"Phantom" Reimbursement Rights? The Battle Over Recoupment of Defense Costs

By Lawrence Bracken, Rachel Hudgins and Andrew Koelz
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The legal obligations of an insurer and the insured are governed by the contract between them, which is the insurance policy, and certain state laws. An important aspect of the insurance relationship arising under a liability insurance policy is the insurer's duty to defend the insured, or to reimburse the insured for defense costs, where the insured timely notifies the insurer of a potentially covered claim. Among other things, where a liability policy includes a right and duty to defend, the insurer must hire and pay for legal counsel to defend an insured in the underlying lawsuit.

RECOUPMENT OF DEFENSE COSTS

When an insurer provides a defense but it is later determined that there was no duty to defend, the insurer may attempt to recoup defense costs from the insured. Some insurance policies expressly require the insured to reimburse the insurer; most do not. Even where the insurance policy does not include an express provision requiring the insured to reimburse defense costs, an insurer may pursue recoupment. Jurisdictions differ on whether an insurer can recoup defense costs in that situation.

If an insurer has defended the insured under a reservation of rights, courts in some states allow the insurer to recover the costs of defense based on equitable remedies such as implied contract or unjust enrichment. These courts reason that the insured was never entitled to payments for defense costs under the insurance policy if there was no duty to defend from the outset, and the insured must reimburse an insurer for those payments.[1] Other courts have applied a restitution theory to find that reimbursement is necessary to ensure adherence to the terms of the insurance policy, again reasoning that the policyholder "was never entitled" to a defense under the contract terms.[2]

Courts in other states, however, restrict an insurer's right to recoupment only to situations in which the insurance policy expressly provides for such reimbursement. These courts generally hold that a court would be amending or altering the insurance policy if it were to grant the insurer a right that does not exist under the terms of the insurance contract. The decisions frequently rely on state law that imposes a broad duty to defend on liability insurers, one that is broader than the duty to indemnify.

ELEVENTH CIRCUIT: NO RECOUPMENT ABSENT AN EXPRESS POLICY PROVISION

In a recent decision applying Georgia law, the U.S. Court of Appeals for the Eleventh Circuit held that insurers should be limited to contractual rights under the language of the insurance policies, not under a new contract supposedly created in the insurers' reservation of rights letters. The court in *Continental*

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Casualty Co. v. Winder Laboratories, LLC ("*Winder Labs*") predicted how the Georgia courts would rule on reimbursement of defense costs absent an express reimbursement provision in the policy.[3] Persuaded by the logic of other jurisdictions that "wide-ranging reimbursement is necessarily inappropriate in a system—like Georgia's—that is predicated on a broad duty to defend and a more limited duty to indemnify," the Eleventh Circuit predicted that "the Supreme Court of Georgia would follow that logic to adopt a 'no recoupment' rule to protect its insurance system."[4]

In so deciding, the court affirmed a Georgia federal district court decision holding that the insurers did not have a duty to defend Winder Laboratories or its manager in an underlying lawsuit alleging that Winder Laboratories falsely or misleadingly advertised a generic pharmaceutical. The operative claim fell within a "failure to conform" exclusion within the policies, so neither insurer had an ongoing duty to defend as a result of the district court's ruling.[5]

More significantly, the Eleventh Circuit decided, as a matter of first impression under Georgia law, whether a reservation of rights letter that asserts a right to reimbursement entitles an insurer to recoup defense costs even though the policy does not contain such a condition. The court held that it does not.[6]

The insurance policies at issue in *Winder Labs* had no language conferring a right to reimbursement of defense costs and did not specify who would choose defense counsel. After the insurers received notice of the underlying lawsuit, they sent a series of reservation of rights letters that purported to reserve the right to seek reimbursement of defense costs for all claims that were not covered under the policies. The letters also gave the insureds a choice to retain their own defense counsel or to have the insurers choose defense counsel. The insureds responded that they would retain their own defense counsel. After the district court found that the insurers had no duty to defend, the insurers stopped paying defense costs and sought to recoup costs that they had previously paid.

