INSURER RECOUPMENT OF DEFENSE COSTS: WHY THE RESTATEMENT ADOPTS THE WRONG APPROACH

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The default rule that the April 30, 2015 Discussion Draft of the American Law Institute's ("ALI") Restatement of the Law of Liability Insurance adopts, with respect to insurer recoupment of defense costs, is one of the more controversial provisions in the draft, having taken a view that is at odds with the majority of courts and with another ALI Restatement, the Restatement (Third) of Restitution and Unjust Enrichment ("R3RUE").

In adopting the minority view in a sweeping rule that would prohibit recoupment in all circumstances where there is no explicit contractual agreement permitting it, this section of the draft turns too far away from articulating black letter law as it stands. To the extent this section is seeking "to ascertain the relative desirability of competing rules,"[1] a Restatement provision reversing the majority common law approach to recoupment is unsound because it is not a subtle change in the law, but a major one—and this change is not supported by reliable empirical analysis or (as shown below) a clear trend in the direction of the law. Further, adherence to the majority view allowing recoupment is justified based on coherence with other precedents—such as the ALI's own R3RUE—and the law as a whole. The Restatement should adopt the majority view, providing a default rule allowing recoupment of the costs of defense when a court later determines that an insurer advanced costs under a reservation of rights for an uncovered claim. As it stands, the Restatement does not even give courts the flexibility to apply equitable

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1. RESTATEMENT OF THE LAW OF LIAB. INS. at xi (AM. LAW INST., Discussion Draft 2015).

considerations and reach just results with respect to recoupment claims taking into account the individual circumstances of each claim.

In the most recent Restatement draft, section 21, "Insurer Recoupment of the Costs of Defense," provides: "Unless otherwise stated in the insurance policy or otherwise agreed to by the insured, an insurer may not seek recoupment of defense costs from the insured, even when it is subsequently determined that the insurer did not have a duty to defend or pay defense costs."[2] In the April 30 Discussion Draft, the section is described as one that adopts the rule

> that the insurer does not have a right of recoupment of defense costs, even when it is subsequently determined that the insurer did not have the duty to defend or pay for the defense of all or part of a claim. Although existing insurance policies generally do not grant insurers a right to recoupment, a slim majority of the courts that have considered this issue have held that insurers are nevertheless entitled to recover the costs of defending uncovered claims on a theory of unjust enrichment. More recent cases, however, tend to allow the insurer's claim to recoupment in such cases only when it is recognized by a term of the policy or subsequent agreement of the parties.[3]

In fact, most courts do permit insurers to seek reimbursement of expenses incurred in the defense of uncovered claims.[4] Many courts base this right on an implied-in-fact contract theory,[5] while others apply the equitable doctrine of unjust enrichment.[6] Several have even ruled that

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2. *Id.* § 21.

3. *Id.* § 21 cmt. a.

4. *See, e.g.*, Dupree v. Scottsdale Ins. Co., 947 N.Y.S.2d 428, 429 (App. Div. 2012) (citing Fed. Ins. Co. v. Kozlowski, 792 N.Y.S.2d 397 (App. Div. 2005)) (acknowledging an insurer's right to recoupment in the event that a later determination of no coverage is made).

5. *See, e.g.*, United Nat'l Ins. Co. v. SST Fitness Corp., 309 F.3d 914, 921 (6th Cir. 2002); Colony Ins. Co. v. G & E Tires & Serv., Inc., 777 So. 2d 1034, 1039 (Fla. Dist. Ct. App. 2000); Travelers Cas. & Sur. Co. v. Ribi ImmunoChem Research, Inc., 108 P.3d 469, 480 (Mont. 2005). *But see* Capitol Indem. Corp. v. Blazer, 51 F. Supp. 2d 1080, 1090 (D. Nev. 1999) (disallowing recoupment after finding "no understanding between the parties" (citing St. Paul Mercury Ins. Co. v. Ralee Eng'g Co., 804 F.2d 520, 522 (9th Cir. 1986))).

6. *See, e.g.*, Travelers Prop. Cas. Co. of Am. v. Hillerich & Bradsby Co., 598 F.3d 257, 269 (6th Cir. 2010); Scottsdale Ins. v. Sullivan Props., Inc., No. 04-00550 HG-BMK, 2007 WL 2247795, at *4 (D. Haw. Aug. 2, 2007); Cincinnati Ins. Co. v. Grand Pointe, LLC, 501 F. Supp. 2d 1145, 1169 (E.D. Tenn. 2007); Sec. Ins. Co. of Hartford v. Lumbermens Mut. Cas. Co., 826 A.2d 107, 125 (Conn. 2003) (quoting *Buss*, 939 P.2d at 776); NCMIC Ins. Co. v. Dailey, No. 267801, 2006 WL 2035597, at *6 (Mich. Ct. App. July 20, 2006); Hebela v. Healthcare Ins. Co., 851 A.2d 75, 86 (N.J. Super. Ct. App. Div. 2004) (citing Buss v.

