Recoupment of Defense Costs: When Can an Insurance Company Get Defense Costs Back From the Insured?

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Under many insurance policies, the insurer has to defend the insured when the complaint alleges a claim that is potentially or arguably covered by the policy. But if an insurance company defends its insured and it becomes clear there is no claim that could trigger indemnification under the policy, is an insurance company entitled to seek from its insured those costs it incurred in the defense? Under what circumstances can the insurer seek to recoup its costs if it issued a proper reservation of rights and/or has recoupment language in its policy if it is later determined that no coverage exists? Courts across the country, and Ohio state courts in particular, are split or silent on the matter. But the issue continues to be of interest to both insurers and insureds alike.

Policyholders often argue that an insurer's right to seek reimbursement for defense costs is contradictory because an insurer's duty to defend is broad, and an insurer's decision to provide a defense (whether or not conditional) suggests that an action involves at least one covered claim. Plus, if in doubt, the insurer could bring a declaratory judgment action to resolve the issue.

Insurers, however, are faced with the practical reality that they sometimes need to defend under a reservation of rights to avoid a later finding of bad faith or breach of contract. Insurers ground their requests for recoupment in basic contract principles — the insurer offered to defend under a reservation, which the insured accepted. This agreement creates a binding contract between the parties that allows the insurer to seek recoupment as long as the right was expressly reserved. In addition, some policies expressly provide insureds with the right to seek recoupment, which of course will strengthen the insurer's ability to
seek recoupment.

"Without a clear directive from the Ohio Supreme Court, uncertainty regarding the right of recoupment will continue to exist. Thus, it is essential for insurers and insureds to understand when insurers may be able to get their money back."

Jurisdictions Outside of Ohio

Courts outside of Ohio that have addressed the issue tend to rely on two different lines of reasoning. One line bases the entitlement to recoupment in contract law. *See, e.g.*, *Colony Ins. Co. v. G & E Tires & Serv., Inc*., 777 So.2d 1034 (Fla. Ct. App. 2000). That is, the insurer offered a conditional defense, the insured accepted, and once it was judicially determined that no duty to defend ever existed, the insured cannot unilaterally alter the material terms of the agreement by refusing to pay back defense costs. In some cases, courts have gone one step farther and made clear that the insured's silence in response to the reservation of rights letter and later acceptance of the defense, constitutes an implied agreement. *Knapp v. Commonwealth Land Title Ins. Co*., 932 F. Supp. 1169 (D. Minn. 1996); *see also First Fed. Savings & Loan Ass'n of Fargo, North Dakota v. Transamerica Title Ins. Co*., 793 F. Supp. 265, 269 (D. Colo. 1992) (citations omitted) (because the insured did not object to the insurer's reservation of rights, the insurer was entitled to reimbursement).

Other courts focus on notice. The Southern District of Illinois, for example, held that an insurer must expressly reserve the right to seek reimbursement and provide the insured with adequate notice in order to recoup costs. *Grinnell Mutual Reinsurance Co. v. Shierk*, 996 F. Supp. 836, 839 (S.D. Ill.1998). Likewise, the Middle District of Louisiana held that the insured was entitled to reimbursement because it "specifically referred to the possibility that [it] might seek reimbursement" and "there [was] nothing in the record to suggest [the insured] objected to the reservation." *Resure, Inc. v. Chemical Distributors, Inc*., 927 F. Supp. 190, 194 (M.D. La.1996).

Courts that reject the recoupment of defense costs tend to find defects in the reservation itself. *See Terra Nova Ins. Co. v. 900 Bar Inc*., 887 F.2d 1213 (3d Cir.1989); *In re Hansel*, 160 B.R. 66 (Bankr. S.D. Tex. 1993). In *In re Hansel*, the Bankruptcy Court for the Southern District of Texas found that the reservation of rights letter did not mention that the insurer expected the insureds to reimburse it for the costs of defense should it be found to have no duty to defend. In addition, other courts have rejected reimbursement where the policies at issue do not expressly convey the right. *See, e.g.*, *Westchester Fire Ins. Co. v. Wallerich*, 527 F.Supp.2d 896, 908 (2007), *aff'd in part, rev'd in part,* 563 F.3d 707 (8th Cir. 2009); *Gen. Agents Ins. Co. of Am. v. Midwest Sporting Goods, Co*., 215 Ill.2d 146, 165, 293 Ill. Dec. 594, 828 N.E.2d 1092 (2005); *Shoshone First Bank v. Pacific Emp. Ins. Co*., 2 P.3d 510, 514 (Wy. 2000).

