distress. The insurer was adamant that no defense was owed because the claims were intentional torts and for injuries to employees in the workplace. Nonetheless, after initially sending three disclaimer letters, the insurer finally agreed to defend, subject to a reservation of its right to be reimbursed for "defense costs incurred or to be incurred in the future." *G & E Tires* at 1036. It was ultimately determined that the insurer was correct in its determination—the policy unequivocally excluded coverage for liability arising from the injuries. The insurer sought reimbursement of the defense costs incurred.

While the Florida appeals court in *G & E Tires* cited favorably to *Buss* in finding for the insurer, including quoting *Buss'* restitution analysis, the court did not expressly rely upon this rationale for its decision. Instead, the *G & E Tires Court* rested its decision on contract principles—not flowing from the insurance contract, but, rather, the reservation of rights. The *G & E Tires* Court held:

> Colony timely and expressly reserved the right to seek reimbursement of the costs of defending clearly uncovered claims, which it consistently identified as such. Having accepted Colony's offer of a defense with a reservation of the right to seek reimbursement, G & E ought in fairness make Colony whole, now that it has been judicially determined that no duty to defend ever existed. A party cannot accept tendered performance while unilaterally altering the material terms on which it is offered. *See* generally *Restatement (Second) of Contracts* § 69 (1981). * * * G & E's acceptance of the defense Colony offered to finance manifested acceptance of the terms on which Colony's offer to pay for the defense was tendered. *G & E Tires* at 1039.

See also, Jim Black & Associates, Inc. v. Transcontinental Insurance Company, 2006 Fla. App. LEXIS 10173. (Insurer provided a defense for claims that were determined not to be covered by the policy (patent infringement and unfair competition). Relying upon *G & E Tires*, the court allowed reimbursement of defense costs: "Jim Black agreed to defense counsel and accepted the defense provided; thus, Jim Black 'necessarily agreed to the terms' on which Transcontinental extended its offer to provide a defense.")

Another court to support an insurer's right to reimbursement of defense costs, based upon an implied in fact contract flowing from the reservation of rights letter, was the Sixth Circuit in *United National Insurance Company v. SST Fitness Corporation,* 309 F.3d 914 (6th Cir. 2002). Here, United National paid SST's defense costs in a patent and trademark infringement action, but provided a letter stating that it "reserves the right to recoup from SST any defense costs and fees to be

paid subject to this reservation letter on the basis that no duty to defend now exists or has existed with regard to the tendered suit." *SST Fitness* at 916.

The *SST Fitness* Court described the test to establish an implied in fact contract as follows: "United National must prove that SST accepted the defense costs with the reservation of rights under conditions disallowing an inference that United National acted gratuitously." *SST Fitness* at 920. The court held—over a strong dissent—that, by SST not objecting to the reservation of rights and accepting payment of defense costs, United National did not act gratuitously. Thus, an implied in fact contract was established.

The *SST Fitness* Court also sprinkled some public policy into its implied in fact contract rationale: "We agree that allowing an insurer to recover under an implied in fact contract theory so long as the insurer timely and explicitly reserved its right to recoup the costs and provided specific and adequate notice of the possibility of reimbursement promotes the policy of ensuring defenses are afforded even in questionable cases." *SST Fitness* at 921.

Lastly, the *SST Fitness* Court also rejected the argument that United National was not entitled to reimbursement because, having made a payment with knowledge of the facts and without legal or contractual obligation, it acted as a volunteer. However, the court held that because SST asked United National to pay the defense costs, United National could not be a volunteer.

Still another court to uphold an insurer's right to reimbursement of defense costs, but for less than clear reasons, was the Supreme Court of Guam in *National Union Fire Insurance Co. of Pittsburgh, PA v. Guam Housing and Urban Renewal Authority,* 2003 Guam LEXIS 35. The *Guam Housing* Court cited *Buss'* restitution rationale in support of reimbursement, noting that, to hold otherwise, would provide a windfall to the insured. "Because the insured does not bargain for a defense for claims which are not potentially covered, there is no duty under the policy to pay those defense costs, and the insured cannot expect the payment of a defense in such circumstance." *Guam Housing* at 52-53.

The *Guam Housing* Court then stated, curiously, that *Buss'* restitution principle was applied by the Sixth Circuit in *SST Fitness*: "We agree with the rationale articulated by the court in [*SST Fitness*], and find that the use of a unilateral reservation of rights letter is appropriate to apprise the insured of the fact that it cannot accept the windfall of defense costs for which it was not entitled to under the Policy." *Guam Housing* at 54. However, *SST Fitness* made no mention whatsoever of *Buss* and its windfall rationale, but, rather, based its decision upon an implied in fact contract flowing from the reservation of rights letter. The *SST Fitness* Court was clear about this: "A contract implied in law occurs when there is no meeting of the minds, and the law creates an obligation on a person who received a benefit and would be unjustly enriched by the benefit. (Citation omitted.) United National does not contend that this case involves a contract implied at law[.] United National argues, rather, the parties had a contract implied in fact." *SST Fitness* at 919.

