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Why Courts Are Nixing Insurer Defense Recoupment Claims

By **Bradley Nash** (December 14, 2023, 5:04 PM EST)


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The Supreme Court of Hawaii is the most recent state high court to weigh in on an important issue affecting insurance policyholders: whether an insurer is permitted to recoup defense costs based on a finding that it has no duty to indemnify the insured.

In a decision issued on Nov. 14, in St. Paul Fire & Marine Insurance Co. v. Bodell Construction Co., the court, answering a certified question from the U.S. District Court for the District of Hawaii, held that "an insurer may not recover defense costs for defended claims unless the insurance policy contains an express reimbursement provision."[1]

The Bodell decision is an important victory for policyholders that preserves the crucial distinction between the duty to indemnify and the duty to defend.

A Recent Trend In Case Law Finding No Right To Recoup Defense Costs

Liability insurance policies typically require an insurer both to indemnify the insured for certain covered losses, and to defend the insured in litigation. The duty to defend is broader, in several respects, than the duty to indemnify.

As the court in Bodell laid out, the insurer must provide a defense when there is possible coverage, even if the claims are "groundless, false, or fraudulent."[2] And when the duty to defend is triggered, the insurer must defend the entire case, including both covered and uncovered claims.[3]

As a result, it is not unusual for an insurer to defend its insured under a reservation of rights, and later obtain a ruling that it has no obligation to indemnify. In that scenario, can the insurer seek to recoup the defense costs it expended for noncovered claims? Liability policies are often silent on the issue of recoupment, and courts have reached different conclusions on this question.

In one camp are decisions recognizing a right of recoupment, particularly where the insurer expressly reserves a right to recoup defense costs for noncovered claims in a reservation of rights letter. At one time, this was regarded as the majority rule.[4]

The Hawaii Supreme Court has joined what the U.S. Court of Appeals for the Eleventh Circuit described in its decision earlier this year in Continental Casualty Co. v. Winder Laboratories LLC as a "recent trend of state high courts holding that there is no right to reimbursement in similar cases."[5]

In recognition of this national trend, the Restatement of the Law of Liability Insurance has taken the position that "[u]nless otherwise stated in the insurance policy or otherwise agreed to by the insured, an insurer may not obtain recoupment of defense costs from the insured."[6]

The Hawaii Supreme Court's Decision

The Bodell decision provides a concise explanation of the anti-recoupment position, focusing on three considerations.

First, the Hawaii Supreme Court's analysis proceeds from the principle that the parties' rights are governed by the express terms of the policy, which, under established law, "must be construed liberally in favor of the insured and any ambiguities must be resolved against the insurer."[7] Here, the policy expressly provided for a duty to defend, and was silent on the issue of recoupment.

That the insurer had purported to assert a right of recoupment in its reservation of rights letter was unavailing, for while "[i]nsurers may reserve contractual rights," they may "not create new ones" unilaterally.[8] Accordingly, the court concluded that "[i]f an insurance contract has no express right to reimbursement, there's no reimbursement."[9]

Second, the court found that recognizing a right of recoupment would improperly erode the duty to defend.[10] While an insurer "only indemnifies covered claims," the duty to defend is broader, and is triggered whenever there is possible coverage, even for "groundless, false, or fraudulent" claims.[11]

Where only some of the claims against the insured are potentially covered, the insurer must defend the entire case, even those claims that are indisputably outside the scope of coverage.[12] Moreover, the duty to defend must be determined at the outset of the case, "as soon as damages are sought" — unlike the duty to indemnify, which is resolved "after damages are fixed" at the conclusion of the underlying case.[13]

Allowing recoupment of defense costs would have the effect of collapsing the two distinct duties, as insurers would only be required to defend "to the same extent that they must ultimately indemnify."[14]

Although not discussed by the Hawaii Supreme Court, the outcome in Bodell also preserves the distinction between the duty to defend and the separate duty under certain policies to advance defense costs in the absence of a duty to defend.

Where the insurer's contemporaneous payment of defense costs is an advance on the insurer's duty to indemnity, the insurer is sometimes permitted to seek recoupment of the advanced funds upon a determination that there is no indemnity coverage. Recognizing a default right of recoupment would effectively transform the broad duty to defend into the narrower duty to advance defense costs.