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Predictions by the Sixth Circuit Court of Appeals

When faced with this issue in *United National Ins. Co. v. SST Fitness Corp.*, the Sixth Circuit Court of Appeals found no controlling Ohio authority on point and instead relied on some of the above decisions. *United Nat. Ins. Co. v. SST Fitness Corp*., 309 F.3d 914, 917 (6th Cir. 2002) (hereinafter *SST Fitness*). By way of background, SST Fitness purchased commercial general liability insurance from United National, who agreed to provide defense costs and indemnify SST Fitness for any liability. SST Fitness was sued for patent and trademark infringement, and United National provided SST Fitness with a reservation of rights, which expressly "reserve[d] 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."

Over the course of the suit, United National paid over $100,000 to SST Fitness's counsel. SST Fitness accepted payment without objecting. United National then argued that it had no duty to defend in the infringement action and moved under 28 U.S.C. § 2002 for costs paid under reservation. In short, the Southern District of Ohio denied the motion, holding that United National was a "volunteer" when it paid SST Fitness's defense costs.

On appeal, United National argued that SST Fitness's acceptance of defense costs and the reservation of rights created an implied-in-fact contract. The Sixth Circuit ultimately agreed, holding that SST Fitness knew United National may seek reimbursement from the reservation of rights letter, and that SST Fitness did not object the reservation but rather accepted the defense costs. The Court also held that "United National cannot be a volunteer because SST Fitness asked United National to pay the defense costs."

Judge Clay dissented, stating "the insurer cannot pursue recoupment of right when the insured did not preserve the right to do so in the underlying insurance contract."

Post *SST Fitness* State Court Decisions

Only one published Ohio state court opinion has cited to *SST Fitness*. In *Chiquita Brands Int'l., Inc.*, Chiquita appealed the trial court's judgment that National Union was entitled to recoup nearly $12 million in defense costs. *Chiquita Brands Int'l., Inc. v. Nat'l. Union Fire Ins. Co. of Pittsburgh PA*, 2015-Ohio-5477, 57 N.E.3d 97, ¶ 1 (1st Dist.) (hereinafter *Chiquita Brands*). Here, National Union did not fund the defense of the underlying case against Chiquita until the trial court declared that National Union owed a duty to defend. Thereafter, National Union sent defense cost payments to Chiquita with cover letters that stated National Union reserved the right to seek reimbursement of the payments.

On appeal, Chiquita argued that the trial court erred in holding that National Union was entitled to recoup defense costs on the ground that an implied-in-fact contract was created through the cover letters. The First District Court of Appeals agreed in dicta but affirmed that trial court's judgment with a narrow holding:

Specifically, where (1) an insurer does not provide a defense until after a court has entered judgment declaring that the insurer has a duty to defend, (2) the insured demands that the insurer provide a defense, (3) the insurer provides the defense under a reservation-of-rights stating that it may seek to be

reimbursed, and later (4) an appellate court determines that a duty-to-defend never existed, then (5) the insurer is entitled to be reimbursed for its defense-cost expenditures under a theory of restitution.

Notably, the citation to *SST Fitness* comes from Judge Stautberg's dissent. Judge Stautberg acknowledged the split in authority teed up by *SST Fitness* and concluded that "[d]espite numerous National Union policies and provisions, there is simply no right to recoupment or reimbursement to be found therein." Judge Stautberg's dissent would appear to require the policy itself to expressly provide a right of recoupment.

Conclusion

The narrow decision in *Chiquita Brands* and the predictions in *SST Fitness* may hint at how the Ohio Supreme Court would come down on the issue of recoupment of defense costs but are far from providing a clear directive.

But until the Ohio Supreme Court weighs in, the effectiveness of a reservation will likely be evaluated using factors from other jurisdictions, including whether the reservation of rights letter includes an agreement to reimbursement as a pre-condition to the defense, the reservation expressly notifies the insured of the possibility of reimbursement, specific objections by the insured, the presence of a court order directing payment of defense costs, and, of course, and any applicable policy language.

Thus, insurers will take care to expressly reserve the right to recoup defense costs in their reservations letters. Insureds may want to consider objecting to that reservation so as to assuage contract formation and consent issues later. Insurers could also consider a policy revision that would expressly provide for the right of recoupment to remove some of the uncertainty.

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