In any event, confusion aside about how the *Guam Housing* Court arrived at its decision, the court upheld an insurer's right to reimbursement of defense costs, but also recognized that, because the underlying action involved both covered and non-covered claims, the insurer's right to reimbursement was dependent upon its ability to identify those costs which were attributable solely to non-covered claims. *Guam Housing* at 61.

The Supreme Court of Montana recently weighed in on the reimbursement issue in *Travelers Casualty & Surety Co. v. Ribi Immunochem Research,* 108 P.3d 469 (Mont 2005). The court upheld the insurer's right to reimbursement of defense costs after it determined that, because of the applicability of the pollution exclusion, the insurer had no duty to defend. The *Ribi* Court described its decision as follows:

> We likewise conclude the District Court properly determined that Travelers may recoup its defense costs expended on Ribi's behalf for those claims outside the CGL policy's pollution exclusion provision. Travelers timely and explicitly reserved its right to recoup defense costs when it notified Ribi of the reservation prior to the payment of the defense costs in [various] letters. Travelers expressly reserved its right to recoup defense costs if a court determined that it had no duty to provide such costs. Travelers also provided specific and adequate notice of the possibility of reimbursement. Ribi implicitly accepted Traveler's defense under a reservation of rights when it posed no objections. Under these circumstances, the District Court appropriately concluded that Travelers may recoup its defense costs. *Ribi* at 480.

While the *Ribi* Court's analysis of the reimbursement issue was limited, the court cited *G & E Tires* and briefly described *SST Fitness,* characterizing the

Sixth Circuit's holding as follows: A reservation of rights proves enforceable when an insurer timely and explicitly reserves its rights to recoup defense costs and provides specific and adequate notice to the insured of such possibility. *Ribi* at 480. But, most telling of the *Ribi* Court's rationale was its citation to the *Restatement (Second) of Contracts* §69 (1981): "[a] party cannot accept tendered performance while unilaterally altering the material terms on which it is altered." *Id.* Thus, without saying so explicitly, the *Ribi* Court upheld the insurer's right to reimbursement of defense costs on the basis that its reservation of rights letter created an implied in fact contract.

As noted previously, Professor Jerry warned in his 2000 *Arizona Law Review* article that if restitution law remained the framework for deciding the reimbursement issue, courts confronting the issue for the first time were likely to reach inconsistent results. Professor Jerry went on to advocate for a firmer foundation in support of the right to reimbursement—the law of and the concept of interim settlement of an unliquidated claim.

After describing the law of interim settlements and then applying it to the liability insurance context, Professor Jerry concluded that an "insurer has a right to reimbursement for costs incurred in defending noncovered claims, assuming that the insurer reserves its right to assert the reimbursement claim before it undertakes the defense." *Jerry Article* at 73. In support of this conclusion, he noted that, "Under contract law's principles of offer and acceptance, one cannot accept a tendered performance while unilaterally altering the material terms on which it was offered." *Id.* at 71-72. This is the same principle from the *Restatement (Second) of Contracts* that the courts in *G & E Tires* and *Ribi* subsequently cited in support of their decisions that a reservation of rights letter can give rise to an insurer's right to reimbursement of defense costs for noncovered claims.

It has been six years since Professor Jerry published his comprehensive study of defense cost reimbursement. In that time, there has been an explosion in the number of decisions addressing the issue. And several that have concluded that an insurer maintains the right to reimbursement of its defense costs have done so based on the precise firmer foundation that Professor Jerry advocated.

