

Washington Supreme Court: Insurers May Not Reserve the Right to Seek Reimbursement of Non-covered Defense Costs

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The Washington Supreme Court joined a minority of jurisdictions that hold that insurers may not unilaterally reserve the right to seek reimbursement for defense costs paid in defending non-covered claims through a reservation of rights letter. In *National Surety Corp. v. Immunex Corp.*, the Washington Supreme Court, in a five to four decision, held that insurers defending under a reservation of rights may not seek reimbursement for defense costs from the insured, even if there is a determination that the insured is not entitled to coverage under the policy No. 86535-3 (March 7, 2013). In so holding, the court recognized that, upon a showing of actual and substantial prejudice resulting from an insured's delayed tender, an insurer could minimize or avoid liability for defense costs.

In *Immunex*, National Surety Corporation issued umbrella and excess liability policies to Immunex Corporation from 1998 to 2002. In 2001, the insured reported it was under investigation by state and federal government regarding wholesale pricing of its drug product. That same year, various entities sued the insured, alleging the insured reported inflated prices for its products, allowing for Medicare reimbursement to product providers in higher amounts than the provider actually paid for the product.

On October 3, 2006, the insured tendered its defense to National Surety seeking defense and indemnity coverage for the underlying litigations, which began in 2001. In March 2008, National Surety issued a reservation of rights letter, advising it did not believe there was coverage for the insured's claims, but that its investigation was ongoing. The court concluded this statement indicated the coverage determination was

preliminary. Additionally, National Surety agreed to defend the insured until it received a declaration that there is no coverage under the policy, and it agreed to pay reasonable defense costs beginning on the date of tender. National Surety reserved the right to seek reimbursement of defense costs "if it is determined by a court that there is no coverage or duty to defend and that [National Surety] is entitled to reimbursement."

National Surety filed a declaratory judgment action in state court in March 2008, the same month it issued its reservation of rights letter. The trial judge ruled 13 months later that there was no obligation to defend the insured; National Surety was obligated for the insured's defense costs incurred prior to his April 2009 order, but that the obligation could be minimized if National Surety could establish prejudice due to the late tender. The Court of Appeals affirmed and National Surety appealed to the Washington State Supreme Court.

In reaching its decision, the court reviewed the duty to defend under Washington law, including reaffirming that when coverage is uncertain, an insurer is permitted to defend under a reservation of rights and then seek a declaration that it owes no obligations to the insured. Because a reservation of rights creates the risk of conflict between the insurer and the insured, the insurer owes "an enhanced duty of good faith toward the insured." Also important to the court's decision was that an insurer "benefits" from defending under a reservation of rights and filing a declaratory judgment action because, by doing so, the insurer protects "itself against potentially disastrous findings of breach, bad faith, waiver, and coverage by estoppel." The majority rejected the dissent's argument that the insured was unjustly enriched because it received more

than it bargained for under the insurance contract, concluding, instead, that “[u]njust enrichment is simply irrelevant because any ‘enrichment’ of Immunex was more than matched by benefit to National Surety.”

The court analyzed the majority of jurisdictions allowing insurers to reserve the right to seek reimbursement with the minority of jurisdictions holding that insurers are not entitled to a right of reimbursement of defense costs. The court found the minority approach more persuasive – allowing reimbursement of defense costs for non-covered claims, when there is no right to reimbursement under the policy, allows insurers to unilaterally modify the contract. The court held the minority approach was consistent with Washington law, which imposes a broad duty to defend. The court rejected the argument that an insurer could be protected from bad faith claims by the defending under a reservation of rights and could also seek reimbursement, stating the argument was an “‘all reward, no risk’ proposition [which] renders the *defense* portion of a reservation of rights illusory.” Instead, the court found any defense must be “real.” Important to the court is that, by choosing to defend under a reservation of rights, National Surety could not benefit without paying the costs.

The court also held that an insured can recover pre-tender defense costs and fees. Thus, to avoid defense obligations caused by a late tender, the insurer must show it suffered actual and substantial prejudice as a result. National Surety argued the insured’s delayed tender caused it prejudice as a matter of law. While the court recognized an earlier tender would have allowed National Surety to seek an earlier declaration of non-coverage, it concluded that showing the tender was delayed “fails to establish, as a matter of law, that timely tender would have prevented incurring *any* defense costs.” An important fact was that National Surety offered to pay for some defense

costs in its March 2008 letter, indicating National Surety would have incurred some defense costs. However, because whether National Surety was prejudiced was a factual question, the court remanded the issue to the trial court.

The dissent, written by Justice Wiggins, found the majority’s holding to be overly broad and unnecessary. The dissent believes that the majority approach and the approach of Restatement (Third) of Restitution and Unjust Enrichment should have been adopted. Instead of creating a blanket rule, the dissent would have held that insurers who believe a claim is not covered, but defend under a reservation of rights, “have an equitable right to reimbursement under an unjust enrichment theory if it turns out the claim was not covered” and trial courts should analyze reimbursement issues individually under the doctrine of unjust enrichment. Here, the trial court should have determined whether National Surety’s payment of defense costs would have unjustly enriched the insured. The dissent rejects the argument that the insurer is benefited by defending under a reservation of rights because, in doing so, insurers are merely following Washington law as to their obligations.

The court’s decision in *Immunex* will cause insurers to carefully evaluate each claim received in order to determine whether there is any coverage under the policy. Each insurer should consider the policy language and the claims made against the insured before deciding how best proceed in Washington.

To discuss any questions you may have regarding the issues discussed in this Alert, or how they may apply to your particular circumstances, please contact:

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