Third, the court rejected the argument that in the absence of recoupment, policyholders will be unjustly enriched insofar as they receive a defense for claims that turn out not to be covered by the policy.[15] The insurer is compensated for providing a defense, both through its retention of the insured's premiums and by maintaining control of the defense.

A right of recoupment, the Hawaii Supreme Court concluded, could actually result in the unjust enrichment of the insurer, which would be protected from a bad faith of breach of contract action by

providing a defense, without bearing any ultimate responsibility for defense costs.[16]

A Split of Authority on Recoupment Under New York Law

The law in New York remains unsettled on the issue of recoupment of defense costs. In American Western Home Insurance Co. v. Gjonaj Realty & Management Co., a lengthy decision applying reasoning similar to the Hawaii Supreme Court, the Second Department of New York's Appellate Division held in December 2020 that insurers have no right of recoupment absent express authorization in the policy.[17]

On the other hand, the First Department appears to have recognized a right of recoupment in a series of brief decisions that offer no analysis of the legal issues.[18] Trial courts in Manhattan, which are under the jurisdiction of the First Department, have continued to permit insurer recoupment claims, while acknowledging the Second Department's contrary ruling — as in for instance the Liberty Insurance Underwriters Inc. v. The Plaza Condominium decision from March.[19]

Given the divergent appellate authorities, this issue is ripe for resolution by the New York Court of Appeals.

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[1] St. Paul Fire & Marine Ins. Co. v. Bodell Construction Co., No. SCCQ-22-0000658, ___ P.3 ___, 2023 WL 7517083 (Haw. Nov. 14, 2023).

[2] Id., at *3.

[3] Id.

[4] See, e.g., Buss v. Superior Ct., 16 Cal. 4th 35 (Ca. 1997); Nautilus Ins. Co. v. Access Medical LLC, 137 Nev. 96 (Nev. 2021); Security Ins. Co. of Hartford v. Lumbermens Mut. Cas. Co., 264 Conn. 688 (Conn. 2003).

[5] Cont'l Cas. Co. v. Winder Laboratories LLC, 73 F.4th 934, 949 (11th Cir. 2023); see, e.g., National Surety Corp. v. Immunex Corp., 176 Wash.2d 872 (Wash. 2013); General Agents Ins. Co. of America v. Midwest Sporting Goods Co., 215 Ill.2d 146 (Ill. 2005); Am. & Foreign Ins. Co. v. Jerry's Sport Center Inc., 606 Pa. 584 (Pa. 2010); Texas Ass'n of Counties County Government Risk Management Pool v. Matagorda County, 52 S.W.3d 128 (Tex. 2000).

[6] Restatement of the Law of Liability Insurance § 21.

[7] Bodell Construction, 2023 WL 7517083, at *2 (quoting Tri-S Corp. v. Western World Ins. Co., 135 P.3d 82, 98 (Haw. 2006).

[8] Id.

[9] Id.

[10] Id.

[11] Id., at *3.

[12] Id.

[13] Id.

[14] Id.

[15] Id., at *4.

[16] Id.

[17] See American Western Home Ins. Co. v. Gjonaj Realty & Mgt. Co., 192 A.D.3d 28 (N.Y. App. Div. 2d Dep't 2020).

[18] See Certain Underwriters at Lloyd's London v. Avance Transit Co., 188 A.D.3d 523 (N.Y. App. Div. 1st Dep't 2020); American Home Assurance Co. v. Port Authority of N.Y. and N.J., 166 A.D.3d 464 (N.Y. App. Div. 1st Dep't 2018); Certain Underwriters at Lloyd's London v. Lacher & Lovell-Taylor PC, 112 A.D.3d 434 (1st Dep't 2013).

[19] See, e.g., Liberty Ins. Underwriters Inc. v. The Plaza Condominium, No. 656871/2017, 2023 WL 2730472, at *2 (Sup. Ct. N.Y. Cty. March 31, 2023) (acknowledging Second Department's holding in Gjonaj Realty but declining to "ignore binding First Department precedent in deference to a contrary decision from another Department").