Two cases decided only one day apart illustrate the growing divide over whether an insurer is entitled to recover the costs of defending a claim that is ultimately determined not to be covered. In both cases, the policies at issue did not specifically address the reimbursement of defense costs, but the insurers asserted the right in their reservation of rights letters. The Pennsylvania Supreme Court rejected the right to do so, while the U.S. Court of Appeals for the 10th Circuit predicted that an insurer would be entitled to recover defense costs from a policyholder under Colorado law in the face of a no-coverage determination.

In American and Foreign Ins. Co. v. Jerry’s Sport Center, No. J-48-2009 (Pa. Aug. 17, 2010), the policyholders were sued for negligently creating a public nuisance by failing to distribute firearms reasonably and safely. The insurer issued a reservation of rights letter stating that it would provide a defense subject to its right to “seek reimbursement for any and all defense costs ultimately determined not to be covered.” The insurer argued that it had no duty to defend or indemnify the policyholders and sought reimbursement of the defense costs it incurred and/or paid following the date it filed a declaratory judgment action.

Ruling on the insurer’s motion for reimbursement, the trial court determined that the underlying claims were not covered and held that the insurer was entitled to recover its defense costs based on the equitable doctrine of “unjust enrichment.” It reasoned that the insurer had conferred the benefit of a legal defense upon the policyholders and that to allow the policyholders to accept and retain those benefits without payment would unjustly enrich them. On appeal, the Pennsylvania Superior Court reversed, concluding that permitting reimbursement of defense costs pursuant to the insurer’s reservation of rights letter amounted to an impermissible unilateral modification of the insurance policy. On a following appeal to the Pennsylvania Supreme Court, the Court granted allocatur, defining the issue as “whether an insurer is entitled to reimbursement of defense costs when a court has determined that the insurer had no duty to defend the [policyholder] and the insurer has claimed a right to reimbursement only in a series of reservation of rights letters.”

In its August 17, 2010 decision, the Pennsylvania Supreme Court first rejected the insurer’s argument that because the trial court had determined that the claims were not covered, the insurer’s duty to defend was never triggered. As to this point, the Court observed that “whether a complaint raises a claim against an insured that is potentially covered [and thereby triggers an insurer’s duty to defend] is a question to be answered by the insurer in the first instance.” The Court noted that the insurer had answered the question in the affirmative by providing a defense. “The trial court’s subsequent declaratory judgment determination that the claim was not covered relieved [the insurer] of having to defend the case going forward, but did not somehow nullify its initial determination that the claim was potentially covered.” In other words, the Court ruled that an insurer has the initial obligation to determine whether a claim is potentially covered and, consequently, whether it has a duty to defend. Once decided, it is a threshold issue that cannot be retroactively undone by a court.

The Court next rejected the insurer’s argument that its reservation of rights letter created a new contract, holding that an insurer cannot reserve a right it does not already have under the explicit terms of the policy. According to the Court, to hold otherwise would be “tantamount to allowing the insurer to extract a unilateral amendment to
the insurance contract.” The Court further noted that the
insurer had already attempted to amend the scope of its
right to reimbursement several times throughout the course
of the underlying litigation by way of its correspondence
with the policyholders. If such conduct was permissible, the
Court found that “a right of reimbursement outside of the
policy would empower each insurer to design its own right of
reimbursement subject only to the insurer’s designs.”

Finally, the Court rejected the insurer’s unjust enrichment
position, holding that the insurer’s right to control the
defense of its policyholders conferred a benefit upon it,
protecting it against potential indemnity exposure and a
claim for bad faith. “Accordingly, if the insurer could recover
defense costs from its policyholder, then the policyholder
would be paying for the insurer to protect itself.”

It is important to note that the Court did not hold that
reimbursement of defense costs was against public policy
or that an explicit policy provision would not be enforced.
Furthermore, the Court’s decision does not impact an
insurer’s entitlement to reimbursement of defense costs for
those claims the parties agreed were not potentially covered
when the insurer defended against a mix of covered and
uncovered claims.

In stark contrast, the 10th Circuit in Valley Forge Ins. Co. v.
Health Care Mgmt. Partners., Ltd., No. 09-1251 (10th Cir. Aug.
16, 2010), predicted that under Colorado law, an insurer
would be permitted to recoup defense costs from its
policyholder with respect to uncovered claims. In so stating,
the 10th Circuit observed that the Colorado Supreme Court,
without issuing specific rulings, has clearly recognized “an
insurer’s entitlement to reimbursement of defense costs in
the event it is later determined that the insurer did not have a
duty to defend.”

The 10th Circuit found support for its conclusion in Hecla
1991), where the Colorado Supreme Court held that when an
insurer is uncertain as to its duty to defend, it should provide
a defense while reserving its right to seek reimbursement
for claims ultimately determined not to be covered. The
10th Circuit noted that the Colorado Supreme Court further
explained its position in Cotter Corp. v. American Empire
Surplus Lines Ins. Co., 90 P.3d 814 (Colo. 2004), where it stated
that it had attempted in Hecla to properly define the scope
of an insurer’s broad duty to defend under Colorado law by
ensuring that insurance companies are not required “to pay
defense costs if coverage ultimately does not exist under the
policies.” Thus, the Court reasoned, Colorado law ensures
“that [the policyholders] will receive a defense and that
insurers won’t be left holding the bag if it turns out they had
no duty to provide one.”

In reaching its decision, the 10th Circuit apparently weighed
the equitable balance of competing rights and interests
of both insurers and policyholders, although it did not
specifically cite to a particular theory of recovery or public
policy. “Regardless [of] whether the Colorado courts situate
the rule in equity, contract, policy, rule of court, or someplace
else — whatever doctrinal pigeonhole best fits — one
thing is clear: Colorado permits insurers to recoup defense
costs in the circumstances before us.” The 10th Circuit also
refused to decide whether the policyholder could contest the
reasonableness of the attorney fees incurred in its defense
when determining how much the insurer was entitled to
recover, stating that it was not necessary to the disposition
of the case. It further held that the insurer could not recover
prejudgment interest on the defense costs because Colorado
courts had not addressed the issue and the additional
expense might “disincentivize” policyholders from exercising
their rights to a defense and “push them to shoulder their
own defense costs.”

These two decisions are indicative of the continuing split
of authority evolving around the critical reimbursement
of defense costs issue. In fact, the Pennsylvania Supreme
Court noted that, to date, an almost equal number of
courts have either supported or denied an insurer’s right to
reimbursement. It is a closely debated and important right
that will continue to impact the bottom line of insurers and
policyholders alike, and it should continually be monitored on
a state-by-state basis.

Cozen O’Connor is a global leader in representing the insurance
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