recoupment rights are implied by widely-used terms in liability insurance policies.[7] And without resolving these theoretical differences, many courts simply have ruled that insurers are entitled to recoupment.[8] Even the opinions disallowing recoupment concede this to be the majority rule.[9] The Restatement draft adopts an argument advanced by some policyholders in an attempt to build up the credibility of a per se denial of recoupment by asserting that the "trend" is in their favor.[10] But this is just not so—and dozens of recent decisions illustrate the strong and continued vitality of the majority rule.[11]

Superior Court, 939 P.2d 766, 776–78 (Cal. 1997)).

7. *See, e.g.*, *Sullivan Props., Inc.*, 2007 WL 2247795, at *5; Blue Ridge Ins. Co. v. Jacobsen, 22 P.3d 313, 321 (Cal. 2001).

8. *See, e.g.*, Valley Forge Ins. Co. v. Health Care Mgmt. Partners, Ltd., 616 F.3d 1086, 1094 (10th Cir. 2010); Ill. Union Ins. Co. v. NRI Constr. Inc., 846 F. Supp. 2d 1366, 1377 (N.D. Ga. 2012); Auto-Owners Ins. Co. v. Prairie Auto Grp., Inc., No. 06-5065-KES, 2008 WL 2403381, at *3 (D.S.D. June 10, 2008); Melton Truck Lines, Inc. v. Indem. Ins. Co. of N. Am., No. 04-CV-263-JHP-SAJ, 2006 WL 1876528, at *2 (N.D. Okla. June 26, 2006); Resure, Inc. v. Chem. Distribs., Inc., 927 F. Supp. 190, 194 (M.D. La. 1996); Nucor Corp. v. Emp'rs Ins. Co. of Wasau, Nos. 1 CA-CV 10-0174, 1 CA-CV 10-0454, 2012 WL 6117029 (Ariz. Ct. App. Nov. 23, 2012) (citing *Buss*, 939 P.2d 766); Nationwide Mut. Ins. Co. v. Flagg, 789 A.2d 586, 597 (Del. Super. Ct. 2001) (citing First Del. Ins. Co. v. Tilcon Del., Inc., No. CIV.A.97C-06-004JOH, 1998 WL 278311 (Del. Super. Ct. Mar. 31, 1998)).

9. *See, e.g.*, Gen. Agents Ins. Co. of Am. v. Midwest Sporting Goods Co., 828 N.E.2d 1092, 1104 (Ill. 2005); Shoshone First Bank v. Pac. Emp'rs Ins. Co., 2 P.3d 510, 514 (Wyo. 2000).

10. RESTATEMENT OF THE LAW OF LIAB. INS. § 21 reporters' note a (AM. LAW INST., Discussion Draft 2015); *see, e.g.*, Travelers Prop. Cas. Co. v. R.L. Polk & Co., No. 06-12895, 2008 WL 786678, at *2 (E.D. Mich. Mar. 24, 2008); Am. & Foreign Ins. Co. v. Jerry's Sport Ctr., Inc., 2 A.3d 526, 536 (Pa. 2010).

11. *See, e.g.*, *Health Care Mgmt. Partners, Ltd.*, 616 F.3d at 1094 (applying Colorado law and holding that insurers could be entitled to recoup defense costs paid for uncovered claims); *Hillerich & Bradsby Co.*, 598 F.3d at 266, 268 (applying Kentucky law and adopting the "majority rule" of permitting recoupment); *NRI Constr. Inc.*, 846 F. Supp. 2d at 1377 (finding the majority view persuasive and holding that an insurer has a right to recoup defense costs for legal expenses incurred in defending a non-covered claim); Certain Interested Underwriters at Lloyd's, London Subscribing to Certificate of Ins. No. 9214 v. Halikoytakis, No. 8:09-CV-1081-T-17TGW, 2012 WL 487464, at *3 (M.D. Fla. Feb. 2, 2012) (ruling that an insurer was entitled to reimbursement); Elec. Ins. Co. v. Marcantonis, No. 09-5076 (JEI/JS), 2011 WL 883282, at *2 (D.N.J. Mar. 11, 2011) (holding that an insurer was entitled to recoupment on "the principle that an insurer contracts to pay the cost of defending covered claims but not the cost of defending uncovered claims" (citing SL Indus., Inc. v. Am. Motorists Ins. Co., 607 A.2d 1266, 1280 (N.J. 1992))); Phillips & Assocs., P.C. v. Navigators Ins. Co., 764 F. Supp. 2d 1174, 1177–78 (D. Ariz. 2011) (finding that the insurer "may recoup amounts paid in defending and settling" an underlying action, "provided [that] it prevails on the merits of the coverage dispute," because the insurer reserved its right to reimbursement); Lumbermens Mut. Cas. Co. v. RGIS Inventory Specialists, LLC, No. 08 Civ. 1316 (HB), 2010 WL 2017272, at *5 (S.D.N.Y. May 20, 2010) (applying Michigan law and predicting that Michigan would permit recoupment); *Prairie Auto Grp., Inc.*, 2008 WL 2403381, at *3 ("[W]hen an insurance company tenders defense on behalf of its insured, it