Courts Rejecting Reimbursement of Defense Costs

The Third Circuit's 1989 opinion in *Terra Nova Insurance Company, Ltd. v. 900 Bar, Inc., et al.*, 887 F.2d 1213 (3rd Cir. 1989) has become one of the leading decisions nationally in favor of rejecting an insurer's right to reimbursement of defense costs. Decided at a time when there was very little law on the issue, as evidenced by the fact that the *Terra Nova* Court cited none (either controlling or persuasive), the court rested its decision on its notion of certain practicalities of insurance and litigation. The *Terra Nova* Court stated:

> We have been unable to find any Pennsylvania authority that permits an insurer who defends under a reservation of rights to recover defense costs from its insured. We do not, however, rely solely on that negative implication. A rule permitting such recovery would be inconsistent with the legal principles that induce an insurer's offer to defend under reservation of rights. Faced with uncertainty as to its duty to indemnify, an insurer offers a defense under reservation of rights to avoid the risks that an inept or lackadaisical defense of the underlying action may expose it to if it turns out there is a duty to indemnify. At the same time, the insurer wishes to preserve its right to contest the duty to indemnify if the defense is unsuccessful. Thus, such an offer is made at least as much for the insurer's own benefit as for the insured's. If the insurer could recover defense costs, the insured would be required to pay for the insurer's action in protecting itself against the estoppel to deny coverage that would be implied if it undertook the defense without reservation. *Terra Nova* at 1219 – 1220.

The *Terra Nova* Court's rationale for rejecting the insurer's right to reimbursement of defense costs was simple. Since an insurer that is faced with uncertainty about its duty to indemnify receives a benefit from providing a defense, the insured is not unjustly enriched, even if it is ultimately determined that no duty to defend arose.

Terra Nova did not appear to involve the more frequently litigated situation in this area—an insurer that expressly reserved its rights to seek reimbursement of defense costs if it was later determined that no duty to defend was owed. However, several courts that have relied upon *Terra Nova's* lack-of-unjust-enrichment rationale for rejecting an insurer's right to reimbursement of defense costs have done so even when the insurer expressly reserved this right.

In *General Agents Insurance Company of America, Inc. v. Midwest Sporting Goods Company, et al.*, 828

N.E.2d 1092 (Ill. 2005), General Agents Insurance Company of America (Gainsco) funded the defense of Midwest Sporting Goods in an underlying action brought by the City of Chicago alleging that Midwest created a public nuisance by selling guns to inappropriate persons. Gainsco funded the defense, subject to a reservation of rights, specifically informing the insured that such rights "include[ed] 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." *Midwest Sporting Goods* at 1095.

Gainsco filed an action seeking a declaration that it did not owe Midwest Sporting Goods a defense in the underlying *City of Chicago* litigation and that Gainsco was entitled to recoup all defense costs paid to Midwest's counsel in the litigation. It was ultimately determined that Gainsco did not owe a defense to Midwest because the plaintiffs in the underlying litigation were seeking damages for economic loss and not bodily injury. That decision was affirmed by the Illinois Appeals Court and Midwest did not seek further review.

Having established that no duty to defend Midwest was owed, the trial and appeals courts also held that Gainsco, which reserved its right to recoup defense costs, was now entitled to their recovery. That issue made its way to the Illinois Supreme Court.

Midwest argued before the Supreme Court that the Gainsco policy contained no provision allowing for the recovery of defense costs. Gainsco's position was that this argument must fail because, following the courts' determination that no duty to defend was owed, there was no contract governing the parties' relationship.

The *Midwest Sporting Goods* Court acknowledged that other jurisdictions allow an insurer to recover defense costs from its insured where the insurer provides a defense under a reservation of rights, including the right to recoup defense costs, the insured accepts the defense and a court subsequently determines that the insurer did not owe a defense. Nonetheless, the Illinois Supreme Court declined to enroll in this school. The Supreme Court stated that to recognize such an implied agreement "places the insured in the position of making a Hobson's choice between accepting the insurer's additional conditions on its defense or losing its right to a defense from the insurer." *Midwest Sporting Goods* at 1102.

Among other cases, *Midwest Sporting Goods* relied on *Terra Nova*, and its rejection of unjust enrichment as the basis to allow an insurer to recover its defense costs. After quoting most of the lengthy passage from *Terra Nova* that has been previously set out, the *Midwest Sporting Goods* Court agreed that when an insurer tenders a defense pursuant to a reservation of rights, "the insurer is protecting itself at least as much as it is protecting its insured." *Id*. at 1103.

The Illinois Supreme Court also rejected Gainsco's argument that, following the lower courts' decision that no duty to defend existed, there was no contract governing the parties' relationship. The Supreme Court noted that the problem with this argument was that Gainsco was defining its duty to defend based on the outcome of the declaratory judgment action, yet an insurer's duty to defend arises as soon as damages are sought.

Despite its conclusion, the Illinois Supreme Court did not rule out the possibility of an insurer recovering defense costs under different circumstances: "Certainly, if an insurer wishes to retain its right to seek reimbursement of defense costs in the event it later is determined that the underlying claim is not covered by the policy, the insurer is free to include such a term in its insurance contract. Absent such a provision in the policy, however, an insurer cannot later attempt to amend the policy by including the right to reimbursement in its reservation of rights letter." *Midwest Sporting Goods* at 1103. *See also, Employers Mutual Casualty Company v. Industrial Rubber Products, Inc., et al*., 2006 U.S. Dist. LEXIS 9242 (D. Minn.) (Court relied upon *Midwest Sporting Goods*, among other reasons, for denying the insurer the right to reimbursement of defense costs.)