The Eleventh Circuit affirmed the district court's ruling that the insurers did not have a right to reimbursement of defense costs incurred before the district court's duty-to-defend ruling, where the purported reimbursement right was asserted in the reservation of rights letters but was not a contractual requirement of the insurance contract. As an initial matter, because insurers have an "extremely" broad duty to defend under Georgia law, based on the allegations in the complaint, the insurers had a defense obligation until the district court ruled otherwise.[7] The court then rejected two arguments advanced by the insurers in support of their phantom right to reimbursement: (1) the reservation of rights letters created a new contract because the insureds were provided a defense and were allowed to choose their defense counsel, and (2) the insureds were unjustly enriched because they received a defense through the insurers despite the district court ultimately finding no duty to defend.[8]

The Eleventh Circuit held that the insurers' new contract argument failed for lack of consideration.[9] The insurance policies already required the insurers to defend the insureds in the underlying lawsuit (at least at first).[10] Thus, there was no new consideration received for the agreement to pay for the defense stated in the reservation of rights letters.[11] The reservation of rights letters merely reiterated a promise to perform a preexisting contractual obligation under the policies.[12] Similarly, because the insurance policies did not specify who would choose defense counsel, the insurers did not give up any explicit right by allowing the insureds to choose their defense counsel.[13] The key takeaway is that reservation of rights letters do not create new rights or duties or alter the insurance policy—their purpose is to inform the policyholder about the insurer's coverage position and issues that may exist based on the policy. The policy itself dictates the rights and duties under the policy.

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As for the insurers' unjust enrichment argument, the Eleventh Circuit questioned whether it failed at the outset because under Georgia law unjust enrichment is an equitable claim precluded by the existence of a written contract.[14] Even on the merits, though, the Eleventh Circuit concluded that there was nothing unjust about requiring the insurers to fulfill their contractual obligation to provide a defense until the district court ruled that there was no duty to defend[15]

Ultimately, on this matter of first impression, the Eleventh Circuit predicted that "the Supreme Court of Georgia would not allow an insurer to recoup its expenses based on a reservation of rights without any contractual provision allowing for reimbursement."[16] The Eleventh Circuit also noted its belief that "this position comports with the national trend that disfavors recoupment in similar circumstances," citing the following language from the *Restatement of the Law of Liability Insurance*:

> Over the past few decades, the pro-recoupment cases have been viewed as stating the majority position, while anti-recoupment cases have been labeled the minority. But in recent years, several state courts, including several state high courts, have faced recoupment of defense costs as an issue of first impression and have rejected a right of recoupment for the insurer, unless that right is established expressly by contract.[17]

KEY TAKEAWAYS FROM *WINDER LABS*

The recent Eleventh Circuit decision in *Winder Labs* held that, to be actionable, a right to reimbursement must be set forth in the insurance policy or otherwise expressly agreed to by the insurer and the insured. Insurers, however, likely will continue their push to have courts recognize an equitable right to reimbursement, whether or not that right is in the insurance policy. Policyholders therefore should determine—at the time of placing the policy as well as after a liability claim arises—whether their policy expressly provides for reimbursement of defense costs in the event it is later decided that the claim is not covered. After notifying the insurer of a claim, the insured should carefully review all correspondence from the insurer—especially reservation of rights letters—because through the correspondence the insurer may attempt to establish an ancillary agreement to reimburse the insurer for defense costs. The insured also should analyze the applicable jurisdiction's law to evaluate whether the insurer has an extracontractual basis to argue that defense costs may be reimbursable.

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Notes

1. *See, e.g.*, Nautilus Ins. Co. v. Access Med., LLC, 137 Nev. 96, 102, 482 P.3d 683, 689 (2021) (concluding "that when a court determines that the insurer never had a duty to defend, and the insurer clearly and expressly reserved its right to seek reimbursement, it is equitable to require the policyholder to pay").
2. Chiquita Brands Int'l, Inc. v. Nat'l Union Fire Ins. Co., 57 N.E.3d 97, 101 (Ohio Ct. App. Dec. 30, 2015).
3. 73 F.4th 934 (11th Cir. 2023).
4. *Id.* at 950.
5. *Id.* at 942.
6. *Id.* at 945–47.
7. *Id.* at 944, 948.
8. *Id.* at 945–47.
9. *Id.*
10. *Id.* at 947.
11. *Id.*
12. *Id.* at 946.
13. *Id.* at 947.
14. *Id.*
15. *Id.*
16. *Id.* at 950–51.
17. *Id.* at 948–49 (citing Restatement of the L. of Liab. Ins. § 21, cmt. a (Am. L. Inst. 2019)).

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