The other stated justifications for adopting the minority "no recoupment" approach are without empirical support and are unfounded. The Restatement draft states:

> The default rule adopted in this Section would likely result in lower overall litigation costs than would the alternative rule of recoupment. For example, in cases involving covered and noncovered claims, under a recoupment rule there would often have to be subsequent litigation over the question whether, or to what extent, the defense costs were incurred by the insurer in connection with noncovered claims. The rule adopted in this Section entails no such secondary litigation.[12]

This comment overlooks how the proposed approach in the draft would result in increased litigation and litigation costs. Under its approach, insureds would be encouraged to engage in conduct that will drive up litigation costs. When insurers do defend claims while reserving rights, insureds would have an incentive to stave off a judicial determination regarding coverage if the per se anti-recoupment rule prevails. Policyholders could seek to stay any coverage action pending resolution of underlying claims. Indeed, if successful in doing so, they would in essence have created de facto defense coverage. When coverage litigation does proceed, insureds will be motivated to draw it out for as long as possible, such as through frivolous motions and needless discovery disputes, and they will have no reason to defend underlying claims efficiently since the bill will be paid by their insurer. While a court could seek to mitigate these impacts by staying underlying litigation, such a result could delay or prevent the resolution of those claims.

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can reserve a right to seek costs associated with the defense of the claims that were not covered by the issued policy." (first citing Knapp v. Commonwealth Land Title Ins. Co., 932 F. Supp. 1169, 1171–72 (D. Minn. 1996); and then citing Walbrook Ins. Co. v. Goshgarian & Goshgarian, 726 F. Supp. 777, 784 (C.D. Cal. 1989))); *R.L. Polk & Co.*, 2008 WL 786678, at *2 (applying Michigan law and rejecting an insured's argument that the "modern trend" of authority weighed in favor of precluding recoupment); *Sullivan Props., Inc.*, 2007 WL 2247795, at *3 ("A review of Hawaii law shows that Hawaii courts would recognize the right of insurers to recoup defense costs when defending under a reservation of rights letter which expressly reserves the insurers right to reimbursement."); *Nucor Corp.*, 2012 WL 6117029, at *4 (permitting recoupment without identifying the particular theory upon which the costs of uncovered claims are reimbursable); Dupree v. Scottsdale Ins. Co., 947 N.Y.S.2d 428, 429 (App. Div. 2012) (acknowledging an insurer's right to recoupment in the event that a later determination of no coverage is made).

12. RESTATEMENT OF THE LAW OF LIAB. INS. § 21 cmt. a (AM. LAW INST., Discussion Draft 2015).

In addition, the Restatement draft argues that "because this rule is merely a default, if it turns out that the recoupment rule would be relatively easy to administer or that the costs justify the expense, insurers can incorporate an express right to recoupment in their policies."[13] And the draft further posits that "an insurer's choice not to insert a recoupment provision in the policy acquires contractual significance."[14] This argument ignores the reality that many, if not most, recoupment disputes will arise in relation to policies that were issued before the Restatement was adopted, so that there was no opportunity to insert an express contractual term on this point in response to a proposed reversal of the law by the Restatement. Further, it is unsound to suggest that a right to recoupment should only be recognized if explicitly provided for in an insurance policy. By definition, recoupment claims arise in a situation in which the insurer never had a duty to defend under the terms of its insurance policy. Because the insurance policy imposed no defense obligations, and the costs of defense were not incurred pursuant to the insurance policy's dictates, that policy's terms are irrelevant for determining the insurer's right to recoupment.

Given this background, a right to recoupment should be recognized consistent with the prevailing view in the existing case law. Unfortunately, the approach in the draft Restatement is not to recognize a right to recoupment in all cases, thus rejecting the majority view. It turns the majority view on its head and rejects recoupment across the board. Thus, the Restatement approach would not even allow courts to look to the individual facts and circumstances of each case to determine whether recoupment should be allowed. To prove entitlement under an unjust enrichment theory, a plaintiff seeking recoupment must show that the defendant was "unjustly enriched at the [plaintiff's] expense" and that the plaintiff was not a mere volunteer.[15] In the insurance context, the policyholder clearly is enriched if the insurer pays for the defense of uncovered claims, and the insurer presumably is not a volunteer because the policyholder requested a defense.