Another court that recently relied upon *Terra Nova* to deny an insurer the right to reimbursement of defense costs was *L.A. Weight Loss Centers, Inc. v. Lexington Insurance Company,* 2006 Phila. Ct. Com. Pl. LEXIS 127. Here, a Pennsylvania trial court addressed Lexington's right to reimbursement of defense costs, after making a determination that the insurer had no duty to defend under a claims-made policy because the underlying claim was first made prior to the policy period.

After presenting and analyzing the points of the two schools of thought on the reimbursement issue, the *L.A. Weight Loss Court* held that the courts that have denied insurers the right to reimbursement are more persuasive. Besides citing several decisions from around the country that have denied the right of reimbursement, the *L.A. Weight Loss Court* also quoted liberally from *Terra Nova* and concluded that an insured is not unjustly enriched when an insurer tenders a defense, even

if it is later determined that the insurer did not owe a defense. *L.A. Weight Loss* at 22-23.

Not all courts that reject an insurer's right to reimbursement of defense costs have done so based on *Terra Nova's* rationale that unjust enrichment is lacking. In *Shoshone First Bank v. Pacific Employers Insurance Co*., 2 P.3d 510 (Wyo. 2000), the Supreme Court of Wyoming denied an insurer the right to reimbursement of defense costs in a mixed action. At issue was coverage for a wrongful termination of employment claim under a commercial general liability policy. The insurer agreed to defend because a count for invasion of privacy was potentially covered. However, the insurer also asserted that it was entitled to allocate to the insured the cost of the defense related to uncovered claims. The Supreme Court of Wyoming disagreed: "Recognizing that in other jurisdictions allocation is allowed between the insurer and the insured, we eschew this theory, and hold that unless an agreement to the contrary is found in the policy, the insurer is liable for all of the costs of defending the action." *Shoshone* at 514.

The *Shoshone* Court cited several reasons for its decision. First, the court declined to get on the *Buss*. But it is difficult to put much stock in this reason since the *Shoshone* Court clearly misunderstood *Buss*. The *Shoshone* Court stated that *Buss* "illustrates the problems that can be anticipated if the insurer is permitted to pick and choose which claims it will defend. Added to those difficulties would be the predicament of the insured in having to obtain separate counsel to defend non-covered claims and potential disagreements between members of the defense team." *Shoshone* at 515. However, nowhere does *Buss* state that, in a mixed action, the insurer is entitled to provide a defense for only the potentially covered claims, thereby giving rise to multiple members of a defense team, and, hence, potential disagreements.

In any event, the *Shoshone* Court also relied upon *Buss'* observation, without actually citing to it, that "no right of allocation should exist if the costs incurred for the defense of a non-covered claim were necessarily incurred or would have had to be incurred because of the defense of a covered claim." *Id*., citing 1 Allan D. Windt, *Insurance Claims & Disputes*, §4.13 at 201-03 & n.162 (3d ed. Shepard's/McGraw-Hill 1995).

Lastly, the *Shoshone* Court rejected the insurer's argument that its reservation of rights letter can create a right of reimbursement:

> The insurer is not permitted to unilaterally modify and change policy coverage. We agree with the Supreme Court of Hawaii that a reservation of rights letter "does not relieve the insurer of the costs incurred in defending its insured where the insurer was obligated, in the first instance, to provide such a defense." *First Ins. Co. of Hawaii, Inc. v. State, by Minami*, 66 Haw. 413, 665 P.2d 648, 654 (1983). Pacific could have included allocation language in the Policy, but it failed to do so. * * * The policy issued to Shoshone by Pacific states a duty to defend, and allocation is not mentioned. In light of the failure of the policy language to provide for allocation, we will not permit the contract to be amended or altered by a reservation of rights letter. *Id*. at 515-516.

While the *Shoshone* Court concluded that the insurer was not entitled to allocate to the insured the cost of defense related to uncovered claims, the court was at least consistent when it came to the question whether the insurer was entitled to allocate to the insured the cost of prosecuting the insured's counterclaim. "With respect to the costs of prosecuting a counterclaim, unless the policy specifically provides coverage for those expenses, we will not amend the contract. Because there was no coverage for prosecuting the counterclaim in this case, Pacific is not required to assume the expense of Shoshone's counterclaims, and it must be allowed to allocate and recover those costs." *Id.* at 517.