This view is consistent with the ALI's R3RUE, which is at odds with the approach to recoupment adopted in the Restatement draft. The draft attempts to address this problem, stating that:

> Both the R3RUE's premise (about extra-contractual performance) and its conclusion (about unjust enrichment) disappear once

13. *Id.*
14. *Id.*
15. *See* RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 1 (AM. LAW INST. 2011).

> insurance law is understood to include a special no-recoupment default rule. In that case, an insurer that defends under a reservation of rights, without an explicit agreement regarding the right to recoupment, is not performing beyond its contractual obligation, because that obligation incorporates the default no-recoupment rule implied by insurance law.[16]

However, this reasoning is fundamentally suspect because insurance law is *not* understood to include a special no-recoupment rule. To the contrary, the majority of courts across the country—as the Restatement draft itself acknowledges elsewhere—recognize a pro-recoupment rule.[17] It makes no sense to ignore that fact, or assume a different rule, to justify abandoning black letter law. The goals of articulating the common law and promoting coherence with other precedents—such as the ALI's R3RUE[18]—require a result recognizing the prevailing pro-recoupment rule.

The Reporters' Note states:

> Some might contend that the default adopted in this Section is unjust to insurers, because it results in policyholders receiving coverage that they did not contract for. That argument, however, assumes its own conclusion. The reason we need a default rule is that the contract does not say expressly whether recoupment will be provided to the insurer or not. Therefore, it is wrong to conclude that the policyholder did not purchase the right not to face a recoupment claim. That is in fact the question at issue. That is the gap in the policies for which a default rule must be selected.[19]

Again, this reasoning is flawed. In reality, there already *is* a default rule in the existing common law, which supports recoupment. It, thus, *is* entirely appropriate to conclude that the policyholder did not purchase the right not to face a recoupment claim. The existing law provides the answer to that question and the Restatement need not "supply" a different result.

Finally, the Restatement draft proposes a major change by rejecting the majority rule, and this change is not supported by reliable empirical

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16. RESTATEMENT OF THE LAW OF LIAB. INS. § 21 cmt. b (AM. LAW INST., Discussion Draft 2015).
17. *See id.* § 21 cmt. a.
18. *See id.* § 21 cmt. b.
19. *Id.* § 21 reporters' note a.

analysis pointing to the need for reversal. In fact, policy considerations strongly support the existing majority pro-recoupment approach. For instance, if insurers cannot obtain recoupment under any circumstances, then insurers may become less likely to accept the defense of their insureds in situations where a coverage issue is present.[20] This is because any rational insurer would be forced to weigh the risk of an adverse coverage determination (however unlikely or unreasonable such a determination might be) or a finding of bad faith against the potentially long-term obligation to pay defense costs for an uncovered claim. In addition, courts have recognized that a per se rule banning recoupment would raise prices on all policyholders.[21] They have noted that any defense provided to an insured for which it paid no premium is not "free," and it is not borne in the end by insurers, but rather it is passed on to other policyholders in the form of higher premiums.[22] The effect of denying recoupment for uncovered costs is that a policyholder who does not pay a premium for certain coverage is provided coverage, while the other policyholders are left holding the bag. As one court held:

> Allowing an insurer to seek reimbursement also makes good policy sense from the perspective of other policyholders. The premium payments of other policyholders subsidize the defense of non-covered claims. In theory, the insurer's savings from reimbursement of defense costs where the insurer never had a duty to defend under the insurance policy will translate into lower premiums for all policyholders.[23]

For all of the reasons noted, the Restatement errs in its approach to section 21, "Insurer Recoupment of the Costs of Defense," in the current draft. The Restatement should reflect the current law, which, is supported by a majority of courts, consistent with other precedent such as the ALI's own R3RUE, and supported by important policy considerations. At a minimum, a rigid and absolute no-recoupment rule should be avoided. A rule prohibiting recoupment in all circumstances is both overly broad and unnecessary. Rather than create a sweeping rule against recoupment, at a minimum, the Restatement should give courts the flexibility to apply equitable considerations and reach just results.

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20. *See* United Nat'l Ins. Co. v. SST Fitness Corp., 309 F.3d 914, 921 (6th Cir. 2002); *see also* Krueger Int'l, Inc. v. Fed. Ins. Co., 647 F. Supp. 2d 1024, 1045 (E.D. Wis. 2009).

21. *See, e.g.*, Scottsdale Ins. Co. v. Sullivan Props., Inc., No. 04-00550 HG-BMK, 2007 WL 2247795, at *7 (D. Haw. Aug. 2, 2007).

22. *See id.*

23. *Id.*