The latest court to address the reimbursement issue, as of the time of this writing, was the Fourth Circuit in *Perdue Farms v. Travelers Casualty & Surety Company,* 448 F.3d 252 (4th Cir. 2006). In *Perdue Farms*, the court addressed Travelers' right to reimbursement of defense costs under the following circumstances. Travelers issued a Pension and Welfare Fund Fiduciary Responsibility Insurance policy to Perdue. Several current and former Perdue employees filed suit against Perdue, alleging that its compensation and record-keep practices were unlawful. The suit contained counts under ERISA and alleged violations of several states' wage and hours laws. Travelers determined that the ERISA claims were potentially covered and triggered its duty to defend, but that the wage and hour claims were not covered. Travelers reserved its rights, including the right to seek reimbursement of defense costs expended on non-covered claims. Travelers' expenses to defend Perdue—over $4.4 million—was not chicken feed.

Perdue settled the litigation for $10 million and then sought coverage for this entire amount, less $775,092 paid to those plaintiffs asserting only wage and hour claims and $98,515 in plaintiffs'

attorneys' fees related solely to those claims. Perdue conceded that these sums were unrelated to any ERISA claims, and, therefore, not covered by the policy. Travelers sought reimbursement from Perdue of that portion of the approximately $4.4 million in defense costs attributable to non-covered wage and hour claims.

The District Court held that no right of reimbursement existed under Maryland law. The Fourth Circuit agreed. In rejecting Travelers' claim for reimbursement of defense costs, the *Perdue Farms* Court cited to several cases nationally on both sides of the issue. The court ultimately relied on both the breadth of the duty to defend and *Terra Nova* as its rationales for its decision.

The *Perdue Farms* Court cited to *Terra Nova's* rationale that the duty to defend is beneficial to both the insured *and the insurer*. "The insurer … secures the *right* to defend 'as a mechanism for protecting and minimizing its duty of indemnification.'" *Perdue Farms* at 259 (citation omitted) (emphasis in original).

The court also held that, "[u]nder Maryland's comprehensive duty to defend, if an insurance policy potentially covers any claim in an underlying complaint, the insurer, as Travelers did here, must typically defend the entire suit, including non-covered claims. Properly considered, a partial right of reimbursement would thus serve only as a back-door narrowing of the duty to defend, and would appreciably erode Maryland's long-held view that the duty to defend is broader than the duty to indemnify." *Perdue Farms* at 258 (citation omitted). Thus, the *Perdue Farms* Court was "unwilling to grant insurers a substantial rebate on their duty to defend." *Id*. Moreover, the court also noted that, even if Maryland might at some point allow a right of partial reimbursement, the defense costs at issue for covered and uncovered claims may have significantly overlapped. *Id*. In other words, insurers may find that the victory they fought so hard for was hollow.

Conclusion

At the present rate, a consensus is not going to be reached over an insurer's right to reimbursement of defense costs. It seems likely that more cases will come along, some states will embrace reimbursement, others will reject it and there will be no shortage of reasons for the results. In that sense, the reimbursement issue is like so many others involving insurance coverage—the answer will depend on the insured's address on the front of the policy.

On the other, there is also something unique about this coverage issue. The decisions reached by courts addressing it are generally black and white—reimbursement is either permitted or it is not. As readers of this publication are well-aware, this is unusual for a coverage issue, as most are painted shades of gray. For example, even when a coverage issue has been the subject of a clear pronouncement by a state's highest court, nuances in the facts or policy language can still lead to uncertainty in predicting the outcome of a future dispute. For this reasons, insurers sometimes eschew coverage litigation, even when the case law is generally in their favor.

But reimbursement of defense costs is an issue that is less likely than others to be altered by the specifics of a given case. In other words, the issue is more one of law than some other issues, which are often a combination of law and fact. Therefore, an insurer handling claims in a state that permits reimbursement of defense costs, and that takes the necessary steps to preserve this right, will likely have more certainty about the outcome than in other cases.

However, the practical difficulties of allocating defense costs between covered and uncovered claims are not going to change. And many courts will likely continue to respond to this problem by asserting that defense costs incurred to defend actually or potentially covered claims, as well as non-covered claims, cannot be recovered. These realities will likely continue to prevent some insurers from pursuing this issue—either in an attempt to create the right or enforce it. For this reason, the real benefit for insurers when it comes to reimbursement of defense costs will likely be limited to those cases that are not mixed actions, but, rather, that involve an insurer that has undertaken a defense and can then establish that there were in fact no claims whatsoever that triggered such duty.